



An Innovative Technology Company Providing
Energy & Emission Reduction Solutions

▶ Second Quarter Report – FY 2010

Period Ending November 30, 2009



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

CONSOLIDATED BALANCE SHEETS

As at	(Unaudited) Nov 30 2009 \$	May 31 2009 \$
ASSETS		
Current assets		
Cash and cash equivalents (note 4)	1,200,563	3,365,512
Accounts receivable (note 5)	2,018,836	1,404,924
Inventories (note 6)	490,835	554,577
Net investment in lease (note 9)	226,867	332,579
Prepays and other assets	178,274	166,970
	<u>4,115,375</u>	<u>5,824,562</u>
Property, plant and equipment (note 7)	101,554	97,742
Net investment in lease (note 9)	1,659,854	1,670,285
Intangible assets (note 8)	1,414,792	1,508,042
Goodwill	3,588,804	3,449,799
	<u>10,880,379</u>	<u>12,550,430</u>
LIABILITIES		
Current liabilities		
Bank loans (note 11)	229,682	669,087
Accounts payable	458,801	581,146
Accrued liabilities	1,205,924	762,005
Deferred revenue	64,899	20,992
	<u>1,959,306</u>	<u>2,033,230</u>
Non-controlling interest	-2,825	-6,609
SHAREHOLDERS' EQUITY		
Capital stock (note 13)	32,547,779	32,547,779
Contributed surplus	2,284,713	2,284,713
Deficit	-25,790,857	-24,231,240
Accumulated other comprehensive loss	-117,737	-77,443
	<u>8,923,898</u>	<u>10,523,809</u>
	<u>10,880,379</u>	<u>12,550,430</u>

Contingency (note 22)

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





On behalf of the Board

THERMAL ENERGY INTERNATIONAL INC.

CONSOLIDATED OPERATIONS AND COMPREHENSIVE LOSS
(Unaudited)

	Three months ended November 30		Six months ended November 30	
	2009 \$	2008 \$	2009 \$	2008 \$
REVENUE				
Sales	1,564,527	1,140,563	2,869,463	2,198,881
Cost of sales	709,538	317,700	999,497	847,915
Gross profit	854,989	822,863	1,869,966	1,350,966
Expenses				
Administration	757,478	644,552	1,210,762	1,172,131
Selling, marketing and business development	715,375	830,837	1,601,039	1,351,919
Legal fees	38,727	59,797	122,912	69,382
Audit fees	110,067	46,468	175,600	64,468
Insurance	38,534	34,155	76,351	68,403
Amortization of property, plant and equipment	11,175	15,199	22,788	26,890
Amortization of intangible assets	46,625	-	93,250	-
Patent and trademark maintenance	-	14,730	4,106	17,540
Research and development	24,002	83,407	43,519	155,050
Interest and bank charges	12,363	34,868	31,865	65,762
Foreign exchange loss (gain)	11,641	-12,048	28,147	21,264
	1,765,987	1,751,965	3,410,339	3,012,809
Loss before the following:	-910,998	-929,102	-1,540,373	-1,661,843
Interest revenue	41	31,306	41	65,327
Finance revenue	21,535	64,465	82,826	149,517
Loss before income taxes and non-controlling interest	-889,422	-833,331	-1,457,506	-1,446,999
Provision for income taxes	-119,962	-	-119,962	-
Loss before non-controlling interest	-1,009,384	-833,331	-1,577,468	-1,446,999
Non-controlling interest	-1,246	-1,000	-3,692	-3,418
Net loss	-1,010,630	-834,331	-1,581,160	-1,450,417
Unrealized losses on translating financial statements of self-sustaining foreign operations (net of taxes)	-25,527	-40,146	-40,294	-68,304
Comprehensive loss	-1,036,157	-874,477	-1,621,454	-1,518,721
Net loss per share - basic and diluted	(0.006)	(0.005)	(0.009)	(0.009)
Weighted average number of common shares	167,533,922	167,709,197	167,533,922	159,005,606

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

THEMAL ENERGY INTERNATIONAL INC.

CONSOLIDATED DEFICIT AND CONTRIBUTED SURPLUS
(Unaudited)

	Three months ended November 30		Six months ended November 30	
	2009 \$	2008 \$	2009 \$	2008 \$
Deficit				
Balance, beginning of period	-24,790,721	-21,702,668	-24,231,240	-21,086,582
Interest on loans to acquire common shares (net of tax)	10,494	-	21,543	-
Net loss	-1,010,630	-834,331	-1,581,160	-1,450,417
Balance, end of period	-25,790,857	-22,536,999	-25,790,857	-22,536,999
Contributed Surplus				
Balance, beginning of period	2,284,713	2,252,018	2,284,713	1,528,414
Stock-based compensation	-	56,104	-	177,508
Issuance of warrants (note 13)	-	-	-	636,200
	2,284,713	2,308,122	2,284,713	2,342,122
Fair-value of stock options exercised and transferred to capital stock	-	35,000	-	69,000
Balance, end of period	2,284,713	2,273,122	2,284,713	2,273,122

CONSOLIDATED ACCUMULATED OTHER COMPREHENSIVE LOSS
(Unaudited)

	Three months ended November 30		Six months ended November 30	
	2009 \$	2008 \$	2009 \$	2008 \$
Balance, beginning of PERIOD	-92,210	-28,158	-77,443	-
Unrealized losses on translating financial statements of self-sustaining foreign operations	-25,527	-40,146	-40,294	-68,304
Balance, end of PERIOD	-117,737	-68,304	-117,737	-68,304

