



THERMAL ENERGY
INTERNATIONAL INC.

Leading Edge Environmental Compliance and Energy Conservation Solutions



First Quarter Report - FY 2006

August 31, 2005

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THERMAL ENERGY INTERNATIONAL INC
 Incorporated under the Ontario Business Corporations Act

CONSOLIDATED BALANCE SHEETS

As at	(Unaudited) Aug 31 2005 \$	May 31 2005 \$
ASSETS		
Current assets		
Cash	321,579	174,218
Short term investments (note 7)	805,263	800,263
Accounts receivable (note 8)	527,978	231,259
Contracts in progress	65,000	65,000
Prepays and other assets	-	7,611
	1,719,820	1,278,351
Property, plant and equipment (note 11)	36,469	35,778
	1,756,289	1,314,129
LIABILITIES, CAPITAL STOCK, CONTRIBUTED SURPLUS AND DEFICIT		
Current liabilities		
Accounts payable	559,461	411,301
Accrued liabilities	231,526	318,450
Deferred revenue	845,000	474,000
Due to past President (note 10)	54,485	300,972
	1,690,472	1,504,723
Capital stock, contributed surplus and deficit		
Capital stock (note 13)	13,099,791	12,625,487
Contributed surplus (note 13)	1,400,713	1,237,995
Deficit	(14,434,687)	(14,054,076)
	65,817	(190,594)
	1,756,289	1,314,129

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

On behalf of the Board



President and C.E.O.



Chief Financial Officer

THERMAL ENERGY INTERNATIONAL INC.**CONSOLIDATED OPERATIONS AND DEFICIT
(Unaudited)**

Three months ended August 31

	2005	2004
	\$	\$
REVENUE		
Sales	382,180	156,565
Cost of sales	329,355	151,228
Gross profit	52,825	5,337
Expenses		
Administration	106,394	69,173
Selling, marketing and business development	200,812	94,336
Stock-based compensation expense (note 13)	288,189	-
Legal fees	17,094	7,257
Audit fees	11,250	10,500
Insurance	20,637	25,973
Amortization of property, plant and equipment	2,991	3,352
Patent and trademark maintenance	6,355	3,120
Research and development	9,853	2,550
Interest and bank charges	739	7,139
Foreign exchange loss (gain)	(4,555)	-
	659,759	223,400
	(606,934)	(218,063)
Other revenue (note 9)	226,323	-
Net loss	(380,611)	(218,063)
Deficit, beginning of period	(14,054,076)	(11,875,280)
Deficit, end of period	(14,434,687)	(12,093,343)
Net loss per share - basic and diluted	0.00	0.00
Weighted average number of common shares	64,423,478	50,947,118

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

THERMAL ENERGY INTERNATIONAL INC**CONSOLIDATED STATEMENT OF CASH FLOWS
(Unaudited)**

Three months ended August 31

	2005	2004
	\$	\$
OPERATING ACTIVITIES		
Net loss for the period	(380,611)	(218,063)
Add items not involving cash:		
Non-monetary compensation charge	288,189	-
Amortization of property, plant and equipment	2,991	3,352
Changes in non-cash operating working capital (note 6)	143,128	(20,538)
Changes in due to the past President (note 10)	(246,487)	(356,897)
Net cash used in operating activities	(192,790)	(592,146)
INVESTING ACTIVITIES		
Additions to short term investments	(5,000)	-
Additions to property, plant and equipment	(3,682)	-
Net cash used in investing activities	(8,682)	-
FINANCING ACTIVITIES		
Common shares issued net of issue costs (note 13)	348,833	-
Increase in loan receivable	-	2,000
Convertible debentures issued	-	372,575
Net cash provided by financing activities	348,833	374,575
Increase (decrease) in cash for the period	147,361	(217,571)
Cash beginning of period	174,218	261,296
Cash end of period	321,579	43,725
Interest paid	421	6,632

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

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1 These interim unaudited financial statements follow the same accounting policies and methods as in the audited financial statements prepared for the year ended May 31, 2005 and should be read in conjunction with those statements.

2 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.

3 GOING CONCERN

The Company incurred losses from operations in the quarter ended August 31, 2005 and 2004. It had a positive working capital at August 31, 2005 but a deficiency at August 31, 2004.

