



An Innovative Technology Company Providing  
Custom Energy and Emission Reduction Solutions

# Consolidated Financial Statements and Management's Discussion and Analysis

Fiscal Year 2008 ended May 31, 2008



# Raymond Chabot Grant Thornton

## Auditors' Report

**Raymond Chabot Grant Thornton LLP**

2505 St-Laurent Blvd.  
Ottawa, Ontario K1H 1E4

Telephone: 613-236-2211

Fax: 613-236-6104

[www.rcgt.com](http://www.rcgt.com)

To the shareholders of  
Thermal Energy International Inc.

We have audited the consolidated balance sheets of Thermal Energy International Inc. as at May 31, 2008 and 2007 and the consolidated statements of operations, comprehensive loss and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at May 31, 2008 and 2007 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*Raymond Chabot Grant Thornton LLP*

Chartered Accountants,  
Licensed Public Accountants

Ottawa, Canada  
September 23, 2008

**THERMAL ENERGY INTERNATIONAL INC.**  
 Incorporated under the Ontario Business Corporations Act

**CONSOLIDATED BALANCE SHEETS**

As at May 31

	2008	2007
	\$	\$
<b>ASSETS</b>		
<b>Current assets</b>		
Cash	84,717	549,196
Short-term investments (note 5)	552,773	1,020,880
Accounts receivable (note 6)	627,571	428,581
Contracts in progress	156,000	4,000
Net investment in lease	227,034	-
Prepays and other assets	31,934	60,894
	<b>1,680,029</b>	<b>2,063,551</b>
Property, plant and equipment (note 7)	65,066	67,612
Net investment in lease (note 8)	1,948,906	-
	<b>3,694,001</b>	<b>2,131,163</b>
<b>LIABILITIES, CAPITAL STOCK, CONTRIBUTED SURPLUS AND DEFICIT</b>		
<b>Current liabilities</b>		
Bank loan (note 9)	908,667	-
Accounts payable	2,001,801	328,182
Accrued liabilities	459,777	158,082
Deferred revenue	384,908	1,000,000
Due to past President (note 10)	17,937	17,937
	<b>3,773,090</b>	<b>1,504,201</b>
<b>Capital stock, contributed surplus and deficit</b>		
Capital stock (note 11)	19,479,079	17,459,549
Contributed surplus (note 11)	1,528,414	1,881,487
Deficit	-21,086,582	-18,714,074
	<b>-79,089</b>	<b>626,962</b>
	<b>3,694,001</b>	<b>2,131,163</b>

Contingency (note 19)

The accompanying notes are an integral part of these consolidated financial statements

On behalf of the Board



Tim Angus  
 President and C.E.O.



Oliver Toffoli  
 COO & Chief Financial Officer

**THERMAL ENERGY INTERNATIONAL INC.**

**CONSOLIDATED OPERATIONS, COMPREHENSIVE LOSS AND DEFICIT**

Year ended May 31

	2008	2007
	\$	\$
<b>REVENUE</b>		
Sales	4,926,208	821,024
Cost of sales	4,318,184	874,515
<b>Gross profit (loss)</b>	<b>608,024</b>	<b>-53,491</b>
<b>Expenses</b>		
Administration	1,228,984	880,331
Selling, marketing and business development	1,314,208	1,266,359
Legal fees	331,836	18,850
Audit fees	72,839	77,500
Insurance	127,993	78,498
Amortization of property, plant and equipment	31,314	24,828
Patent and trademark maintenance	13,587	23,715
Research and development	87,572	99,875
Interest and bank charges	20,417	16,832
Foreign exchange loss (gain)	40,081	67,787
	<b>3,268,831</b>	<b>2,554,575</b>
Loss before the following:	<b>-2,660,807</b>	<b>-2,608,066</b>
Interest revenue	32,098	562
Finance revenue	56,201	
Other revenue	-	5,240
Other costs	-	-36,001
Loss before income taxes	<b>-2,572,508</b>	<b>-2,638,265</b>
Future income tax recovery (note 14)	200,000	195,000
<b>Net loss and other comprehensive loss</b>	<b>-2,372,508</b>	<b>-2,443,265</b>
Deficit, beginning of year	<b>-18,714,074</b>	<b>-16,270,809</b>
<b>Deficit, end of year</b>	<b>-21,086,582</b>	<b>-18,714,074</b>
Net loss per share - basic and diluted	<b>(0.025)</b>	<b>(0.031)</b>
Weighted average number of common shares	<b>94,665,536</b>	<b>78,443,983</b>

The accompanying notes are an integral part of these consolidated financial statements and Note 15 provides other information on earnings.

