



Independent Auditor's Report

To the Shareholders of
Thermal Energy International Inc.

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We have audited the accompanying consolidated financial statements of Thermal Energy International Inc., which comprise the consolidated statements of financial position as at May 31, 2013 and 2012 and the consolidated statements of comprehensive income, the consolidated statements of changes in equity and the consolidated statements of cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards (IFRS) and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Thermal Energy International Inc. as at May 31, 2013 and 2012 and its financial performance and its cash flows for the years then ended in accordance with International Financial Reporting Standards (IFRS).

Raymond Chabot Grant Thornton LLP

Chartered Accountants,
Licensed Public Accountants

Ottawa, Canada
September 13, 2013

THERMAL ENERGY INTERNATIONAL INC.

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
(EXPRESSED IN CANADIAN DOLLARS)

As at	May 31, 2013 \$	May 31, 2012 \$
ASSETS		
Current assets		
Cash and cash equivalents (Note 4)	1,304,395	1,371,951
Trade and other receivables (Note 5)	1,113,846	3,434,146
Current tax receivable	95,129	-
Inventory (Note 6)	367,906	439,493
Finance lease receivable (Note 7)	761,404	512,496
	3,642,680	5,758,086
Non-current assets		
Finance lease receivable (Note 7)	585,197	-
Property, plant and equipment (Note 8)	45,470	70,324
Other intangible assets (Note 9)	593,784	838,356
Goodwill (Note 10)	1,112,665	3,307,389
Deferred tax asset (Note 22)	52,700	-
	2,389,816	4,216,069
Total assets	6,032,496	9,974,155
LIABILITIES		
Current liabilities		
Trade payables (Note 12)	681,656	1,017,557
Current tax liabilities	57,517	94,215
Pensions and other employer obligations	96,790	86,033
Other liabilities (Note 13)	643,453	1,074,778
Deferred revenue (Note 14)	396,243	703,056
Provisions (Note 15)	215,000	215,000
	2,090,659	3,190,639
Non-current liabilities		
Deferred tax liabilities (Note 22)	118,757	217,667
Total liabilities	2,209,416	3,408,306
EQUITY		
Capital stock (Note 16)	33,136,184	33,136,184
Contributed surplus	2,630,866	2,477,889
Accumulated other comprehensive income	168,788	214,096
Deficit	(32,119,274)	(29,294,251)
Equity attributable to owners of the parent	3,816,564	6,533,918
Non-controlling interest	6,516	31,931
Total equity	3,823,080	6,565,849
Total liabilities and equity	6,032,496	9,974,155

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

On behalf of the Board

President and C.E.O.

Director

THERMAL ENERGY INTERNATIONAL INC.

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(EXPRESSED IN CANADIAN DOLLARS)**

Years ended May 31	2013 \$	2012 \$
Sales (Note 19)	8,210,234	13,152,687
Cost of sales	3,232,782	7,504,316
Gross profit	4,977,452	5,648,371
Expenses:		
Administration	2,668,693	2,651,725
Selling, marketing and business development	2,968,699	2,967,865
Research and development	184,388	8,455
	5,821,780	5,628,045
Operating income (loss) before impairment	(844,328)	20,326
Impairment of goodwill (Note 10)	(2,166,000)	-
Impairment of intangible assets (Note 9)	(139,000)	-
Operating income (loss)	(3,149,328)	20,326
Finance revenue (Note 19)	108,456	102,956
Income (loss) before income taxes	(3,040,872)	123,282
Income taxes (expense) recovery (Note 22)	192,050	(38,551)
Net income (loss) for the year	(2,848,822)	84,731
Other comprehensive income (loss) for the year		
Exchange differences arising on translation of overseas operations	(46,924)	(13,665)
Total comprehensive income (loss) for the year	(2,895,746)	71,066
Net income (loss) for the period attributable to:		
Owners of the parent	(2,825,023)	101,429
Non-controlling interest	(23,799)	(16,698)
Net income (loss) for the year	(2,848,822)	84,731
Total comprehensive income (loss) for the year attributable to:		
Owners of the parent	(2,870,331)	87,544
Non-controlling interest	(25,415)	(16,478)
Total comprehensive income (loss) for the year	(2,895,746)	71,066
Net income (loss) per share - basic and diluted (Note 23)	(0.017)	0.001

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

THERMAL ENERGY INTERNATIONAL INC.