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 and its ability to generate sufficient cash from operations.

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.

Management is of the opinion that sufficient funds will be available from operations, external financing, and the continued financial support of its principal shareholders to meet the Company's liabilities and commitments as they become due.

4 CHANGES IN ACCOUNTING POLICIES

Effective June 1, 2004, the Company adopted the new Canadian standard for "Stock-based Compensation and Other Stock-based Payments", which requires that fair-value method of accounting be applied to all stock-based compensation payments for both employees and non-employees. Under the fair-value based method, compensation cost is measured at fair value at the grant date and is expensed over the awards vesting period. The transitional provisions of the standard allow the Company to adopt this method retroactively without restatement of prior periods.

In March 2004, the CICA issued Emerging Issue Committee Abstract no 146 (EIC-146) "Flow-through Shares", which applies to flow-through share issuances initiated after March 19, 2004. The Corporation adopted prospectively the new recommendations and now records the tax effect related to renounced deductions on the date that the Corporation renounced the deductions to investors.

In July 2003, the Canadian Institute of Chartered Accountants published section 1100 titled Generally Accepted Accounting Principles and section 1400 titled General Standards of Financial Statement Presentation, that apply to fiscal years beginning on or after October 1, 2003. Section 1100 establishes standards for financial reporting in accordance with generally accepted accounting principles. It describes what constitutes Canadian generally accepted accounting principles and its sources. This Section also provides guidance on sources to consult when selecting accounting policies and determining appropriate disclosures, when a matter is not dealt with explicitly in the primary sources of generally accepted accounting principles. Section 1400 provides guidance on the concept of fair presentation in accordance with generally accepted accounting principles. These new standards did not have any impact on the financial situation or the operations of the Company.

5 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 subsidiary, 2003356 Ontario Inc.

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. Actual results could differ from these estimates.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

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 recorded once they can be estimated. 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. Cash and cash equivalents are recorded at cost which approximates fair value.

Amortization

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

Furniture and fixtures	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 and other dilutive instruments. 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 securities 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.

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 period.

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.

THERMAL ENERGY INTERNATIONAL INC.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

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.

6 INFORMATION INCLUDED IN THE STATEMENT OF CASH FLOWS

Changes in working capital items are detailed as follows:

	Aug 31, 2005	Aug 31, 2004
	\$	\$
Accounts receivable	(296,719)	150,116
Contracts in progress	-	(66,000)
Prepays and other assets	7,611	(26,686)
Accounts payable	148,160	(60,693)
Accrued liabilities	(86,924)	6,925
Deferred revenue	371,000	(24,200)
	143,128	(20,538)

7 SHORT TERM INVESTMENTS

The Company has invested cash, surplus to its current requirements, in a cashable guaranteed investment certificate which bears an interest rate of 2.5%, renewable on June 2, 2006.

8 ACCOUNTS RECEIVABLE

	Aug 31, 2005	Aug 31, 2004
	\$	\$
Trade	470,418	90,532
Other	57,560	10,527
	527,978	101,059

At August 31, 2005 and August 31, 2004 all trade receivables and revenues were from one customer and were all in Canadian dollars.

9 OTHER REVENUE

In March 2005, a resolution of the Board of Directors cancelled a convertible debenture issued in July 2004 with a face value of \$376,704. After review by the past President, creditors and the Company in June 2005, agreement was reached to reduce the resulting obligations to \$50,000 and a cheque for this amount was issued to the past President in August 2005 (note 10). The resulting gain of \$326,704 was credited to other revenue.

There was no other revenue in the quarter ended August 31, 2004.

THERMAL ENERGY INTERNATIONAL INC.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

10 RELATED PARTY TRANSACTIONS

Related party transactions are measured at exchange value which represents the amounts established and agreed upon by both parties.