**THERMAL ENERGY INTERNATIONAL INC**

**CONSOLIDATED STATEMENT OF CASH FLOWS**

Year ended May 31

	2008	2007
	\$	\$
<b>OPERATING ACTIVITIES</b>		
Net loss for the year	-2,372,508	-2,443,265
Add items not involving cash:		
Stock-based compensation charge	495,786	377,755
Amortization of property, plant and equipment	31,314	24,828
Future income taxes	-200,000	-195,000
Write-off of past President loan to acquire shares	-	151,500
Non-monetary compensation charge	152,171	13,031
Changes in non-cash operating working capital		
Accounts receivable	-198,990	197,914
Contracts in progress	-152,000	85,000
Prepays and other assets	28,960	-19,117
Accounts payable	1,673,619	-437,487
Accrued liabilities	301,695	-8,646
Deferred revenue	-615,092	901,000
Net cash used in operating activities	-855,045	-1,352,487
<b>INVESTING ACTIVITIES</b>		
Disposal (acquisition) of short-term investments	468,107	-1,020,880
Additions to property, plant and equipment	-28,768	-32,902
Decrease in loan receivable	-	55,500
Net cash used in investing activities	439,339	-998,282
<b>FINANCING ACTIVITIES</b>		
Increase in bank loan	908,667	-
Net investment in lease (note 8)	-2,209,842	-
Lease payments received	33,902	-
Common shares issued (note 11)	1,218,500	2,840,846
Net cash provided by financing activities	-48,773	2,840,846
Increase (decrease) in cash for the year	-464,479	490,077
Cash, beginning of year	549,196	59,119
Cash, end of year	84,717	549,196
Interest paid	5,444	3,242
Tax impact of renounced expenditures	200,000	195,000
Shareholder loans to acquire shares	529,977	7,500

The accompanying notes are an integral part of these consolidated financial statements.

# **THERMAL ENERGY INTERNATIONAL INC.**

## **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

### **1 GOVERNING STATUTES AND NATURE OF OPERATIONS**

The Company was incorporated under the Ontario Business Corporations Act on May 22, 1991 and is primarily engaged in the development, engineering and supply of pollution control and heat recovery systems.

### **2 GOING CONCERN**

The Company incurred losses from operations in the current and prior year and as at May 31, 2008 no financial covenant was met.

The Company's ability to meet its obligations as they fall due is dependent upon any combination of the following: the continued financial support of its shareholders, its ability to arrange long-term financing, its ability to generate sufficient cash from operations and its ability to operate with a gross margin.

The financial statements have been prepared on the going concern basis, which assumes the realization of assets and the satisfaction of liabilities in the normal course of business. These financial statements do not include any adjustments to the carrying value or classification of assets and liabilities, nor to the results of operations, should the Company not continue to operate as a going concern.

### **3 BASIS OF PRESENTATION AND ACCOUNTING CHANGES**

The accompanying consolidated financial statements of Thermal Energy International Inc. have been prepared by management in accordance with Canadian generally accepted accounting principles applicable to consolidated financial statements.

On June 1, 2007, in accordance with the applicable transitional provisions, the Company applied the recommendations of new Section 1506, "Accounting Changes", of the Canadian Institute of Chartered Accountants' (CICA) Handbook. This new section, effective for the years beginning on or after January 1, 2007, prescribes the criteria for changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and corrections of errors. Furthermore, the new standard requires the communication of the new primary sources of GAAP that are issued but not yet effective or not yet adopted by the Company. The new standard had no impact on the Company's financial results.

Effective June 1, 2007, the Company adopted the new recommendations under CICA Handbook Section 1530, Comprehensive Income, Section 3251, Equity, Section 3855, Financial Instruments; Recognition and Measurement, Section 3861, Financial Instruments; Disclosure and Presentation and Section 3865, Hedges. These new Handbook sections provide requirements for the recognition, measurement and presentation and disclosure of financial instruments.

Under Section 3855, all financial instruments are to be classified into one of five categories and measured at fair value except for loans and receivables, held-to-maturity investments and other financial liabilities which are to be measured at amortized cost. Held-for-trading financial assets are to be measured at fair value and changes in fair value are to be recognized in net income. Available-for-sale financial instruments are to be measured at fair value with changes in fair value recorded in other comprehensive income until the instrument is derecognized or impaired. Section 1530 establishes standards for the reporting of comprehensive income, defined as the change in equity from transactions and other events from non-owner sources.