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

THERMAL ENERGY INTERNATIONAL INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Three months ended November 30		Six months ended November 30	
	2009	2008	2009	2008
	\$	\$	\$	\$
OPERATING ACTIVITIES				
Net loss for the period	-1,010,630	-834,331	-1,581,160	-1,450,417
Add items not involving cash:				
Stock-based compensation charge	-	56,104	-	177,508
Amortization of property, plant and equipment	11,175	15,199	22,788	26,890
Amortization of intangible assets	46,625	-	93,250	-
Non-monetary compensation charge	-	10,808	-	17,500
Non-controlling interest	1,246	1,000	3,692	3,418
Changes in non-cash operating working capital				
Accounts receivable	-280,049	-462,616	-709,987	89,427
Contracts in progress	-	194,000	-	156,000
Inventories	73,516	-	49,446	-
Prepays and other assets	13,056	5,013	-12,500	-5,785
Accounts payable	1,722	64,412	-86,886	-1,506,401
Accrued liabilities	665,559	27,670	502,594	-219,418
Deferred revenue	-107,440	70,000	50,005	-314,908
Net cash used in operating activities	-585,220	-852,741	-1,668,758	-3,026,186
INVESTING ACTIVITIES				
Acquisition of Gardner Energy Management Limited	-53,535	-	-139,005	-5,411,394
Additions to property, plant and equipment	-4,261	-21,367	-26,600	-37,811
Net cash used in investing activities	-57,796	-21,367	-165,605	-5,449,205
FINANCING ACTIVITIES				
Decrease in bank loan	-307,136	-113,969	-439,405	-405,506
Lease payments received	28,446	44,574	116,143	108,245
Common shares issued (note 13)	-	-	-	14,900,400
Financing fees	-	-	-	-1,223,226
Net cash provided by financing activities	-278,690	-69,395	-323,262	13,379,913
Effect of exchange rate fluctuations on cash and cash equivalents	-4,795	367	-7,324	2,264
Increase (decrease) in cash and cash equivalents for the period	-926,501	-943,136	-2,164,949	4,906,786
Cash and cash equivalents, beginning of period	2,127,064	6,487,412	3,365,512	637,490
Cash and cash equivalents end of period	1,200,563	5,544,276	1,200,563	5,544,276
Interest paid	5,131	39,058	9,981	58,753
Shareholder loans to acquire shares	-	65,000	-	212,600
Fair value of options exercised transferred to capital stock	-	35,000	-	69,000
Fair value of warrants issued for financing fees	-	-	-	636,200

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, heat recovery systems and condensate return solutions.

2 GOING CONCERN

The Company incurred losses from operations in the quarters and six months ended November 30, 2009 and 2008.

There is significant doubt about the Company's ability to continue as a going concern. The Company's ability to realize its assets and discharge its liabilities depends on 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.

3 BASIS OF PRESENTATION AND ACCOUNTING CHANGES

The accompanying interim unaudited consolidated financial statements of Thermal Energy International Inc. have been prepared by management in accordance with Canadian generally accepted accounting principles applicable to interim consolidated financial statements and do not include all the information required for complete financial statements. The interim unaudited consolidated financial statements and accompanying notes should be read in conjunction with the audited consolidated financial statements and accompanying notes for the year ended May 31, 2009. These interim consolidated financial statements are also prepared in accordance with the accounting policies described in the Company's audited consolidated financial statements for the year ended May 31, 2009 except for the changes in accounting policies, and new accounting policies adopted and described below.

Goodwill and intangible assets

In February 2008, the CICA published Section 3064, "Goodwill and Intangible Assets" establishing 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.

The Company implemented this new standard in its first quarter of fiscal year 2010 but it had no effect on the financial statements for the quarter and six months ended November 30, 2009.

4 CASH AND CASH EQUIVALENTS

Cash equivalents consist of excess cash invested in money market funds.

	Nov 30, 2009	May 31, 2009
	\$	\$
Cash	404,652	224,597
Money market funds	795,911	3,140,915
	1,200,563	3,365,512

5 ACCOUNTS RECEIVABLE

	Nov 30, 2009	May 31, 2009
	\$	\$
Trade	1,703,322	1,046,272
Commodity taxes	9,219	17,994
Directors and Officers	18,459	125,078
Other	287,836	215,580
	2,018,836	1,404,924

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

6 INVENTORIES

	Nov 30, 2009	May 31, 2009
	\$	\$
Work in process	490,835	554,577

Partly finished product is purchased from suppliers and held in inventory pending finishing to the customers requirements.

7 PROPERTY, PLANT AND EQUIPMENT

	Nov 30, 2009		May 31, 2009	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
	\$	\$	\$	\$
Plant and equipment	70,283	58,965	70,283	56,537
Furniture and fixtures	108,623	96,718	108,623	95,147
Laboratory equipment	52,857	29,356	52,857	26,878
Computers	288,052	236,230	259,875	223,979
Software	33,213	28,629	33,213	24,568
Leasehold improvements	21,401	21,401	21,401	21,401
Foreign exchange adjustment	(1,577)			
	572,852	471,298	546,252	448,510
Accumulated amortization	(471,298)		(448,510)	
Net book value	101,554		97,742	

8 INTANGIBLE ASSETS

	Nov 30, 2009		May 31, 2009	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
	\$	\$	\$	\$
Trade names and trademarks	928,000	-	928,000	-
Non compete agreement	121,000	85,708	121,000	55,458
Industrial know-how	141,000	39,950	141,000	25,850
Designs and drawings	156,000	44,200	156,000	28,600
Customer relationships	333,000	94,350	333,000	68,383
	1,679,000	264,208	1,679,000	170,958
Accumulated amortization	(264,208)		(170,958)	
Net book value	1,414,792		1,508,042	

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

9 NET INVESTMENT IN LEASE

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

	Nov 30, 2009	May 31, 2009
	\$	\$
Total estimated minimum lease payments receivable	2,531,029	2,729,998
Less: unearned income	(644,308)	(727,134)
	1,886,721	2,002,864
Less: current portion	(226,867)	(332,579)
	1,659,854	1,670,285

The estimated minimum lease payments receivable represent the estimated monthly energy outputs of the leased asset and are based on assumptions regarding the efficiency of the asset, the operations of the plant in which it is located and penalty payments resulting from temporary plant shut-downs. The lease expires April 2014, at which time the customer has the option to purchase the asset for \$1.