	Aug 31, 2005 \$	Aug 31, 2004 \$
<hr/> Transactions with and balances owing to/from directors		
Fees for services	-	32,668
Accounts payable	-	2,365
Accrued liabilities	6,750	-
<hr/> Directors share options outstanding at Aug 31		
Issued	2,525,000	1,533,000
Exercisable	2,180,000	1,533,000
<hr/> Transactions with and balances owing to/from officers		
Fees for services	46,500	-
Accounts receivable	2,955	-
Accrued liabilities	2,667	-
<hr/> Officers share options outstanding at Aug 31		
Issued	1,043,000	589,000
Exercisable	870,000	589,000
<hr/> Changes to the amounts due to (from) the past President during the quarter were as follows:		
	Aug 31, 2005 \$	Aug 31, 2004 \$
Balance due to the past President, beginning of period	300,972	334,001
Issuance of convertible debentures to the past President	-	(346,895)
Debt settlement	(195,757)	-
Cash payment to Past president	(50,000)	-
Payments made on behalf of past President	(730)	(10,002)
Balance due to (from) the past President, end of period	54,485	(22,896)

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
(Unaudited)**

11 PROPERTY, PLANT AND EQUIPMENT

	Aug 31, 2005		Aug 31, 2004	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
	\$	\$	\$	\$
Furniture and fixtures	85,105	60,439	75,072	56,371
Computers	133,310	123,035	123,795	120,605
Software	12,081	10,553	12,081	8,262
Leasehold improvements	54,548	54,548	54,548	54,548
	285,044	248,575	265,496	239,786
Accumulated amortization	(248,575)		(239,786)	
Net book value	36,469		25,710	

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:

	\$
2006	54,200
2007	9,800
2008	4,400
2009	3,600
2010	2,100
Total	74,100

THERMAL ENERGY INTERNATIONAL INC.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

13 CAPITAL STOCK AND CONTRIBUTED SURPLUS

	Aug 31, 2005		Aug 31, 2004	
	# Shares	\$	# Shares	\$
Authorized				
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 at \$0.01 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.				
Class A Common shares issued				
Balance, beginning of quarter	63,198,899	12,776,987	50,947,118	11,008,303
Issued in settlement of liabilities, net of issue costs	295,000	41,300	-	-
Issued for cash, net of issue costs	627,333	114,033	-	-
Issued as a result of the exercise of options	1,250,000	318,971	-	-
	65,371,232	13,251,291	50,947,118	11,008,303
Less: loans outstanding to assist a shareholder in purchasing capital stock (i)		(151,500)		(151,500)
Balance, end of quarter	65,371,232	13,099,791	50,947,118	10,856,803

(i) The past President received shareholder loans of \$151,500 to purchase shares during 1999. These loans are due upon demand, bear no interest and have no fixed repayment terms.

In fiscal 2004 and 2005 the Company completed private placements. The funds were raised by issuing Units that included one Class A common share and one non-transferable share purchase warrant. Given the inherent subjectivity of evaluating the warrants, the Company determined it preferable to attribute the full amount of the proceeds to the issued shares.

The following table summarizes the status of warrants outstanding at Aug 31, 2005:

Warrants Outstanding	Exercise Price \$	Expiry Date
383,000	0.14	December 30, 2005
695,000	0.14	January 12, 2006
1,665,000	0.16	March 18, 2006
400,000	0.16	July 21, 2006
3,450,002	0.10	To November 4, 2005, and
	0.20	To November 4, 2006
2,192,030	0.15	To January 18, 2006, and
	0.60	To January 18, 2007
2,806,333	0.50	To June 19, 2007, and
	0.75	To June 19, 2008
11,591,365		

Contributed surplus

	Aug 31, 2005	Aug 31, 2004
	\$	\$
Balance, beginning of period	1,237,995	166,150
Stock-based compensation	288,189	-
	1,526,184	166,150
Fair-value of options exercised and transferred to capital stock	125,471	-
Balance, end of period	1,400,713	166,150

THERMAL ENERGY INTERNATIONAL INC.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

14 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 the first quarter ended August 31, 2005 had vesting periods of four months. There were no new options granted in the first quarter of 2004.

(a) Activity in stock options was as follows:

	Aug 31, 2005		Aug 31, 2004	
	# Options	Weighted Average \$	# Options	Weighted Average \$
Outstanding, beginning of period	7,043,714	0.16	6,512,714	0.19
Granted	400,000	0.24	-	-
Exercised	(1,350,000)	0.15	-	-
Cancelled/expired	(1,100,000)	0.19	-	-
Outstanding, end of period	4,993,714	0.19	6,512,714	0.19
Number of options exercisable as at May 31	3,964,964		6,237,714	

Options exercised during the quarter were as follows:

	Aug 31, 2005		Aug 31, 2004	
	# shares	\$	# shares	\$
Employees	925,000	157,500	-	-
Directors	225,000	34,000	-	-
Consultants	200,000	20,000	-	-
	1,350,000	211,500	-	-

All options were exercised for cash.