Adoption of these new recommendations resulted in the following impacts on the classification and measurement of the Company's financial instruments, which were previously recognized at cost:

- Cash is classified as a held-for-trading financial asset. This change had no impact on the consolidated financial statements as at May 31, 2008.
- Short-term investments are classified as available-for-sale. Since the fair value and the cost base of the Company's short-term investments was the same on June 1, 2007 and May 31, 2008, there was no adjustment to the opening or closing fair value of short-term investments.
- Trade accounts receivable and other accounts receivable are classified as loans and receivables. Trade accounts receivable are measured at amortized cost, which is generally the initially recognized amount, less any allowance for doubtful accounts. Other receivables are recognized at amortized cost using the effective interest method, less any impairment. This change had no impact on the consolidated financial statements as at May 31, 2008.
- The bank loan, accounts payable, accrued liabilities and amounts due to past President are classified as other financial liabilities. They are valued at amortized cost using the effective interest method. This change had no impact on the consolidated financial statements as at May 31, 2008.

## THERMAL ENERGY INTERNATIONAL INC.

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

- Long-term debt is classified as other financial liabilities. It is measured at amortized cost using the effective interest method. This change had no impact on the consolidated financial statements as at May 31, 2008.

#### 4 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The significant accounting policies are as follows:

##### **Basis of consolidation**

The consolidated financial statements of the Company include the accounts of its wholly owned subsidiaries, ForEverGreen Energy Inc., 2003356 Ontario Inc., 2153639 Ontario Inc. and Thermal Energy International Corporation incorporated under the laws of the State of Delaware in the United States of America.

##### **Use of estimates**

Since a precise determination of many assets and liabilities is dependent upon future events, the preparation of financial statements for a period in conformity with Canadian generally accepted accounting principles necessarily involves the use of estimates and approximations which have been made by management using careful judgment. Such estimates include determination of the percentage of completion for contracts and assumptions used in the Black-Scholes fair value calculations. Actual results could differ from these estimates.

##### **Revenue recognition**

Contract income is recorded under the percentage-of-completion method. Under this method, contract income and profit are recognized proportionately with the degree of completion of work. Degree of completion is determined using the cost-to-cost method, which consists in comparing the costs incurred at the date of the financial statements with the last estimate of the total cost of work to be performed. Contracts in progress are valued considering labour, material and some overhead costs, which include estimated profits. Losses are recognized when total cost estimates indicate a loss. Amounts billed or payments received but not yet earned are deferred until the revenue is earned.

##### **Cash and cash equivalents**

All highly liquid investments with original maturities of three months or less are classified as cash equivalents.

##### **Amortization**

Property, plant and equipment are recorded at cost. Amortization is computed using the following annual rates and methods:

Thermal-AUD™ plant and equipment	Straight-line based on terms of contract
Furniture and fixtures	20% declining-balance
Laboratory equipment	20% declining balance
Computers	3 years straight-line
Software	50% declining-balance
Leasehold improvements	3 years straight-line

##### **Loss per share**

The basic loss per share is calculated on the basis of net loss divided by the weighted average number of common shares outstanding during the year. The diluted per share amount is calculated giving effect to the potential dilution that would occur if securities or other contracts to issue common shares were exercised or converted to common shares. The treasury stock method is used to determine the dilutive effect of stock options. The treasury stock method assumes that proceeds received from the exercise of the in-the-money stock options are used to repurchase common shares at the prevailing market rate. The diluted loss per share is equal to the basic loss per share because the effect of dilutive stock options described in Note 12 is antidilutive.

##### **Income taxes**

The liability method is used to account for income taxes. Future tax assets and liabilities are recognized for tax consequences of temporary differences between the financial statement carrying amounts and the tax bases of assets and liabilities. Future tax assets and liabilities are measured using substantively enacted tax rates in effect for the year in which the differences are expected to be recovered or settled. A valuation allowance is established to reduce the future tax asset if it is not "more likely than not" that the related tax benefits will be realized in the future.

## THERMAL ENERGY INTERNATIONAL INC.

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

#### Research and development costs and government assistance

The Company carries on various research and development programs, and from time to time these are funded by the Government of Canada. Funding received is accounted for using the cost reduction approach and is netted against research or development costs. Research costs are expensed as incurred. Development costs are charged to expense as incurred unless they meet generally accepted accounting criteria for deferral and amortization. No costs have been deferred to date.

#### Foreign currency translation

All monetary assets and liabilities denominated in foreign currency are translated into Canadian dollars at the exchange rate in effect at the balance sheet date, whereas other assets and liabilities are translated at exchange rates in effect at transaction dates. Revenues and expenses in foreign currency are translated at the average exchange rate in effect during the period. Gains and losses are included in the earnings for the year.

#### Investment tax credits

Investment tax credits are accounted for under the cost reduction method whereby they are netted against the cost of the property, plant and equipment to which they relate. Investment tax credits are recorded when the Company has incurred qualifying expenditures and there is reasonable assurance the tax credit will be realized.

#### Sales-type lease

Finance income related to the sales-type lease is recognized in a manner that produces a constant rate of return on the investment in the lease. The investment in the lease for purposes of income recognition is composed of net minimum lease payments and unearned finance income.