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY
(EXPRESSED IN CANADIAN DOLLARS)

	Capital Stock \$	Contributed Surplus \$	Deficit \$	Accumulated Other Comprehensive Income \$	Total Attributable to Owners of the Parent \$	Non -controlling Interest \$	Total Equity \$
Balance at June 1, 2011	33,148,184	2,354,784	(29,373,653)	227,981	6,357,296	48,409	6,405,705
Interest on cancelled loans			(22,027)		(22,027)		(22,027)
Cancelled shares	(12,000)				(12,000)		(12,000)
Stock-based compensation (Note 18)		123,105			123,105		123,105
Transactions with owners	(12,000)	123,105	(22,027)	-	89,078	-	89,078
Net income (loss) for the year			101,429		101,429	(16,698)	84,731
Other comprehensive income: exchange differences arising on translation of overseas operations				(13,885)	(13,885)	220	(13,665)
Total comprehensive income (loss) for the year	-	-	101,429	(13,885)	87,544	(16,478)	71,066
Balance at May 31, 2012	33,136,184	2,477,889	(29,294,251)	214,096	6,533,918	31,931	6,565,849
Balance at June 1, 2012	33,136,184	2,477,889	(29,294,251)	214,096	6,533,918	31,931	6,565,849
Stock-based compensation (Note 18)		152,977			152,977		152,977
Transactions with owners	-	152,977	-	-	152,977	-	152,977
Net loss for the year			(2,825,023)		(2,825,023)	(23,799)	(2,848,822)
Other comprehensive income: exchange differences arising on translation of overseas operations				(45,308)	(45,308)	(1,616)	(46,924)
Total comprehensive loss for the year	-	-	(2,825,023)	(45,308)	(2,870,331)	(25,415)	(2,895,746)
Balance at May 31, 2013	33,136,184	2,630,866	(32,119,274)	168,788	3,816,564	6,516	3,823,080

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

THERMAL ENERGY INTERNATIONAL INC.

**CONSOLIDATED STATEMENT OF CASH FLOWS
(EXPRESSED IN CANADIAN DOLLARS)**

	Year ended May 31	
	2013	2012
	\$	\$
OPERATING ACTIVITIES		
Net income (loss) for the year	(2,848,822)	84,731
Add items not involving cash:		
Stock-based compensation (Note 18)	152,977	123,105
Depreciation of property, plant and equipment	45,623	45,851
Amortization of intangible assets	98,295	99,126
Deferred income taxes (recovery)	(151,610)	(58,332)
Write-down of financial lease receivable	-	54,758
Unrealized foreign exchange and translation adjustments	(10,923)	(2,534)
Impairment of goodwill and intangible assets	2,305,000	
Net investment in finance lease	(1,546,318)	-
Other non-cash equity items	-	(34,027)
Changes in working capital :		
Trade and other receivables	2,320,300	(1,582,769)
Income tax receivable	(95,129)	-
Inventory	71,587	(18,494)
Trade payables	(335,901)	399,436
Deferred revenue	(306,813)	359,357
Other liabilities	(457,266)	414,587
Net cash provided (used) in operating activities	(759,000)	(115,205)
INVESTING ACTIVITIES		
Finance lease payments received	712,213	554,076
Additions to property, plant and equipment	(21,078)	(41,599)
Net cash provided by investing activities	691,135	512,477
(Decrease) increase in cash and cash equivalents for the year	(67,865)	397,272
Cash and cash equivalents, beginning of year	1,371,951	972,163
Exchange differences on cash and cash equivalents	309	2,516
Cash and cash equivalents, end of year	1,304,395	1,371,951