THERMAL ENERGY INTERNATIONAL INC.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

(b) The following options are outstanding and/or exercisable at August 31, 2005:

Number of Options Outstanding	Number of Options Exercisable	Exercise Price Per Share \$	Expiry Date
750,000	750,000	0.15	January 16, 2007
425,714	425,714	0.18	January 16, 2007
218,000	218,000	0.10	January 12, 2008
100,000	100,000	0.12	January 20, 2008
250,000	250,000	0.20	January 24, 2008
1,000,000	655,000	0.10	February 1, 2008
500,000	327,500	0.12	February 1, 2008
150,000	38,750	0.24	March 1, 2008
950,000	950,000	0.22	April 29, 2008
250,000	250,000	0.24	May 19, 2008
100,000		0.24	June 2/08
150,000		0.24	June 10/08
150,000		0.24	Aug 15/08
4,993,714	3,964,964		

c) Stock-based compensation to employees

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

	Aug 31, 2005
Weighted average assumptions:	
Expected dividend	0.00%
Expected volatility	122%
Risk-free interest rate	3.75%
Expected option life in years	2.4

The weighted average fair value of the Company's stock options, calculated using the Black-Scholes option pricing-model, granted during the quarter ended August 31, 2005 was \$0.18 (2004 \$nil).

(d) Stock-based compensation to non-employees

No options were issued to non-employees in the quarters ended August 31, 2005 and 2004.

15 SEGMENTED INFORMATION

The Corporation operates in one operating segment – energy conservation and environmental compliance (air). 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. Revenue is 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.

One unaffiliated customer accounted for 100% of sales in 2005 and in 2004. The Company is working aggressively with other potential partners to attract new customers.

THERMAL ENERGY INTERNATIONAL INC.

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)**

16 FINANCIAL INSTRUMENTS

Given that they will mature shortly, the carrying values of the Company's short-term financial instruments are equivalent to their carrying amounts.

The Company is exposed to foreign exchange risk due to accounts payable denominated in U.S. dollars. As at August 31, 2005, accounts payable denominated in U.S. dollars totalled US\$67,119 (US\$109,255 at August 31, 2004).

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

17 SUBSEQUENT EVENTS

On October 20, 2005 the Company announced that the voluntary mediation between the Company and its past President had ended without resolution. As a consequence, the Company planned to seek damages in excess of \$2.5 million from its past President. On October 25, 2005 the Company announced that it had been served with a statement of claim for \$2.3 million by its past President. The Company is confident that this latter claim is frivolous, without merit and will be defended vigorously.

18 COMPARATIVE AMOUNTS

Certain 2005 amounts have been reclassified to conform with the current period's presentation.



FIRST QUARTER REPORT Period Ending August 31, 2005

MANAGEMENT DISCUSSION AND ANALYSIS

The following discussion explains material changes in the Corporation's financial condition and results of operations for the 1st quarter of fiscal year 2006, ended August 31, 2005. The Quarterly Report constitutes an integral part of the discussion and should be read in conjunction with these comments.

Description of Business

Thermal Energy has established itself since 1987 as a leading provider of cost-effective energy conservation and environmental compliance (air) products and solutions. Thermal Energy is providing its integrated turnkey solutions for customers to economically reduce multiple air pollutant emissions while deriving substantial energy savings benefits through advanced heat recycling. Thermal Energy's innovative abilities and unique technologies have ensured that the implemented solutions met or exceeded the air pollution control performance expectations, while at the same time generated sufficient renewable energy and operating cost savings so as to produce an attractive return on investment ("ROI"), thereby causing the solution to be self-financing.

Thermal Energy has developed cost-effective air compliance solutions for efficiently removing and reducing multiple air pollutant emissions including: Nitrogen Oxides (NOx) "Smog", Sulfur Oxides (SOx) "Acid Rain", Carbon Dioxide (CO₂) "Greenhouse Gas", Fine Particulate Matter (PM_{2.5}) "Lung Irritants", Heavy Metals (HM) including Mercury (Hg) "Carcinogenic Bio-accumulators", Toxic Organic Compounds (TOC) "Poisonous", and Volatile Organic Compounds (VOC) "Odorous or Toxic".