#### Stock-based compensation

The Company accounts for its grants under stock-based compensation plans using the fair value method and compensation expense is recognized in the period in which the options vest. When holders exercise their options, any consideration received and any contributed surplus related to these options is credited to capital stock.

Share purchase loans are accounted for in accordance with EIC Abstract 132 "Share Purchase Financing". These loans, which were extended to shareholders to purchase Class A common shares are considered to be stock options and are treated as stock-based compensation and recorded at their fair market value.

#### Share issue expenses

Share issue expenses are recorded as a reduction of share capital when the related shares are issued.

## 5 SHORT-TERM INVESTMENTS

Short-term investments consist of excess cash invested in money market funds.

## 6 ACCOUNTS RECEIVABLE

	2008	2007
	\$	\$
Trade	438,592	377,124
Commodity taxes	145,928	22,764
Directors and Officers	34,500	-
Other	8,551	28,693
	627,571	428,581

At May 31, 2008, 68% (2007 – 94%) of trade receivables were from one customer.

**THERMAL ENERGY INTERNATIONAL INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**7 PROPERTY, PLANT AND EQUIPMENT**

	2008		2007	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
	\$	\$	\$	\$
Furniture and fixtures	81,671	66,330	81,671	62,597
Laboratory equipment	52,857	21,073	46,675	14,183
Computers	157,861	144,787	140,166	133,675
Software	16,971	14,525	12,081	12,081
Leasehold improvements	21,401	18,980	21,401	11,846
	<b>330,761</b>	<b>265,695</b>	301,994	234,382
Accumulated amortization	<b>(265,695)</b>		<b>(234,382)</b>	
<b>Net book value</b>	<b>65,066</b>		67,612	

**8 NET INVESTMENT IN LEASE**

The Company's net investment in lease includes the following:

	2008
	\$
Total minimum lease payments receivable	3,605,747
Unearned income	1,429,807
	<b>2,175,940</b>
Less: current portion	<b>(227,034)</b>
	<b>1,948,906</b>

Future minimum lease payments receivable under the sales-type lease are as follows:

	\$
2009	615,972
2010	615,972
2011	615,972
2012	615,972
2013	615,972
2014	525,887
	<b>3,605,747</b>

**9 BANK LOAN**

During the year, the Company obtained bank financing with an authorized amount of \$2,500,000. At May 31, 2008 this loan, secured by accounts receivable and a general security agreement with interest rate at prime plus 0.25% amounted to \$908,667 (2007 - \$Nil). Prime rate at May 31, 2008 is 4.75%.

In accordance with the loan agreement, the Company is subject to certain loan covenants and must meet certain financial ratios. At May 31, 2008 no financial covenant was met.

**THERMAL ENERGY INTERNATIONAL INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**10 RELATED PARTY TRANSACTIONS**

Related party transactions, in the normal course of operations, are measured at exchange value which represents the amounts established and agreed upon by both parties.

	<b>2008</b>	2007
<hr/>		
Balances owing to/from directors		
Accounts receivable	<b>\$34,450</b>	-
Loans receivable	<b>\$289,647</b>	-
Accrued liabilities	<b>\$75,534</b>	\$18,750
<hr/>		
Directors share options and warrants outstanding at May 31		
Issued	<b>3,500,000</b>	4,000,000
Exercisable	<b>2,461,000</b>	3,233,000
Warrants outstanding	<b>37,500</b>	-
<hr/>		
Balances owing to/from officers		
Accounts receivable	<b>\$8,000</b>	\$192,000
Loans receivable	<b>\$319,800</b>	-
Accrued liabilities	-	\$7,500
<hr/>		
Officers share options and warrants outstanding at May 31		
Issued	-	1,993,000
Exercisable	-	1,434,000
<hr/>		
Transactions with directors and officers were as follows:		
Directors fees for services	<b>\$116,750</b>	\$36,750
Officers fees for services	<b>\$188,000</b>	\$192,000
<hr/>		
Shares issued to Directors	<b>2,366,667</b>	293,125
Shares issued to officers	<b>1,843,000</b>	268,081
<hr/>		

Amounts due to the past President have no fixed repayment terms and are non-interest bearing.