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

Supplemental information related to operating activities:

Income taxes paid	81,311	118,850
Interest paid	3,982	3,169
Interest received	54	149

Non-cash supplemental information:

Interest on cancelled shareholder loans	-	22,027
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THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

For the years ended May 31, 2013 and 2012

(Expressed in Canadian Dollars)

1. NATURE OF OPERATIONS AND GOING CONCERN

Thermal Energy International Inc. (the "Company" or the "parent") 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. The parent company's common shares are listed on the TSX Venture Exchange ("TSX.V") under the symbol TMG. The primary office is located at 36 Bentley Avenue, Ottawa, Ontario, Canada, K2E 6T8.

These audited consolidated financial statements were approved and authorized for issue by the Board of Directors on September 16, 2013. The consolidated financial statements comprise the financial results of the parent and its subsidiaries (collectively known as "the Company") for the years ended May 31, 2013 and 2012.

The consolidated 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. The Company incurred a loss in the year ended May 31, 2013 and has significant accumulated deficits at the year ended May 31, 2013.

There is 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.

Management is concentrating on building upon the revenue growth experienced in years FY 2010 through to FY 2012 and continuing to manage expenditures in order to produce positive cash flows from operations in order to meet the Company's obligations. The Company earned an income from operations in the year ended May 31, 2012. Although the Company experienced a decrease in revenue and a consequent loss in FY 2013, orders received to date expected to be recognized as revenue in FY 2014 indicates that this was an anomaly caused by timing of projects. Consequently, management is of the opinion that there is no significant doubt concerning the Company's ability to continue as a going concern. Statements about the expected timing of revenue recognition and management's expectations about the Company's ability to continue as a going concern are forward looking statements. These statements are not guarantees of future performance and involve a number of risks, uncertainties and assumptions. Many factors, some of which are outside of the Company's control, could cause events and results to differ materially from those stated. The Company's ability to deliver against orders received to date and the recognition of the revenue associated with those orders could be postponed or delayed for a number of reasons or such orders could be cancelled or revised.

These consolidated 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.

2. SUMMARY OF ACCOUNTING POLICIES

2.1. Statement of compliance with IFRS and basis of presentation

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") that are in effect at May 31, 2013 using the historical cost method.

2.2. Basis of consolidation

The consolidated financial statements incorporate the financial statements of the parent, which is the ultimate parent, and its subsidiaries. Subsidiaries are consolidated from the date on which the Company obtains control, and continue to be consolidated until control ceases. Control is established when the Company has the power to govern the financial and operating policy decisions of the entity, and generally exists when more than 50% of the voting power of the entity is held by the Company or where the Company has the ability to determine the strategic, operating, investing and financing policies of a company without the co-operation of others. The financial statements of the subsidiaries are prepared using consistent accounting policies and all material inter-company transactions are eliminated in full upon consolidation.

Where the ownership of a subsidiary is less than 100% and a non-controlling interest thus exists, any losses of that subsidiary are attributed to the owners of the parent and to the non-controlling interest even if that results in the non-controlling interest having a deficit balance. Non-controlling interest presented as part of equity represents the portion of a subsidiary's net income or loss and net assets that are not held by the Company. The Company attributes total comprehensive income (loss) of subsidiaries between the owners of the parent and the non-controlling interests based on their respective ownership interests. A change in the ownership interest of a subsidiary, without a loss of control, is accounted for as an equity transaction.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

For the years ended May 31, 2013 and 2012

(Expressed in Canadian Dollars)

The following subsidiaries have been consolidated within the consolidated financial statements:

Name of subsidiary	Place of incorporation	Ownership interest	Functional currency	Principal activity
ForEverGreen Energy Inc. ⁽¹⁾	Ontario, Canada	100%	CAD	Finance leasing
2003356 Ontario Inc.	Ontario, Canada	100%	CAD	Non-operating
2153639 Ontario Inc.	Ontario, Canada	100%	CAD	Holding company
Thermal Energy International (UK) Ltd. ⁽²⁾	United Kingdom	100%	GBP	Manufacture and sale of condensate return solutions and sale of heat recovery solutions
Thermal Energy International Corporation	Delaware, U.S.	100%	USD	Non-operating
Thermal Energy International (Guangzhou) Ltd.	Guangzhou, China	55%	Chinese Renminbi	Sale of heat recovery and condensate return solutions

⁽¹⁾ ForEverGreen Energy Inc. was wound up to the Canadian parent company on May 31, 2013. All assets and liabilities of ForEverGreen Energy Inc. were transferred to the parent company prior to the wind-up.

⁽²⁾ Formerly Gardner Energy Management Ltd., Thermal Energy International (UK) Ltd owns 67% of GEMchem Ltd., a company incorporated in the United Kingdom.

All subsidiaries have a reporting date of May 31.

2.3. Business combinations

The Company measures goodwill as the fair value of the consideration transferred including any contingent consideration to be transferred and the recognized amount of any non-controlling interest in the acquired entity, less the net recognized amount of the fair value of the identifiable assets acquired and liabilities assumed, all measured as of the acquisition date. When the excess is negative, a bargain purchase gain is recognized immediately in profit or loss. The Company elects on a transaction-by-transaction basis whether to measure non-controlling interest at fair value or at their proportionate share of the recognized amount of the identifiable net assets at the acquisition date. If the business combination is achieved in stages, the acquisition date fair value of the previously held interest in the acquired entity is re-measured to fair value as at the acquisition date through profit or loss. Transaction costs, other than those associated with the issue of debt or equity securities that the Company incurs in connection with a business combination, are expensed as incurred.

2.4. Functional currency and foreign currency translation

These consolidated financial statements are presented in Canadian dollars, which is the functional currency of the parent. The functional currency of each entity consolidated with the Company is determined by the currency of the primary economic environment in which it operates.

In preparing the financial statements of the individual entities, transactions in currencies other than the entity's functional currency are recognized at the rates of exchange prevailing at the dates of the transactions. At the end of each reporting period: monetary assets and liabilities denominated in foreign currencies are translated at the rates of exchange prevailing at that date; non-monetary assets and liabilities carried at fair value that are denominated in foreign currencies are retranslated at the rates of exchange prevailing at the date when fair value was determined; and non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are not retranslated. Such exchange differences arising from translation at period-end are recognized in profit or loss.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the end of each reporting period. These exchange differences are recognized in accumulated other comprehensive income or loss.

Foreign operations are translated from their functional currencies into Canadian dollars on consolidation by applying the exchange rates prevailing at the end of the reporting period for assets and liabilities and the average exchange rate for the period for consolidated statements of comprehensive income items. Such exchange differences, including differences that arise relating to long-term inter-company balances that form part of the net investment in the foreign operation, are recognized in other comprehensive income or loss. On disposal of a foreign entity, the related cumulative translation differences recognized in equity are reclassified to profit or loss and are recognized as part of the gain or loss on disposal.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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(Expressed in Canadian Dollars)

2.5. Segment reporting

In identifying its operating segments, management generally follows the Company's key geographical areas, which reflect the business of the Company's two main operating units in Ottawa, Canada and Bristol, UK. In determining its reportable segments, the Company considers qualitative factors, such as operations which are considered to be significant by management, as well as quantitative factors, so that material revenues and expenses are appropriately disclosed. Management considers assets and liabilities on a global basis, and does not assess on a segment basis. The reportable segments' financial results are reviewed quarterly by senior management and the Board. Corporate and other costs which are not easily attributable to any particular operating segment are separately disclosed within reconciling items.

The two main operating units are as follows:

- North America and China, managed from the Ottawa office.
- Europe and rest of world, managed from the Bristol office.