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

	\$
2010	382,829
2011	560,400
2012	560,400
2013	560,400
2014	467,000
	2,531,029

Refer to Note 19 - FINANCIAL RISK OBJECTIVES AND POLICIES, AND FINANCIAL RISKS, Credit Risk

10 INVESTMENT IN JOINT VENTURE

The Company has entered into a partnership agreement on November 7, 2007 with two partners established under the laws of the Peoples Republic of China with the name of Thermal Energy International (Guangzhou) Ltd. in which the Company owns a 55% interest. The Joint Venture has been established to market, sell and install Thermal Energy International Inc.'s suite of products in China. The start-up capital required was \$200,000 CDN and each partner contributed their respective share during the year ended May 31, 2009.

The consolidated financial statements include the Company's proportionate share of the revenue, expenses, assets and liabilities of the joint venture as follows:

	Nov 30, 2009	Nov 30, 2008
	\$	\$
Current assets	96,222	-
Fixed assets	1,029	-
Current liabilities	25,599	-
Sales	42,976	-
Cost of sales	43,405	-
Adjustments to accrued expenses	(63,086)	-
Net profit	62,657	-

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

11 BANK LOANS

At November 30, 2009, the Company had two bank loans aggregating to \$229,682. The first loan has an authorized amount of \$2,500,000. At November 30, 2009 this loan, secured by accounts receivable and a general security agreement, with interest rate at prime plus 0.25%, amounted to \$158,667 (May 31, 2009 - \$408,667) and is guaranteed by the Export Development Corporation in an amount of USD \$215,540. Prime rate at November 30, 2009 was 2.25% (May 31, 2009 – 2.25%).

In accordance with the loan agreement, the Company is subject to certain loan covenants and must meet certain financial ratios. At November 30, 2009 not all financial covenants were met.

At November 30, 2009, the second loan amounted to \$71,015 (May 31, 2008 - \$260,420). It is secured by certain trade accounts receivable of a subsidiary and carries a service charge of 0.805% of the gross loan subject to a minimum annual charge of approximately \$30,000 and an interest rate of 1.95% over the LIBOR rate. At November 30, 2009 the LIBOR rate was 0.5% (May 31, 2009 0.5%).

12 RELATED PARTY TRANSACTIONS

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

	November 30, 2009	November 30, 2008
<hr/>		
Balances owing to/from directors		
Accounts receivable	-	\$38,500
Loans receivable, including accrued interest	\$188,438	\$369,447
Accrued liabilities	\$26,875	\$26,250
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Directors share options and warrants outstanding		
Issued	1,000,000	3,500,000
Exercisable	1,000,000	2,711,000
Warrants outstanding	25,000	37,500
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Balances owing from officers		
Accounts receivable	-	\$8,000
Loans receivable, including accrued interest	\$65,021	\$292,740
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Officers share options and warrants outstanding		
Issued	500,000	-
Exercisable	500,000	-
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Balances owing from shareholders		
Loans receivable, including accrued interest	\$656,155	\$292,606
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Transactions with directors and officers were as follows:		
Directors fees for services	\$20,437	\$31,500
Officers fees for services	\$38,500	\$66,000
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Shares issued to Directors	-	800,000
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THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

13 CAPITAL STOCK AND CONTRIBUTED SURPLUS

	Quarter Ended Nov 30, 2009	
	# 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 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	167,533,922	35,278,330
Less: loans outstanding to assist a shareholder in purchasing capital stock (iii)		(827,351)
Share issue costs		(1,903,200)
Balance, end of quarter	167,533,922	32,547,779

	Year to Date Nov 30, 2009		Year Ended May 31, 2009	
	# Shares	\$	# Shares	\$
Class A Common shares issued				
Balance, beginning of period	167,533,922	35,278,330	99,052,104	20,122,830
Issued in settlement of liabilities	-	-	50,000	17,500
Issued for loans (i)	-	-	430,000	94,600
Issued for cash	-	-	67,651,818	14,954,400
Issued as a result of the exercise of options for loans (ii)	-	-	350,000	89,000
	167,533,922	35,278,330	167,533,922	35,278,330
Less: loans outstanding to assist shareholders in purchasing capital stock (iii)		(827,351)		(827,351)
Share issue costs		(1,903,200)		(1,903,200)
Balance, end of period	167,533,922	32,547,779	167,533,922	32,547,779

(i) In fiscal 2009, shares were issued to shareholders for loans which resulted in a stock-based compensation charge of \$56,100.

(ii)	Quarter ended November 30		Year to date November 30	
	2009	2008	2009	2008
Loans to exercise options granted during the period				
Directors and officers	-	65,000	-	89,000

Shares issued as a result of the exercise of options for loans has resulted in stock-based compensation expense in the following amounts:

	Quarter ended November 30		Year to date November 30	
	2009	2008	2009	2008
Loans to exercise options granted during the period				
Directors and officers	-	18,100	-	24,100

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(iii) Repayments made on these loans during the quarter and six months ended November 30, 2009 and 2008 were \$nil.

	Loans to acquire shares	
	Nov 30, 2009	May 31, 2009
	\$	\$
President	-	124,647
Directors and Officers	235,000	402,800
Other shareholders	592,351	299,904
	827,351	827,351

Loans were extended to employees, shareholders, directors and officers to acquire shares of the Company through the exercise of options. These loans bear interest at a rate of 5% and mature at dates which range from 2 to 5 years from the date of issue. In certain instances, 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 before maturity, at which time the shares with an equivalent value to the repayment will be released to the borrower by the Company. The loans are secured by the share certificates.