**THERMAL ENERGY INTERNATIONAL INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**11 CAPITAL STOCK AND CONTRIBUTED SURPLUS**

	2008		2007	
	# Shares	\$	# Shares	\$
<b>Authorized</b>				
Unlimited number of Class A common shares, no par value				
Unlimited number of Series 1 preferred shares, voting only in the case of dissolution of the Company, redeemable at the option of the Company, per share and convertible to common shares on a 1 to 1 basis at the rate of 20% of the number originally issued per year.				
<b>Class A Common shares issued</b>				
Balance, beginning of year	90,918,419	17,573,323	74,570,256	14,733,084
Issued in settlement of liabilities	350,685	104,848	1,160,584	181,393
Issued for cash, net of flow through share tax benefit (i)	4,190,000	1,867,359	15,137,579	2,645,846
Issued as a result of the exercise of options for loans (ii)	3,593,000	577,300	50,000	13,000
	<b>99,052,104</b>	<b>20,122,830</b>	90,918,419	17,573,323
Less: loans outstanding to assist shareholders in purchasing capital stock (iii)		<b>(643,751)</b>		<b>(113,774)</b>
Balance, end of year	<b>99,052,104</b>	<b>19,479,079</b>	90,918,419	17,459,549

(i) In fiscal 2008, the Company renounced expenditures of \$615,000 (2007 - \$540,000) from 4,190,000 (2007 - 3,484,334) flow-through common shares issued during the respective fiscal years. The resulting future income tax recovery of \$200,000 (2007 - \$195,000) was charged against capital stock as share expenses.

(ii)	2008	2007
	\$	\$
Loans to exercise options:		
Directors and officers	<b>577,300</b>	13,000

Loans were extended to directors and officers to acquire shares of the Company through the exercise of options. These loans are for a two year period with an interest rate of 5%. The borrower's liability in respect of these loans shall at all times be limited to the value of the underlying shares for which the loan was granted. They can be repaid in part or in full at any time within the two year period at which time the shares with an equivalent value to the repayment will be released to the borrower by the Company.

(iii) Repayments made on these loans during the year were \$47,323 (2007 - \$170,031)

	2008	2007
	\$	\$
President	<b>124,647</b>	46,970
Directors and Officers	<b>361,800</b>	7,500
Other shareholders	<b>157,304</b>	59,304
	<b>643,751</b>	113,774

**THERMAL ENERGY INTERNATIONAL INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

Stock-based compensation on these loans was estimated using the Black-Scholes option pricing model with the following assumptions:

	Loans to exercise options	Loans to acquire shares	
	2008	2008	2007
Weighted average assumptions:			
Expected dividend	0%	0%	0%
Expected volatility	80%	98%	74%
Risk-free interest rate	4.50%	4.50%	3.85%
Expected option life in years	2.0	1.0	1.0

The Company has a five year licensing and purchasing agreement with Mabarex for their Dry-Rex™ system ending September 8, 2011. Under the terms of this agreement, the Company is required to issue 125,000 common shares at \$0.16 each to Mabarex for each of the first two contracts to use the Dry-Rex™ system.

In addition, the Company is committed to issue 539,000 options to directors to purchase common shares at \$0.16 per share based on Company performance and which will expire on December 20, 2009.

(a) In fiscal 2008 and 2007 the Company completed private placements. In both years funds were raised by issuing Units that included one Class A common share and one non-transferable share purchase warrant. In 2008, funds were also raised by issuing flow-through shares. Activity in share purchase warrants was as follows:

	2008		2007	
	# Warrants	Weighted Average Exercise Price	# Warrants	Weighted Average Exercise Price
		\$		\$
Balance, beginning of period	14,480,390	0.35	10,154,896	0.30
Issued	1,517,500	0.50	7,312,162	0.37
Exercised	(392,828)	0.32	-	-
Expired	(6,816,561)	0.32	(2,986,668)	0.25
Balance, end of period	8,788,501	0.40	14,480,390	0.35

(b) The following table summarizes the status of warrants outstanding at May 31, 2008:

Warrants Outstanding	Exercise Price \$	Expiry Date
760,000	0.30	To October 10, 2008
260,000	0.30	To November 2, 2008
229,084	0.30	To November 30, 2008
324,000	0.30	To December 6, 2008
281,250	0.30	To December 29, 2008
4,166,667	0.40	To May 23, 2009
1,250,000	0.40	To May 29, 2009
1,517,500	0.50	To December 7, 2009
<u>8,788,501</u>		

**Contributed surplus**

	2008	2007
	\$	\$
Balance, beginning of year	1,881,487	1,509,232
Stock-based compensation	495,786	377,755
	<u>2,377,273</u>	1,886,987
Fair-value of options exercised and transferred to capital stock	848,859	5,500
Balance, end of year	1,528,414	1,881,487

**THERMAL ENERGY INTERNATIONAL INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**12 COMMITMENTS**

The Company is committed under the terms of operating leases for premises and office equipment contracts with various expiry dates in the following amounts:

	\$
2009	109,800
2010	84,800
2011	4,800
2012	4,800
2013	400
<b>Total</b>	<b>204,600</b>

**13 SHARE OPTION PLAN**

The Company established the Company's Share Option Plan applicable to Directors, Officers and full-time and part-time employees of the Company. In the plan, the aggregate number of options may not exceed 20% of the outstanding shares and the total number of shares to be optioned to any optionee may not exceed 5% of the number of issued and outstanding shares as at the option granting date. The options are granted with an exercise price equal to the market value of the common shares of the Company at the date of grant, less any permissible discounts, and may be exercised at any time after the vesting date, not to exceed five years from the date of granting. Vesting period for options granted is at the discretion of the Board of Directors. Options granted in fiscal 2008 and 2007 had vesting periods ranging from four to twelve months.