Reconciling items comprise corporate administration costs, stock-based compensation, professional fees, depreciation of property, plant and equipment, bank charges and interest and foreign exchange differences. Corporate administration costs include employment costs of the Chief Executive Officer and Chief Finance Officer, directors' fees, directors and officers' liability insurance, and shareholder and investor services expenses.

2.6. Cash and cash equivalents

Cash and cash equivalents in the consolidated statements of financial position comprise cash at banks and on hand, and highly liquid investments with an original maturity of three months or less, and which are readily convertible into a known amount of cash and which are subject to an insignificant risk of change in value.

2.7. Inventories

Inventories are valued at the lower of cost and net realizable value. Cost is determined by the first in, first out method and includes all direct costs and an appropriate proportion of fixed and variable overheads where applicable. Net realizable value is the estimated selling price in the ordinary course of business, less the estimated selling costs.

2.8. Leases

(i) The Company as a lessor – finance leases

Finance leases are those where substantially all of the benefits and risks of ownership of the equipment are transferred to the customer. Sales revenue recognized at the inception of the lease represents the fair value of the asset or, if lower, the present value of the minimum lease payments, net of any executory costs and related profit included therein, computed at the market rate of interest. The cost of sale recognized at the commencement of the lease term is the cost, or carrying amount if different, of the leased property less the present value of the unguaranteed residual value. Unearned finance income, effectively the difference between the total minimum lease payments adjusted for executory costs and the aggregate present value, is deferred and presented as finance lease receivable in the consolidated statements of financial position. Finance lease income is allocated to accounting periods over the lease term so as to reflect a constant periodic rate of return on the Company's net investment in the lease.

Finance leases receivable are measured at total estimated minimum lease payments receivable, net of estimated expected finance revenue. Finance leases receivable are assessed for recoverability at each period end. Any indication of impairment of the net investment in lease will result in a write-down to the revised estimated recoverable amount. Indications that a finance lease receivable may be impaired include customers experiencing significant financial difficulties, the increasing possibility of a customer going bankrupt or undergoing a financial restructuring and payment default or delays.

(ii) The Company as a lessee

The economic ownership of a leased asset is transferred to the lessee whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the lessee. The related asset is then recognized at the inception of the lease at the fair value of the leased asset or, if lower, the present value of the lease payments plus incidental payments, if any. A corresponding amount is recognized as a finance leasing liability, irrespective of whether some of these lease payments are payable up-front at the date of inception of the lease. The corresponding finance leasing liability is reduced by lease payments less finance charges, which are expensed as part of administrative expenses. The interest

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element of leasing payments represents a constant proportion of the capital balance outstanding and is charged to profit or loss over the period of the lease.

All other leases are classified as operating leases. Payments on operating lease agreements are recognized as an expense on a straight line basis over the lease term. Associated costs, such as maintenance and insurance, are expensed as incurred.

2.9. Property, plant and equipment

Property, plant and equipment are initially recognized at acquisition cost and are subsequently carried at cost less accumulated depreciation and accumulated impairment losses. Subsequent costs of replacing components are recognized only if it is probable that future economic benefits embodied within the component will flow to the Company, and its cost can be measured reliably. The carrying amount of the replaced component is derecognized. The cost of other replacement parts and general servicing of property, plant and equipment is recognized immediately in profit or loss.

Depreciation is computed using the following annual rates and methods which reflect the estimated useful life of the assets less estimated residual value:

Plant and equipment	5 years straight-line
Furniture and fixtures	5 years straight-line
Laboratory equipment	5 years straight-line
Computers	3 years straight-line
Leasehold improvements	3 years straight-line
Motor vehicles	4 years straight-line

Depreciation methods, useful lives and residual values are reviewed at each reporting period and adjusted if appropriate. In the case of assets held under finance leases, expected useful lives are determined by reference to comparable owned assets or over the term of the lease, if shorter. Depreciation and impairment charges are included within administrative expenses.