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	
	Quarter ended Nov 30		Quarter ended Nov 30	
	2009	2008	2009	2008
Weighted average assumptions:				
Expected dividend	-	0%	-	-
Expected volatility	-	79%	-	-
Risk-free interest rate	-	2.50%	-	-
Expected option life in years	-	2.0	-	-

	Loans to exercise options		Loans to acquire shares	
	Year to date Nov 30		Year to date Nov 30	
	2009	2008	2009	2008
Weighted average assumptions:				
Expected dividend	-	0%	-	0%
Expected volatility	-	81%	-	82%
Risk-free interest rate	-	2.50%	-	2.50%
Expected option life in years	-	2.0	-	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 578,000 options to shareholders to purchase common shares at \$0.16 per share, based on Company performance and which will expire on December 20, 2009.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Warrants

(a) In fiscal 2009, the Company completed a private placement and as a result the agent was issued 5,236,363 transferable warrants, which have been valued at \$636,200. Activity in share purchase warrants was as follows:

	Year to date Nov 30, 2009		Year to date Nov 30, 2008	
	# Warrants	Weighted Average Exercise Price	# Warrants	Weighted Average Exercise Price
		\$		\$
Balance, beginning of period	6,753,863	0.28	8,788,501	0.40
Issued	-	-	5,236,363	0.22
Exercised	-	-	-	-
Expired	-	-	(1,249,084)	0.30
Balance, end of period	6,753,863	0.28	12,775,780	0.34

(b) The following table summarizes the status of warrants outstanding at November 30, 2009:

Warrants Outstanding	Exercise Price \$	Expiry Date
1,517,500	0.50	To December 7, 2009
5,236,363	0.22	To June 20, 2010
<u>6,753,863</u>		

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 quarter and six months ended November 30, 2008 had a vesting period of four months.

(a) Activity in stock options was as follows:

	Quarter Ended Nov 30, 2009		Quarter Ended Nov 30, 2008	
	# Options	Weighted Average Exercise Price \$	# Options	Weighted Average Exercise Price \$
Outstanding, beginning of quarter	5,325,000	0.20	5,875,000	0.22
Granted	-	-	250,000	0.25
Exercised	-	-	(250,000)	0.26
Forfeited	(400,000)	0.19	-	-
Expired	-	-	-	-
Outstanding, end of quarter	4,925,000	0.20	5,875,000	0.22
	Year to date Nov 30, 2009		Year to date Nov 30, 2008	
	# Options	Weighted Average Exercise Price \$	# Options	Weighted Average Exercise Price \$
Outstanding, beginning of period	5,325,000	0.20	5,857,143	0.21
Granted	-	-	625,000	0.30
Exercised	-	-	(450,000)	0.25
Forfeited	(400,000)	0.19	(57,143)	0.21
Expired	-	-	(100,000)	0.24
Outstanding, end of period	4,925,000	0.20	5,875,000	0.22
Number of options exercisable as at November 30	4,347,000		4,672,000	

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Options exercised during the periods were as follows:

	Quarter ended Nov 30, 2009		Quarter ended Nov 30, 2008	
	# shares	\$	# shares	\$
Employees	-	-	-	-
Directors	-	-	250,000	65,000
Consultants	-	-	-	-
	-	-	250,000	65,000

	Year to date Nov 30, 2009		Year to date Nov 30, 2008	
	# shares	\$	# shares	\$
Employees	-	-	200,000	48,000
Directors	-	-	250,000	65,000
Consultants	-	-	-	-
	-	-	450,000	113,000

In the six months ended November 30, 2008, 350,000 options were exercised in consideration of loans receivable of \$89,000 and 100,000 options were exercised for cash of \$24,000.

(b) The following options are outstanding and/or exercisable at November 30, 2009:

Number of Options Outstanding	Number of Options Exercisable	Exercise Price Per Share \$	Expiry Date
2,850,000	2,272,000	0.16	December 20, 2009
500,000	500,000	0.20	March 15, 2010
250,000	250,000	0.37	June 11, 2010
100,000	100,000	0.43	July 20, 2010
250,000	250,000	0.20	January 25, 2011
250,000	250,000	0.285	April 29, 2011
250,000	250,000	0.27	May 16, 2011
225,000	225,000	0.33	August 15, 2011
250,000	250,000	0.25	September 9, 2011
4,925,000	4,347,000		

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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:

	Quarter ended November 30		Year to date November 30	
	2009	2008	2009	2008
Expected dividend	-	0.00%	-	0.00%
Expected volatility	-	72%	-	76%
Risk-free interest rate	-	2.50%	-	2.50%
Expected option life in years	-	2.4	-	2.4

The weighted average fair value of options granted in the quarter and six months ended November 30, 2008 was \$0.11.

Stock-based compensation expense related to the issuance of stock option in fiscal 2009 was included in administration expense and is broken down as follows:

	Quarter ended November 30		Year to date November 30	
	2009	2008	2009	2008
Employees	-	56,104	-	116,088
Consultants	-	-	-	5,320
Shareholders	-	-	-	56,100

15 INFORMATION INCLUDED IN OPERATIONS

	Quarter ended Nov 30		Year to date Nov 30	
	2009	2008	2009	2008
	\$	\$	\$	\$
Interest expense	5,131	39,058	9,981	58,753

Research and development expense and selling, marketing and business development expense are presented net of government assistance of \$9,924 in the quarter ended November 30, 2009 (2008 - \$Nil) and \$18,870 in the six months ended November 30, 2009 (2008 - \$Nil).

16 PENSION PLAN

The Company contributes to a defined contribution pension plan for permanent employees of one of its subsidiaries. The Company matches employee contributions. The plan and its assets are held by independent managers. The pension charge represents contributions paid by the company and amounted to \$7,481 for the quarter ended November 30, 2009 (2008 - \$7,611) and \$11,735 for the six months ended November 30, 2009 (2008 - \$19,210).

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

17 SEGMENTED INFORMATION

In the quarters and six months ended November 30, 2009 and 2008 the Company operated in the energy conservation and environmental compliance (air) industry in North America and Europe 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 three retrofit technology lines – waste energy recovery solutions, air emission control solutions and condensate return system solutions. Assets are located in Canada and Europe.