(a) Activity in stock options was as follows:

	2008		2007	
	# Options	Weighted Average Exercise Price \$	# Options	Weighted Average Exercise Price \$
Outstanding, beginning of year	8,368,000	0.17	4,718,714	0.17
Granted	1,850,000	0.30	4,475,000	0.17
Exercised	(4,210,857)	0.17	(50,000)	0.15
Forfeited	(150,000)	0.21	(250,000)	0.19
Expired	-	-	(525,714)	0.16
<b>Outstanding, end of year</b>	<b>5,857,143</b>	<b>0.21</b>	<b>8,368,000</b>	<b>0.17</b>
Number of options exercisable as at May 31	4,779,143		6,126,000	

Options exercised during the year were as follows:

	2008		2007	
	# shares	\$	# shares	\$
Employees	1,885,857	320,300	50,000	7,500
Directors	1,750,000	265,000	-	-
Consultants	575,000	117,000	-	-
	<b>4,210,857</b>	<b>702,300</b>	<b>50,000</b>	<b>7,500</b>

In fiscal 2008, 3,593,000 options were exercised in consideration of loans receivable of \$577,300 (2007 – 50,000 for \$7,500), 475,000 options were exercised for cash of \$95,000 and 142,857 options were exercised as a settlement of debt in the amount of \$30,000.

**THERMAL ENERGY INTERNATIONAL INC.**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

(b) The following options are outstanding and/or exercisable at May 31, 2008:

<b>Number of Options Outstanding</b>	<b>Number of Options Exercisable</b>	<b>Exercise Price Per Share \$</b>	<b>Expiry Date</b>
150,000	150,000	0.24	June 10, 2008
150,000	150,000	0.24	August 15, 2008
250,000	250,000	0.26	September 9, 2008
57,143	57,143	0.21	September 7, 2009
3,000,000	2,422,000	0.16	December 20, 2009
500,000	500,000	0.20	March 15, 2010
350,000	350,000	0.37	June 11, 2010
300,000	300,000	0.35	June 15, 2010
100,000	100,000	0.43	July 20, 2010
500,000	500,000	0.20	January 25, 2011
250,000		0.285	April 29, 2011
250,000		0.27	May 16, 2011
<b>5,857,143</b>	<b>4,779,143</b>		

c) Stock-based compensation

The fair value of options granted was estimated using the Black-Scholes option pricing model with the following weighted average assumptions:

	<b>2008</b>	<b>2007</b>
Expected dividend	<b>0.00%</b>	0.00%
Expected volatility	<b>88%</b>	90%
Risk-free interest rate	<b>4.50%</b>	3.85%
Expected option life in years	<b>2.4</b>	2.4

Stock-based compensation expense in fiscal 2008 includes an amount of \$114,235 for options granted to consultants (2007 - \$20,505). Employee stock-based compensation expense is \$381,551 (2007 - \$357,250).

## THERMAL ENERGY INTERNATIONAL INC.

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

#### 14 INCOME TAXES

The Company's effective tax rate differs from the combined federal and provincial income tax rate in Canada. This difference comes from the following items:

	2008	2007
	\$	\$
Loss before income taxes	<b>(2,572,508)</b>	(2,638,265)
Income taxes calculated using the combined federal and provincial income tax rate in Canada of 35.45% (2007 – 36.12%)	<b>(912,000)</b>	(952,900)
Stock-based compensation	<b>175,800</b>	136,400
Other	<b>3,300</b>	3,800
Effect of change in tax rates	<b>788,700</b>	-
Effect of changes in valuation allowance	<b>(255,800)</b>	617,700
<b>Future income tax provision (recovery)</b>	<b>(200,000)</b>	(195,000)

The future income tax assets and liabilities result from differences between the carrying amount and the tax basis of the following:

	2008	2007
	\$	\$
Future income tax assets		
Non-capital losses	<b>2,457,800</b>	2,289,300
Intangible assets	<b>794,300</b>	989,300
Property, plant and equipment	<b>502,200</b>	99,700
Share issue costs	-	800
	<b>3,754,300</b>	3,379,100
Future income tax liabilities		
Lease adjustment	<b>(631,000)</b>	
Net future income tax asset before valuation allowance	<b>3,123,300</b>	(3,379,100)
Valuation allowance	<b>(3,123,300)</b>	(3,379,100)
Net future income tax asset	-	-