Thermal Energy has developed cost-effective air pollution control technology solutions for efficiently removing and reducing multiple air pollutants emissions including: Nitrogen Oxides (NOx) "Smog", Sulfur Oxides (SOx) "Acid Rain", Carbon Dioxide (CO₂) "Greenhouse Gas", Fine Particulate Matter (PM_{2.5}) "Lung Irritants", Heavy Metals (HM) including Mercury (Hg) "Carcinogenic Bio-accumulators", Toxic Organic Compounds (TOC) "Poisonous", and Volatile Organic Compounds (VOC) "Odorous or Toxic".

More information on Thermal Energy can be found at www.thermalenergy.com. FLU-ACE® is a registered trademark of Thermal Energy. Common shares of Thermal Energy are traded on the TSX Venture Exchange under the symbol TMG.

Discussion of Operations and Financial Conditions

Revenue and Gross Profit

Total sales for the 1st quarter ended August 31, 2005 increased to \$382,180 compared to \$156,565 one year earlier. The sales amount is representative of new work started at the Camco, Inc. (Montreal) and Minas Basin Pulp and Power Co. Ltd. sites. Most of the revenue for the start-up of new work has been deferred to the following quarters as it is earned.



Gross profits were higher at \$52,825 (13.8%) in the 1st quarter ended August 31, 2005 compared with \$5,337 (3.4%) for the 1st quarter ending August 31, 2004.

Expenses

Administration expenses in Q1 FY 2006 were \$106,394 compared with \$69,173 in Q1 FY 2005 showing a comparative Q1 increase of \$37,221 (or 53.80%). Administration expenses have increased year over year because of increases arising from the additions of new personnel to the Corporation.

Selling and marketing and business development expenses were \$200,812 in Q1 FY 2006 compared with \$94,336 in Q1 FY 2005 showing a comparative Q1 increase of \$106,476 (or 112.86%). Comprising the total, an amount of \$58,951 represents sales commissions paid on the successful award of the Minas Basin project. The remaining marginal increases were due to the hiring of new employees dedicated to sales and business development and to increases in travel expenses.

Stock based compensation expenses increased to \$288,189 in Q1 FY 2006 compared with \$nil in Q1 FY 2005 due to an award of stock incentives in part to retain a few old employees and to a greater extent to attract new employees and Directors.

Legal expenses were \$17,094 in Q1 FY 2006 compared with \$7,257 in Q1 FY 2005 showing an increase of \$9,837. The major expenses involved the legal framework of the Corporation's negotiations and settlement of the Convertible Debenture issue with the former President and CEO.

Patent and Trademark maintenance costs were \$6,355 in Q1 FY 2006 compared to \$3,120 in Q1 FY 2005 with respect to countries where patents have been granted. All Patent and Trademark costs incurred by the corporation are expensed as incurred.

Research and Development costs were \$9,853 in Q1 FY 2006 compared to \$2,550 in Q1 FY 2005. The increase in expenditures was as a result of the Corporation's commitment to resume work in developing its patented THERMALONox technology through laboratory testing at minimal costs. This is in stark contrast to the past decision by the former CEO of the Corporation of seeking first sufficient investment funds or a strong partner to finance the substantial costs of a pilot project in order to demonstrate the THERMALONox technology.

Amortization of property, plant and equipment was \$2,991 in Q1 FY 2006 compared to \$3,352 in Q1 FY 2005.

Other revenue was \$226,323 in Q1 FY 2006 compared to \$nil in Q1 FY 2005 mostly as a result of the negotiated settlement of the cancelled Convertible Debenture.

Net Loss was \$380,611 in Q1 FY 2006 compared to \$218,063 in Q1 FY 2005. Contributing to the loss in the current first quarter was a stock-based compensation expense in the amount of \$288,189 associated with hiring agreements of new employees and appointments of new directors. Stock-based compensation expenses in the next quarter will be



significantly reduced to a modest amount. Additionally, it included a one time charge to expense a previous loan to the past President in the amount of \$134,066.