The Company operates in three reportable segments, waste energy recovery systems, condensate return systems (GEM™), and Thermal-AUD™ financed projects whereby the Company finances the sale and installation of the product at the customer's facility and then leases the product back to the customer. These three reportable segments are detailed below:

	Waste energy recovery systems		Thermal-AUD™ Financed projects		GEM™	
	Quarter ended Nov 30		Quarter ended Nov 30		Quarter ended Nov 30	
	2009	2008	2009	2008	2009	2008
	\$	\$	\$	\$	\$	\$
Revenue from external customers	468,692	33,198	-	-	1,095,835	1,107,365
Inter-segment revenues	9,556	41,067	-	-	102,086	12,545
Segment loss (profit)	949,542	988,518	173,379	(14,327)	(112,291)	(139,860)

	Waste energy Recovery systems		Thermal-AUD™ Financed projects		GEM™	
	Year to date Nov 30		Year to date Nov 30		Year to date Nov 30	
	2009	2008	2009	2008	2009	2008
	\$	\$	\$	\$	\$	\$
Revenue from external customers	472,749	535,022	-	-	2,396,714	1,663,859
Inter-segment revenues	38,223	69,734	-	-	185,533	14,945
Segment loss (profit)	1,609,105	1,638,866	139,952	(56,953)	(167,897)	(131,496)
Total assets	3,915,387	7,731,770	1,912,371	2,134,033	7,765,181	6,908,641

	Quarter ended Nov 30, 2009	Nov 30, 2008	Year to Date Nov 30, 2009	Nov 30, 2008
	\$	\$	\$	\$
Reconciliation of loss to financial statements				
Total loss for reported segments	1,010,630	834,331	1,581,160	1,450,417
Net loss	1,010,630	834,331	1,581,160	1,450,417

	Nov 30, 2009	Nov 30, 2008
	\$	\$
Reconciliation of assets to financial statements		
Total assets for reported segments	13,592,939	16,774,444
Elimination of inter-segment receivables	2,712,560	2,153,681
Total assets	10,880,379	14,620,763

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

18 CAPITAL MANAGEMENT

The Company's objectives when managing capital is to safeguard the Company's ability to continue as a going concern and to maintain flexible capital structure for its projects for the benefit of its stakeholders. In the management of capital, the Company includes the components of shareholders' equity, excluding accumulated other comprehensive loss. The Company manages the capital structure and makes adjustments to it in light of changes in economic conditions and the risk characteristics of the underlying assets. To maintain or adjust the capital structure, the Company may attempt to issue new shares. Management reviews the capital structure on a regular basis to ensure that objectives are met.

The Company's share capital is not subject to external restrictions; however the Company's bank loans include certain loan covenant and certain financial ratios. The Company was not in compliance with all these covenant and ratios at November 30, 2009.

19 FINANCIAL RISK OBJECTIVES AND POLICIES, AND FINANCIAL RISKS

Market risk

Market risk is the risk that changes in market prices, such as interest rates and foreign exchange, will affect the Company's net earnings or loss or the value of its financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable limits, while maximising returns.

Interest rate risk

The Company has contracted short-term bank loans bearing floating rates of interest. These financial instruments expose the Company to risk in the event market interest rates fluctuate. These loans aggregated \$229,682 at November 30, 2009. Under the terms of the first loan agreement in the amount of \$158,667, it is expected that this loan will be fully retired within fiscal 2010. Any significant fluctuation in the interest rate during this period which would adversely affect the company is considered minimal. Any fluctuation in the interest rate on the second loan held by a subsidiary in the amount of \$71,015 is considered manageable.

Foreign exchange risk

The Company is exposed to foreign exchange risk as follows:

	November 30, 2009			May 31, 2009		
	US\$	£	Euros	US\$	£	Euros
Cash and cash equivalents	30,978	80,161	81,459	26,093	34,039	17,160
Accounts receivable	274,554	635,961	82,269	279,688	246,698	174,631
Inventories	-	267,329	-	-	300,254	11,337
Bank loans	-	40,931	-	-	69,967	86,563
Accounts payable	43,663	167,764	1,874	196,935	93,373	3,720
Accrued liabilities	-	316,891	38,661	-	144,964	19,042

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

The Company operates internationally with a subsidiary in the United Kingdom, a joint venture in China and operations in the United States. The Company incurs expenses and earns revenues in U.S. dollars, Euros and Chinese renminbi. The majority of the transactions are in U.S. dollars, GBP and Euros.

Credit risk

The financial instruments that potentially expose the Company to credit risk are accounts receivable, market funds and the net investment in lease. The risk associated with the lease arises from the client filing for protection from its creditors under the Companies' Creditors Arrangement Act. Although the Company has taken a \$180,000 provision against the accounts receivable balance related to this lease, it has made no provision against the Net Investment in Lease, as it is expected that a new lease agreement will be negotiated during the restructuring process.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

The continuity of the allowance for doubtful accounts is as follows:

	November 30, 2009	May 31, 2009
	\$	\$
Opening balance	60,000	30,000
Increase during the period	180,000	30,000
Closing balance	240,000	60,000

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. A bank loan in the amount of \$158,667 is expected to be retired in fiscal 2010. The Company continues to actively seek external financing to ensure it has the necessary funds to fulfill its obligations.

Fair value of financial instruments

The fair value of accounts receivable, accounts payables, accrued liabilities and bank loans approximate the carrying amounts given that they will mature shortly.

The fair value of money market fund is equivalent to the market value determined using the last bid price.

20 COMPARATIVE AMOUNTS

Certain fiscal 2009 amounts have been reclassified to conform with the current year's presentation.