The Company has financed part of the start-up phase of renewable energy and energy conservation projects through the issuance of flow-through shares. Under the terms of the flow-through share agreements, the tax attributes of the related expenditures are renounced to subscribers. To recognize the foregoing tax benefits to the Company, the carrying value of the shares issued is reduced by the tax effect of the tax benefits renounced to subscribers. The tax effect of the renouncement is recognized on the date the Company files the renouncement documents with the tax authorities to renounce the tax credits associated with the expenditures, provided there is reasonable assurance that the expenditures will be made. During fiscal 2008, the Company renounced approximately \$615,000 (2007 - \$540,000) of expenditures. At May 31, 2008 and 2007 there are no expenditures that are required to be incurred before December 31, 2008. Participation in this program is subject to verification by tax authorities with respect to the nature and timing of expenditures.

## THERMAL ENERGY INTERNATIONAL INC.

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

As at May 31, 2008, the Company had available non-capital income tax loss carry forwards in the following amounts which may be used to reduce federal and provincial taxable income.

<b>Year of Expiry</b>	<b>Amount</b>
2009	1,086,000
2010	1,395,000
2014	355,000
2015	533,000
2026	1,276,000
2027	1,693,000
2028	2,137,000
<b>Total</b>	<b>8,475,000</b>

#### 15 INFORMATION INCLUDED IN OPERATIONS

	<b>2008</b>	<b>2007</b>
	<b>\$</b>	<b>\$</b>
Interest expense	<b>15,223</b>	13,570

Administration expense and selling, marketing and business development expense are presented net of government assistance of \$20,203 and \$196,922 respectively.

#### 16 SEGMENTED INFORMATION

In fiscal 2008 the Company operated in the energy conservation and environmental compliance (air) industry in North America and was also engaged in the start-up phase of similar operations in China. Within this business segment, the Corporation markets, sells, engineers, fabricates, constructs, installs and supports two retrofit technology lines – waste energy recovery solutions and air pollution control solutions. In fiscal 2008 revenue was derived mainly from engineering and constructing the complete retrofit energy recovery and air pollution control solution, with some revenue derived from the custom fabrication and assembly of the proprietary hardware components and the core major equipment package of the technologies. All assets are located in Canada.

## THERMAL ENERGY INTERNATIONAL INC.

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Prior to fiscal 2008, customers financed these projects entirely from their own resources and accordingly, the Company operated in only one segment. In 2008 the Company introduced its Thermal-AUD™ product whereby it finances the project, recovers and obtains a return on its investment by leasing back the facility on an agreed basis to the customer. Construction of the first Thermal-AUD™ project was completed in late fiscal 2008. This gave rise to two reportable segments which are detailed below:

	May 31, 2008	
	Customer financed contracts and other \$	Thermal-AUD™ contract \$
Revenue from external customers	2,716,366	2,209,842
Inter-segment revenues	19,111	-
Interest and finance revenue	32,098	56,201
Interest expense and bank charges	13,503	6,914
Stock-based compensation charge	495,786	-
Amortization of capital assets	31,314	-
Segment loss (profit)	2,391,014	(18,506)
Segment assets	2,755,526	2,225,562
Expenditures for capital assets	28,768	-
Reconciliation to financial statements		May 31, 2008 \$
<b>Revenues</b>		
Total revenues for reporting segments		4,945,319
Elimination of inter-segment revenues		(19,111)
<b>Total company revenues</b>		<b>4,926,208</b>
<b>Loss</b>		
Total loss for reported segments		2,572,508
Income tax recovery		(200,000)
<b>Net loss</b>		<b>2,372,508</b>
<b>Assets</b>		
Total assets for reported segments		4,981,088
Elimination of inter-segment receivables		(1,287,087)
<b>Total assets</b>		<b>3,694,001</b>

Other significant items	Segment totals \$	Adjustments \$	Company totals \$
Interest revenue	32,098	-	32,098
Interest expense and bank charges	20,417	-	20,417
Finance revenue	56,201	-	56,201
Stock-based compensation charge	495,786	-	495,786
Amortization of capital assets	31,314	-	31,314
Expenditures for capital assets	28,768	-	28,768

## THERMAL ENERGY INTERNATIONAL INC.

### NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Geographic Segments	May 31, 2008	
	Revenues \$	Capital Assets \$
Canada	2,382,444	2,013,972
United States	2,507,137	-
China	36,627	-
<b>Total</b>	<b>4,926,208</b>	<b>2,013,972</b>

Revenues from outside customers are attributed to the geographic segments based on the location of the project.

Two unaffiliated customers accounted for 94% of sales in 2008 and two unaffiliated customers for 100% in 2007.