2.10. Other intangible assets

Intangible assets were acquired at the fair value with the acquisition of Gardner Energy Management on July 1, 2008 and are reported at cost less accumulated amortization and accumulated impairment loss, if any. Amortization is computed using the following rates and methods which reflect the estimated useful life of the assets:

Trade names and trademarks	indefinite life
Non-compete agreements	2 years straight-line
Industrial know-how	5 years straight-line
Designs and drawings	5 years straight-line
Customer relationships	5 years straight-line

Amortization methods, useful lives and residual values are reviewed at each reporting period and adjusted if appropriate. Other intangible assets with indefinite lives are subject to annual impairment testing. See Note 2.12 for a description of impairment testing procedures.

The indefinite life intangible assets represent the GEM[®] Trademark and Trade name, which are used to set the product apart from those of competitors producing traditional mechanical steam traps. Management considers the reputation of the GEM product as continuing to strengthen and cannot be assigned a finite life after which it will have no value.

Amortization is included within administrative expenses.

2.11. Goodwill

Goodwill represents the future economic benefits arising from a business combination that are not individually identified and separately recognized. See Note 2.3 for information on how goodwill is initially determined. Goodwill is carried at cost less accumulated impairment losses. See Note 2.12 for a description of impairment testing procedures. Impairment losses on goodwill are not reversed.

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(Expressed in Canadian Dollars)

2.12. Impairment testing of goodwill, other intangible assets and property, plant and equipment

For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are largely independent cash inflows (cash-generating units). As a result, some assets are tested individually for impairment and some are tested at cash-generating unit level. Goodwill is allocated to those cash-generating units that are expected to benefit from synergies of the related business combination and represent the lowest level within the Company at which management monitors goodwill.

Cash-generating units to which goodwill has been allocated and intangible assets with indefinite useful lives are tested for impairment at least annually. All other individual assets or cash-generating units are tested for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable.

An impairment loss is recognized for the amount by which the asset's or cash-generating unit's carrying amount exceeds its recoverable amount, which is the higher of fair value less costs to sell and value-in-use. To determine the value-in-use, management estimates expected future cash flows from each cash-generating unit and determines a suitable interest rate in order to calculate the present value of those cash flows. The data used for impairment testing procedures are directly linked to the Company's latest approved budget. Discount factors are determined individually for each cash-generating unit and reflect their respective risk profiles as assessed by management.

Impairment losses for cash-generating units reduce first the carrying amount of any goodwill allocated to that cash-generating unit. Any remaining impairment loss is charged pro rata to the other assets in the cash-generating unit. With the exception of goodwill, all assets are subsequently reassessed for indications that an impairment loss previously recognized may no longer exist. An impairment charge is reversed if the cash-generating unit's recoverable amount exceeds its carrying amount.

2.13. Provisions, contingent liabilities and contingent assets

Provisions are recognized when present obligations as a result of a past event will probably lead to an outflow of economic resources from the Company and amounts can be estimated reliably. Timing or amount of the outflow may still be uncertain. A present obligation arises from the presence of a legal or constructive commitment that has resulted from past events, for example, product warranties granted, legal disputes or onerous contracts. Provisions are not recognized for future operating losses.

Provisions are measured at the estimated expenditure required to settle the present obligation, based on the most reliable evidence available at the reporting date, including the risks and uncertainties associated with the present obligation. Where there are a number of similar obligations, the likelihood that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Provisions are discounted to their present values, where the time value of money is material.

Any reimbursement that the Company can be virtually certain to collect from a third party with respect to the obligation is recognized as a separate asset. However, this asset may not exceed the amount of the related provision.

All provisions are reviewed at each reporting date and adjusted to reflect the current best estimate.

In those cases where the possible outflow of economic resources as a result of present obligations is considered improbable or remote, no liability is recognized, unless it was assumed in the course of a business combination.