21 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:

	\$
2010	61,700
2011	48,800
2012	47,900
2013	40,800
2014	3,600
Total	202,800

Additionally, on July 1, 2008 the Company acquired all of the issued and outstanding shares of Gardner Energy Management Limited of Bristol, England, a company engaged in the condensate return solutions business, for a total cash consideration of \$5,411,394, including acquisition costs. An additional payment of up to £1,300,000 may be made in cash and shares over a three-year period based on Gardner Energy Management Limited meeting certain performance targets. The liability for additional payments aggregated \$463,591 to November 30, 2009, was recorded as goodwill and brought the acquisition cost to \$5,874,985. \$324,586 was recorded in fiscal 2009, \$54,436 in the quarter ended August 31, 2009 and \$84,569 in the quarter ended November 30, 2009. This liability has been satisfied to November 30, 2009 by cash payments of \$392,156 and a provision in the accounts of \$71,435 as at November 30, 2009 (2008 - \$nil).

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

22 CONTINGENCY

As previously announced, the Company is defending a lawsuit brought by a former president. Among other things, the lawsuit alleges that the former president was wrongfully dismissed from his employment. Damages are claimed in the amount of \$4,000,000, plus an as yet undetermined value of share options, interest and legal costs. The Company has filed a statement of defence in response and has counterclaimed for \$5,400,000 in damages plus interest and costs. Two attempts have been made at a mediated settlement. Neither attempt has been successful. Although the lawsuit was commenced in October 2005, the plaintiff has yet to take the proceedings to the point of oral examinations for discovery. As a result, there is still much that is still unknown about the former president's case. Following the latest unsuccessful mediation in November 2009, the Company has recorded a charge of \$190,000 in its financial statements. This charge is intended to account for possible net liabilities resulting from the claim and the counterclaim.

The Company has received a Statement of Claim filed by a former acting CFO in the amount of approximately \$350,000 for wrongful dismissal and other damages related to services with the Company. The Company believes it has acted reasonably to date and intends to vigorously defend the claim.



SECOND QUARTER REPORT Period Ended November 30, 2009

MANAGEMENT DISCUSSION AND ANALYSIS

The following discussion explains material changes in the Corporation's financial condition and results of operations for the second quarter of Fiscal Year 2010, ended November 30, 2009. The quarterly financial statements constitute an integral part of the discussion and should be read in conjunction with these comments.

Description of Business

Thermal Energy International Inc. ("Thermal Energy" or the "Company") has established itself since 1991 as an innovative technology company providing custom energy and emission reduction solutions. Our award winning energy recovery, conservation and bioenergy solutions provide significant financial and environmental benefits to our customers.

Thermal Energy engages clients through a unique mix of process, energy, environmental, financial and other expertise combined with the best technology solutions and financial offerings. The Company's client can expect compelling returns and solutions with an excellent track record of longevity, proven reliability and performance.

More information on Thermal Energy can be found at www.thermalenergy.com. FLU-ACE®, THERMALONOX™, GEM® and DRY-REX™ are trademarks 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 second quarter ended November 30, 2009 were \$1,564,527, an increase of 37% compared with \$1,140,563 in 2008.

For the six months ended November 30, 2009 sales were \$2,869,463, up 30% compared to \$2,198,881 in Fiscal Year 2008.

Gross profit for the second quarter ended November 30, 2009 was \$854,989 (55%) compared with \$822,863 (72%) in 2008. The drop in gross margin on a comparative basis from the same period in 2008 was due to a lesser proportion of revenue coming from GEM sales. Sales of waste energy recovery products amounted to \$468,692 in the quarter compared to \$33,198 from the same period in 2008. Waste energy recovery products typically have lower gross margins than the GEM related thus reducing gross margin.

For the six months ended November 30, 2009 gross profit was \$1,869,966 (65%), up 38% compared to \$1,350,966 (61%) from the same period in 2008.



Expenses

Administration and Selling, Marketing and Business Development expenses in the second quarter ended November 30, 2009 totalled \$1,472,853, a decrease of \$2,536 or 0.1% from the \$1,475,389 incurred in 2008. Included in administration costs for the current quarter is a \$180,000 provision against the accounts receivable balance related to amounts owing pursuant to the Thermal-AUD™ financed contract, as the customer has filed for protection from its creditors under the Companies' Creditors Arrangement Act and collection of this account receivable is therefore considered doubtful at this time. Also included in administration costs for the current quarter is a \$190,000 provision intended to account for possible net liabilities resulting from a claim and a counterclaim with a former President of the Company. Excluding this \$190,000 provision and the \$180,000 provision related to amounts owing pursuant to the Thermal-AUD™ financed contract, administration, selling, marketing and business developments expenses for the second quarter ended November 30, 2009 decreased \$372,536 or 25% compared with the same period last year. This decrease was due to cost cutting measures that the Company undertook.

Legal expenses in the second quarter ended November 30, 2009 were \$38,727, compared with \$59,797 in 2008. 2008 costs included approximately \$22,000 in relation to the dismissal of an underperforming European Sales Person.

Audit fee expense in the second quarter ended November 30, 2009 was \$110,067 an increase of \$63,599, compared to \$46,468 incurred in 2008. The 2008 expense represented accrued costs for that year to date, however recent changes in the accounting rules now require reporting of the auditing expense upon receipt of the auditors invoice and not accrued as was the process followed in the past. The 2009 expense relates to the audit of the Fiscal Year 2009 financial statements which are higher than last year because the Fiscal Year 2009 audit includes a consolidation of Gardner Energy Management Ltd. and Thermal Energy International (Guangzhou) Ltd. and also required a valuation of intangible assets and goodwill as at May 31, 2009.

Insurance costs in the second quarter ended November 30, 2009 were \$38,534 an increase of \$4,379 compared to \$34,155 in 2008.

Amortization of property, plant and equipment was at \$11,175 in the second quarter ended November 30, 2009 compared with \$15,199 in 2008.

Amortization of intangible assets was \$46,625 in the second quarter ended November 30, 2009. The intangible assets were acquired with the purchase of GEM and amortization was first recognised in the Fiscal Year 2009 year-end financial statements.