Liquidity and Solvency

As of August 31, 2005, the **working capital** was \$29,348 compared to (\$226,372) at May 31, 2005. The Q1-FY 2006 working capital increased in part from the resolution and settlement of an issue pertaining to the cancelled Convertible Debentures in the amount of \$376,704 for the new settled amount of \$54,280. In addition the working capital improved as a result of increases in sales and profitability and from other revenues derived from the exercise of stock options and warrants of the Corporation. Nevertheless, management continues to recognize the requirement to further improve liquidity in order to continue as a going concern, and as a result is aggressively working to increase sales and is continuing to develop new cooperative business relationships.

Business Risks

The Corporation is engaged in the development, engineering and supply of pollution control and heat recovery systems. Operational risks of the company include the corporation's ability to continue to secure and implement multiple sales contracts per year for standard, hybrid, and multi-air pollutant FLU-ACE® technology solutions. In addition, the Corporation has not yet been able to finance and complete the development and commercialization of its patented THERMALONOX™ technology. The THERMALONOX™ patented technology has not been tested yet; however, the Corporation will be seeking potential partners and investors to sponsor the costs associated with the implementation of a THERMALONOX™ demonstration pilot project upon the successful completion of laboratory testing. Cost Effective Energy Conservation and Environmental Compliance Solutions Sales through the Johnson Controls L.P. cooperation has not limited the size of the market but has increased the market potential.

Financial risks of the corporation include: the ability to continue to grow sales through the existing JCLP cooperation agreement, the ability to establish new cooperative partnerships and strategic alliances, the ability to license the corporations technologies, the ability to secure and maintain the required outside working capital financing, and the ability to achieve profitable operations through increased sales generation.

Highlights

On June 1, 2005 the Corporation announced that it had granted 250,000 new stock options at a deemed price of \$0.24 per share to a new director, John Kelly. The Corporation also announced the settling of a debt with one employee for 100,000 flow-through common shares of the Corporation at a deemed price of \$0.25 per share.

On June 13, 2005 the Corporation announced that it had significantly strengthened its financials and cleaned up the Company's debt position. Part of this improvement to the



balance sheet includes the settling of an unsecured Convertible Debenture of \$376,704 for \$54,280.

On June 23, 2005 the Corporation announced that it had re-engaged Stuart McCarthy to provide in-house investor relations and communications services. Mr. McCarthy is now the Corporation's primary contact for shareholders seeking timely responses to investor and corporate matters.

On June 23, 2005 the Corporation announced the departure of Chief Technology Officer Thomas V. Hinke from the Corporation. Earlier in the year Mr. Hinke resigned as President and CEO and also from his position on the Board of Directors, to facilitate the appointment of a stronger management team to accelerate the growth and to maximize shareholder value of the Corporation.

On August 2, 2005 the Corporation announced that it would supply a FLU-ACE® heat recovery system to JCLP as part of a multi-million dollar energy efficiency project at Minas Basin Pulp and Power Co. Ltd., of Hantsport, Nova Scotia. This contract is the largest to date and represents a tremendous breakthrough into a new market segment, the pulp and paper industry.

On August 19, 2005 the Corporation announced that the Honourable George Smitherman, Health Minister for the Province of Ontario joined officials of the Corporation for the official start-up of the Corporation's latest FLU-ACE® installation at the Stratford General Hospital site of the Huron Perth Alliance. This installation will cut natural gas use and greenhouse gas emissions by 20% and free money for health care needs.

Subsequent Events

On September 12, 2005 the Corporation announced the appointment of R. James Ansell to the Board of Directors. Mr. Ansell has been President and CEO of Generation Resources Holding Co. LLC., of Leawood, Kansas, a private investment and holding Company, which finances, develops, operates and maintains cost-effective production operations in renewable energy projects in the United States. He is also Chairman of First Energy Sustainable Energy Funds and sits on the Board of Directors of the Pennsylvania Environmental Council. Prior to founding Generation Resources, Mr. Ansell was Vice President of strategic development and alliances for Black and Veatch, a \$2 billion global construction and engineering firm specializing in energy, water and information technology projects.