Warranties

The Company guarantees its condensate return solution product against defects for ten years and does not offer extended warranties. A provision for warranty expense is recorded when the revenue for the related product is recognized. The provision is based upon the terms of the warranty, the Company's historical experience and management estimates of future expense for replacement or repairs. The provision is recorded in cost of sales.

2.14. Equity

Capital stock represents the amount received on the issue of shares, less share issue expenses, net of any underlying income tax benefit from the issuance costs.

Contributed surplus includes charges related to stock options and warrants. When stock options and warrants are exercised, the related compensation cost is transferred to capital stock.

Deficit includes all current and prior period retained losses.

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(Expressed in Canadian Dollars)

Accumulated other comprehensive income or loss represents foreign currency translation differences arising on the translation of the Company's foreign subsidiaries, net of income taxes.

All transactions with owners of the parent are recorded separately in equity.

Issuance of flow-through shares represents in substance an issue of ordinary shares and the sale of the right to tax deductions to the investors. When the flow-through shares are issued, the sale of the right to tax deductions is deferred and presented as other liabilities in the consolidated statements of financial position. The proceeds received from flow-through placements are allocated between capital stock and the liability using the residual method. Proceeds are first allocated to shares according to the quoted price of existing shares at the time of issuance and the residual proceeds are allocated to the liability. The liability component recorded initially on the issuance of shares is reversed on renouncement of the right to tax deductions to the investors and when eligible expenses are incurred and recognized in profit or loss in reduction of deferred income tax expense. A deferred tax liability is also recognized for the taxable temporary difference that arises from the difference between the carrying amount of eligible expenditures capitalized as an asset and its tax basis.

2.15. Equity-settled stock-based compensation

The Company offers an equity-settled stock-based compensation plan for its directors, employees and consultants. None of the Company's plans feature any options for a cash settlement.

All goods and services received in exchange for the grant of any share-based payments are measured at their fair values, unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received, the entity shall measure their value indirectly by reference to the fair value of the equity instruments granted. For the transactions with employees and others providing similar services, the Company measures the fair value of the services received by reference to the fair value of the equity instruments granted.

All equity-settled share-based payments (except warrants to brokers) are ultimately recognized as an expense in the profit or loss with a corresponding credit to contributed surplus, in equity. Equity-settled share-based payments to brokers, in respect of an equity financing are recognized as issuance cost of the equity instruments with a corresponding credit to contributed surplus, in equity.

If vesting periods or other vesting conditions apply, the expense is allocated over the vesting year, based on the best available estimate of the number of awards expected to vest. Non-market vesting conditions are included in assumptions about the number of awards that are expected to become exercisable. Estimates are subsequently revised if there is any indication that the number expected to vest differs from previous estimates. Any cumulative adjustment prior to vesting is recognized in the current period. No adjustment is made to any expense recognized in prior periods if awards ultimately exercised are different to that estimated on vesting.

Each tranche of an award with different vesting dates is considered a separate grant for the calculation of fair value and the resulting fair value is amortized over the vesting period of the respective tranches.

When stock options are exercised, any consideration paid by employees is credited to capital stock in addition to the amount previously recorded in contributed surplus.

2.16. Revenue recognition

Revenue comprises revenue from the sale of goods and rendering of services. Revenue is measured by reference to the fair value of consideration received or receivable by the Company for goods supplied and services provided, excluding sales tax and trade discounts.

Revenue is recognized when the amount of revenue can be measured reliably, collection is probable, the costs incurred can be measured reliably, and when the criteria for each of the Company's different activities have been met, as described below.

Sale of goods

Revenue from product sales is recognized when the Company has transferred to the buyer the significant risks and rewards of ownership of the goods supplied. Significant risks and rewards are generally considered to be transferred to the buyer when the customer has taken undisputed delivery of the goods. Amounts received in advance of meeting the revenue recognition criteria is recorded as deferred revenue on the consolidated statements of financial position. Products shipped prior to agreed billing terms are included in unbilled product revenue.