Patent and Trademark maintenance costs were \$nil in the second quarter ended November 30, 2009, compared to \$14,730 in 2008. All Patent and Trademark costs incurred by the Company are expensed as incurred.

Research and Development costs were \$24,002 in the second quarter ended November 30, 2009, compared to \$83,407 in 2008. The decrease was primarily due to a stoppage of work related to the testing of the THERMALONOX™ technology in China. The costs were mainly for the testing of biomass material pertaining to the development of potential DRY-REX projects.



Interest and bank charges were \$12,363 in the second quarter ended November 30, 2009 compared with \$34,868 in 2008. This decrease was due to the significant decline in interest rates and the lower level of bank loans.

Foreign exchange loss on monetary assets and liabilities in the second quarter ended November 30, 2009 was \$11,641 compared with a gain of \$12,048 in 2008.

Interest revenue of \$41 in the quarter ended November 30, 2009 compared with \$31,306 in 2008. Declining interest rates and a lower level of short-term investments were the reason.

Finance revenue was \$21,535 in the second quarter ended November 30, 2009 from the THERMAL-AUD™ financed project, compared to \$64,465 in 2008. Invoicing pursuant to the THERMAL-AUD™ financed project was suspended in October 2009, as the customer has filed for protection from its creditors under the Companies' Creditors Arrangement Act.

Loss before income taxes and non-controlling interest for the second quarter ended November 30, 2009 was \$889,422, an increase of \$56,091 from the same period last year. Excluding the \$190,000 provision intended to account for possible net liabilities resulting from a claim and a counterclaim with a former President of the company and the \$180,000 provision related to amounts owing pursuant to the Thermal-AUD™ financed contract, the Loss before income taxes and non-controlling interest for the second quarter ended November 30, 2009 would have been \$519,422, an improvement of \$313,909 from the same period last year.

For the six months ended November 30, 2009 the loss before income taxes and non-controlling interest was \$1,457,506, a decrease of \$10,507 from the same period last year. Excluding the \$190,000 provision of intended to account for possible net liabilities resulting from a claim and a counterclaim with a former President of the company and the \$180,000 provision related to amounts owing pursuant to the Thermal-AUD™ financed contract, the loss before income taxes and non-controlling interest for the six months ended November 30, 2009 would have been \$1,087,506, an improvement of \$359,493 from the same period last year.

Provision for income taxes must be calculated for each Company within the Thermal Energy Group, in accordance with local tax legislation. The provision for the year to date relates to taxes against profits attributable to Gardner Energy Management Limited, based in the UK.

Net Loss was \$1,010,630 in the second quarter ended November 30, 2009 compared to a net loss of \$834,331 in 2008. Management continues to work hard to control overhead costs but its main focus at the present time is to leverage the sales of its proprietary technologies worldwide in a cost effective manner by continuing to develop a number of strategic alliances, cooperative partnerships, synergistic sales agencies and agreements with companies in all of its key markets.

Liquidity and Solvency

At November 30, 2009, the Company had working capital of \$2,156,069 compared to working capital of \$3,791,332 at May 31, 2009. The \$1,635,263 decrease in working capital is accounted for by a \$1,725,544 decrease in net cash (Cash and cash equivalents less Bank loans) and a \$90,281 increase in non-cash working capital (working capital excluding Cash and cash equivalents and Bank loans). Non-cash current assets increased by \$455,762, led



by a \$613,912 increase in accounts receivable. Non-cash current liabilities increased by \$365,481. The major changes include a decrease in accounts payable of \$122,345, an increase in accrued liabilities of \$443,919 and an increase in deferred revenue of \$43,907. The large increase in accrued liabilities includes taxation payable for the UK entity of \$119,962 on the current year profits, provisions for potential liabilities with former employees totalling \$248,050 plus accruals relating to the cost of equipment not yet invoiced by suppliers totalling \$209,256. Offsetting these increases was a decrease in GEM earn-outs payable of \$253,151.

For the quarter ending November 30, 2009 the Company's net cash (Cash and cash equivalents less Bank loans) position decreased by \$619,365 to \$970,881.

Management continues to recognize the requirement to maintain liquidity in order to continue as a going concern, and as a result is aggressively working to increase sales, reduce costs and manage working capital.

Related Party Transactions

As at November 30, 2009, loans to Directors and Officers to exercise options and acquire shares were \$235,000 (\$527,447 as at May 31, 2009) and to Shareholders \$592,351 (\$299,904 as at May 31, 2009). Accrued interest on these loans stood at \$18,459 on loans to Directors and Officers as at November 30, 2009 (\$38,652 as at May 31, 2009) and \$63,803 on loans to Shareholders (\$22,038 as at May 31, 2009)

SEGMENTED INFORMATION

In the quarters ended November 30, 2009 and 2008 the Company operated in the energy conservation and environmental compliance (air) industry in North America and Europe 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 product lines – waste energy recovery solutions and condensate return system solutions. Assets are located in Canada, Europe and China.

The Company operates in three reportable segments, waste energy recovery systems, condensate return systems (GEM™), and Thermal-AUD™ financed projects whereby the Company finances the sale and installation of the product at the customer's facility and then leases the product back to the customer. These three reportable segments are detailed below:

	Waste Energy Recovery Systems		Thermal -AUD™ Financed Projects		GEM™	
	Quarter ended Nov 30 2009	Nov 30 2008	Quarter ended Nov 30 2009	Nov 30 2008	Quarter ended Nov 30 2009	Nov 30 2008
	\$	\$	\$	\$	\$	\$
Revenue from external customers	468,692	33,198	-	-	1,095,835	1,107,365
Inter-segment revenues	9,556	41,067	-	-	102,086	12,545
Segment loss (profit)	949,542	988,518	173,379	(14,327)	(112,291)	(139,860)
Total assets	3,915,387	7,731,770	1,912,371	2,134,033	7,765,181	6,908,641



	Quarter ended Nov 30, 2009 \$	Quarter ended Nov 30, 2008 \$
Reconciliation of loss to financial statements		
Total loss for reported segments	1,010,630	834,331

The following table shows selected consolidated financial data for the most recent eight quarters. The quarterly information has been prepared on the same basis as the consolidated financial statements.