#### 17 FINANCIAL RISKS

##### Interest rate risk

The Company has contracted a short-term bank loan bearing a floating rate of interest. This financial instrument exposes the Company to risk in the event market interest rates fluctuate.

##### Foreign exchange risk

The Company is exposed to foreign exchange risk due to cash, short-term investments, accounts receivable and accounts payable denominated in U.S. dollars. As at May 31, 2008, cash, short-term investments, accounts receivable and accounts payable denominated in U.S. dollars totalled US\$7,115, US\$200, US\$394,798 and US\$824,252 respectively (US\$244,694, US\$300,000, US\$343,075 and US\$29,390 as at May 31, 2007).

The Company does not enter into arrangements to hedge its foreign exchange risk.

##### Credit risk

The financial instruments that potentially expose the Company to credit risk are accounts receivable and loans outstanding to assist shareholders in purchasing capital stock. At May 31, 2008, 68% (2007 – 94%) of trade receivables were from one customer.

##### Liquidity risk

Liquidity risk management serves to maintain a sufficient amount of cash and cash equivalents and to ensure that the Company has financing sources such as bank loans for a sufficient authorized amount. The Company continues to actively seek external financing to ensure it has the necessary funds to fulfill its obligations.

##### Fair value of financial instruments

Given that they will mature shortly, the fair value of short-term financial assets and liabilities are equivalent to their carrying amount.

#### 18 COMPARATIVE AMOUNTS

Certain 2007 amounts have been reclassified to conform with the current year's presentation.

#### 19 CONTINGENCY

On October 20, 2005 the Company announced that the voluntary mediation between the Company and its past President had ended without resolution. On October 25, 2005 the Company had been served with a statement of claim for \$2.3 million from its past President. On December 2, 2005 the Company had filed its statement of defence and had filed a counterclaim seeking damages from the past President in the amount of \$5.4 million. The Company is confident in the merits of its own case and that the claim by the past President is frivolous and without merit and the Company will defend it vigorously. Accordingly, no provision for any potential loss has been recorded in connection with this claim.

## **THERMAL ENERGY INTERNATIONAL INC.**

### **NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

#### **20 RECENTLY ISSUED ACCOUNTING STANDARDS NOT YET IMPLEMENTED**

##### **Capital disclosures and financial instruments disclosures and presentation**

Between December 2006 and February 2008, the CICA issued the following new standards: Section 3862 "Financial Instruments – Disclosures", Section 3863 "Financial Instruments – Presentation", Section 1535 "Capital Disclosures", Section 1400 "General Standards of Financial Statement Presentation", Section 3064 "Goodwill and Intangible Assets" and Section 3031 "Inventories". These new standards are applicable to fiscal years beginning on or after October 1, 2007.

Section 3862 describes the required disclosures related to the significance of financial instruments on the entity's financial position and performance and the nature and extent of risks arising from financial instruments to which the entity is exposed and how the entity manages those risks. This Section complements principles of recognition, measurement and presentation of financial instruments of Section 3855 "Financial Instruments – Recognition and Measurement", 3863 "Financial Instruments – Presentation" and 3865 "Hedges".

Section 3863 establishes standards for presentation of financial instruments and non-financial derivatives. It replaces standards of Section 3861 "Financial Instruments – Disclosure and Presentation".

Section 1535 establishes standards for disclosing information about an entity's capital and how it is managed to enable users of financial statements to evaluate the entity's objectives, policies and procedures for managing capital.

Section 1400 requires that management make an assessment of the Company's ability to continue as a going concern over a period which is at least, but is not limited to, twelve months from the balance sheet date.

Section 3064 establishes standards for the recognition, measurement, presentation and disclosure of goodwill and intangible assets by profit-oriented companies. It clarifies the recognition of intangible assets and deals with the recognition of internally generated intangible assets.

Section 3031 "Inventories", provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realizable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

The Company will implement these new standards in its first quarter of fiscal year 2009 and is currently evaluating the impact of their adoption on its consolidated financial statements.

#### **21 SUBSEQUENT EVENTS**

On June 3, 2008 the Company announced that it had closed a brokered private placement of 68,181,818 common shares at \$0.22 per share for gross proceeds of \$15,000,000. The funds raised were to complete the acquisition of Gardner Energy Management Ltd. in the United Kingdom for approximately \$5,400,000 and to provide funds to finance the construction of plant and equipment for future ThermalAud™ contracts.

On July 2, 2008 the Company announced that it had completed the acquisition of Gardner Energy Management Ltd. of Bristol, England. The terms of the acquisition required the company to make an initial payment of £2,700,000 sterling or approximately \$5,400,000 upon closing July 1, 2008. An additional payment of up to £1,300,000 sterling or approximately \$2,600,000 may be made in cash and shares over a three year period based on Gardner Energy Management Ltd. meeting certain performance targets.