On September 28, 2005 the Corporation announced that it had resumed work on developing its patented THERMALONOX™ technology as a cost-effective solution for reducing nitrogen oxide (NOx) emissions from coal-fired electric-generating units and large industrial boilers. The Corporation appointed Dr. Raymond Belanger as chief scientist to head up its renewed research and development program. Mr. Belanger previously worked during the past five years for a fuel cell technology company based in British Columbia in charge of research and development. Dr. Belanger received his doctorate in physical chemistry at the University of Waterloo in 1996, where his thesis examined the chemical reactions involving NOx and carbon oxides on metal-oxygen clusters.

On October 20, 2005 the Corporation announced that the voluntary mediation between the Corporation and its former President and CEO (Mr. Hinke) ended without resolution and as a result now the Corporation planned to seek damages in excess of \$2.5 million from Mr.



Hinke. The Corporation was notified that Mr. Hinke intended to seek damages from the Corporation surrounding his dismissal.

On October 25, 2005 the Corporation announced that it was served with a statement of claim in the amount of \$2.3 million by its former President and CEO (Mr. Hinke). The Corporation and its legal counsel are confident that the claim is frivolous and without merit and will be defended vigorously. The Corporation stated that it was very confident in the merits of its forthcoming counterclaim against Mr. Hinke.

On October 25, 2005 the Corporation settled an outstanding balance owing in the amount of US\$57,708.99 with Emerson/Fabcon (the supplier of record for a past AEP Project at its Conesville plant in Ohio) with a negotiated amount of US\$30,000.00.

On October 27, 2005 the Corporation announced that it had also received an offer of settlement on the same day of the submitted claim from its former President and CEO (Mr. Hinke) to settle his \$2.3 million claim for the amount of \$425,000. The Corporation further advised that it was in the process of preparing its defense to the claim and a counterclaim against Mr. Hinke.

Signed in Ottawa on this 31st day of October 2005.

A handwritten signature in black ink that reads "Tim Angus". The signature is written in a cursive style with a long, sweeping underline.

Tim K. Angus
President and CEO

A handwritten signature in black ink that reads "Oliver Toffoli". The signature is written in a cursive style with a long, sweeping underline.

Oliver Toffoli, P.Eng
General Manager & CFO

Form 52-109F2 - Certification of Interim Filings

I, **Tim Angus, President & CEO, Thermal Energy International Inc.**, certify that:

1. I have reviewed the interim filings (as this term is defined in Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings*) of **Thermal Energy International Inc.**, (the issuer) for the interim period ending **August 31, 2005**;
2. Based on my knowledge, the interim filings do not contain any untrue statement of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, with respect to the period covered by the interim filings;
3. Based on my knowledge, the interim financial statements together with the other financial information included in the interim filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer, as of the date and for the periods presented in the interim filings;
4. The issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting for the issuer, and we have:
 - (a) designed such disclosure controls and procedures, or caused them to be designed under our supervision, to provide reasonable assurance that material information relating to the issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which the interim filings are being prepared; and
 - (b) designed such internal control over financial reporting, or caused it to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the issuer's GAAP; and
5. I have caused the issuer to disclose in the interim MD&A any change in the issuer's internal control over financial reporting that occurred during the issuer's most recent interim period that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

Date: October 31, 2005

Signature: 

Tim Angus
President & CEO

Form 52-109F2 - Certification of Interim Filings

I, **Oliver Toffoli, CFO, Thermal Energy International Inc.**, certify that:

1. I have reviewed the interim filings (as this term is defined in Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings*) of **Thermal Energy International Inc.**, (the issuer) for the interim period ending **August 31, 2005**;
2. Based on my knowledge, the interim filings do not contain any untrue statement of a material fact or omit to state a material fact required to be stated or that is necessary to make a statement not misleading in light of the circumstances under which it was made, with respect to the period covered by the interim filings;
3. Based on my knowledge, the interim financial statements together with the other financial information included in the interim filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer, as of the date and for the periods presented in the interim filings;
4. The issuer's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting for the issuer, and we have:
 - (a) designed such disclosure controls and procedures, or caused them to be designed under our supervision, to provide reasonable assurance that material information relating to the issuer, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which the interim filings are being prepared; and
 - (b) designed such internal control over financial reporting, or caused it to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with the issuer's GAAP; and
5. I have caused the issuer to disclose in the interim MD&A any change in the issuer's internal control over financial reporting that occurred during the issuer's most recent interim period that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

Date: October 31, 2005.

Signature: Oliver Toffoli

Oliver Toffoli
CFO