Quarterly financial information (unaudited)
For the eight quarters ended November 30, 2009

	2008		2009				2010	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Sales	509,074	2,750,487	1,058,318	1,140,563	682,341	1,077,700	1,304,936	1,564,527
Net Loss	569,794	521,388	616,086	834,331	1,181,735	573,225	570,530	1,010,630
Net loss per share basic and diluted	0.006	0.005	0.004	0.005	0.007	0.003	0.003	0.006

Trend Analysis:

The losses in Q3 Fiscal Year 2008 were consistent with previous quarters.

Q4 2008 saw losses of \$521,388. This level of losses was consistent with previous quarters, but was based on a higher level of revenue. Revenue of \$2,750,487 included the recognition of the Fraser Papers Canada Thurso mill sale. Although this sale generated a profit, losses were suffered on the Philips project, resulting in a gross profit of just 13%. In addition, legal costs of \$262k relating to the purchase of GEM and litigation with the former CEO inflated SGA costs.

The losses in Q1 Fiscal Year 2009 increased to \$616,086. Gross margins were much improved but were more than offset by increases in the major areas of administration and sales and marketing and increases in R&D expenditures for equipment related to testing the THERMALONox® technology. Expenses were impacted on a comparative basis by the acquisition of GEM on 1st July 2008.

The losses in Q2 Fiscal Year 2009 increased to \$834,331. Gross margins were improved from the previous quarter but were more than offset by increases in the major areas of administration and sales and marketing and increases in R&D expenditures related to testing the THERMALONox® technology in China. Expenses were impacted to a greater degree from the first quarter on a comparative basis by the acquisition of GEM.



Q3 Fiscal Year 2009 illustrated the impact of the global recession, with revenue down significantly on prior quarters. As a result, despite cost reductions elsewhere, losses increased to \$1,181,735.

Q4 Fiscal Year 2009 saw an improvement in sales despite the continuing recession. This, combined with further reduced costs, brought the losses back down to \$573,225 for the quarter.

Despite a further increase in sales in Q1 Fiscal Year 2010, at \$570,530 losses barely changed from the previous quarter. The additional \$297,987 gross profit was offset mainly by legal fees relating to the TSXV review and new distributor agreement with Kemco Systems (\$84,185), four additional staff in the UK office (three from European Kemco operations plus a new sales person for the UK) plus an increase in travel costs within US.

The losses in Q2 2010 increased to \$1,010,630, again despite an increase in revenue. The increase in revenue resulted from sales of Kemco products, which attract lower margins than GEM Traps. In addition, provisions for potential liabilities with the former employees totalling \$248,050 were made in the current quarter, as well as a \$180,000 provision related to amounts owing pursuant to the Thermal-AUD™ financed contract.

In summary, other than Q3 and Q4 2009, in which the effects of the poor economic climate were most greatly felt, revenue has been steadily climbing. Losses, however, have fluctuated inconsistently, as detailed above. This demonstrates the need to significantly increase sales to cover and exceed the amount of fixed costs in order to overcome the consistent pattern of losses.

Outlook

On December 22, 2009, the Corporation announced the receipt of a Statement of Claim filed by former acting CFO, Mr. Oliver Toffoli in the amount of approximately \$350,000 for wrongful dismissal and other damages related to Mr. Toffoli's services with the company. Thermal Energy believes it has acted reasonably to date and intends to vigorously defend the claim.

On December 23, the Corporation announced the receipt of a non-binding purchase order for approximately \$4 million from Kruger Products Limited, a subsidiary of Kruger Inc., to provide a FLU-ACE® heat recovery solution for its tissue mill operations located in Gatineau, Quebec

Critical Accounting Estimates

As previously announced, the Company is defending a lawsuit brought by a former president. Among other things, the lawsuit alleges that the former president was wrongfully dismissed from his employment. Damages are claimed in the amount of \$4 million, plus an as yet undetermined value of share options, interest and legal costs. The Company has filed a statement of defence in response and has counterclaimed for \$5.4 million in damages plus interest and costs. Two attempts have been made at a mediated settlement. Neither attempt has been successful. Although the lawsuit was commenced in October, 2005, the plaintiff has yet to take the proceeding to the point of oral examinations for discovery. As a result, there is much that is still unknown about the former president's case. Following the



latest unsuccessful mediation in November, 2009, the Company has recorded a charge of \$190,000 in its financial statements. This charge is intended to account for possible net liabilities resulting from the claim and the counterclaim.

As at November 30, 2009, the financial statements of the Company are showing total assets of \$1,886,721 as Net Investment in Lease with a party that has filed for protection from its creditors under the Companies' Creditors Arrangement Act. Although the Company has taken a \$180,000 provision against the accounts receivable balance related to this lease, it has made no provision against the Net Investment in Lease, as it is expected that a new lease agreement will be negotiated during the restructuring process.

Changes in Accounting Policies

On February 13, 2008, the Accounting Standards Board confirmed that the use of International Financial Reporting Standards ("IFRS") will be required for Fiscal Years beginning on or after January 1, 2011 for publicly accountable profit-oriented enterprises. After that date, IFRS will replace Canadian GAAP for those enterprises. While IFRS is based on a conceptual framework similar to Canadian GAAP, there are significant differences with respect to recognition, measurement and disclosures. The Company is in the process of developing a plan for the implementation of IFRS and will assess the impact of the differences in accounting standards on the Company's consolidated financial statements. It is not possible to quantify the impact of these differences at this time. The Company expects to make changes to processes and systems before the 2012 Fiscal Year, in time to enable the Company to record transactions under IFRS. Training and additional resources will be utilized to ensure timely conversion to IFRS.

Summary of Outstanding Shares

The Company currently has 167,533,922 common shares issued and outstanding.