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Rendering of services

Services comprise surveys, installation of goods, project development and after-sales service and maintenance. Revenue is recognized when the services are provided by reference to the stage of completion of the contract at the reporting date. Amounts received in advance of meeting the revenue recognition criteria is recorded as deferred revenue on the consolidated statements of financial position. Services rendered prior to agreed billing terms are included in unbilled product revenue.

Contracts for heat recovery solutions

The Company provides heat recovery solutions specifically customized to each customer. These contracts specify a fixed price for the development and installation of heat recovery equipment, and are within the scope of IAS 11 "Construction Contracts".

Contract revenue includes the initial amount agreed in the contract plus any variations in contract work, to the extent that it is probable that they will result in revenue and can be measured reliably. As soon as the outcome of a contract can be estimated reliably, contract revenue is recognized by reference to the stage of completion of the contract. When the Company cannot measure the outcome of a contract reliably, revenue is recognized only to the extent of contract costs that have been incurred and are recoverable. Contract costs are recognized in the period in which they are incurred. Any expected loss on a contract is recognized immediately in profit or loss.

The stage of completion is determined by reference to the proportion of contract costs for work performed to date compare to the estimated total contract costs. Only those contract costs that reflect work performed are included in costs incurred to date. Contract costs relating to work not yet performed on the contract create an asset related to future contract activity. The gross amount due to customers for contract work is presented as deferred revenue for all contracts in progress for which progress billings exceed costs incurred plus recognized profits (less losses). Costs incurred to date in excess of progress billings create a work in progress balance within current assets.

Interest revenue and expenses

Interest revenue and expenses are reported on an accrual basis using the effective interest method.

2.17. Post employee benefits and short term employee benefits

Certain subsidiaries of the Company provide post-employment benefits through defined contribution plans. A defined contribution plan is a pension plan under which the Company pays fixed contributions into an independent entity. The Company has no legal or constructive obligations to pay further contributions after its payment of the fixed contribution. The cost of the Company's pension benefits for defined contribution plans are expensed when employees have rendered services entitling them to contributions.

Short-term employee benefits, including holiday entitlement, are current liabilities included in "pension and other employee obligations", measured at the undiscounted amount that the Company expects to pay as a result of the unused entitlement.

2.18. Research costs and government assistance

The Company carries on various research 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 costs. Research costs are expensed as incurred.

2.19. Investment tax credits

Investment tax credits are accounted for under the cost reduction method whereby they are presented 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. The investment tax credits must be examined and approved by the tax authorities and it is possible that the amounts granted will differ from the amounts recorded.

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2.20. Income taxes

Tax expense recognized in profit or loss comprises the sum of deferred tax and current tax not recognized in other comprehensive income or directly in equity.

Current income tax assets and / or liabilities comprise those obligations to, or claims from, fiscal authorities relating to the current or prior reporting periods, that are unpaid at the reporting date. Current tax is payable on taxable profit, which differs from profit or loss in the financial statements. Calculation of current tax is based on tax rates and tax laws that have been enacted or substantively enacted by the end of the reporting year.

Deferred income taxes are calculated using the liability method on temporary differences between the financial statement carrying amounts and the tax bases of assets and liabilities. Deferred tax liabilities are always recognized for all taxable temporary differences, and deferred tax assets are generally recognized for all deductible temporary differences to the extent that it is probable that future taxable income will be available against which those deductible temporary differences can be utilized. Such assets and liabilities are not recognized if the taxable temporary difference arises from the initial recognition of goodwill or the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither the taxable income or loss, nor the income or loss for the period reported in the Company's statements of comprehensive income (loss).

Deferred tax liabilities are recognized for taxable temporary differences associated with investments in subsidiaries and joint venture, except where the Company is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future. Deferred tax assets arising from deductible temporary differences associated with such investments are only recognized to the extent that it is probable that there will be sufficient taxable income against which to utilize the benefits of the temporary differences and they are expected to reverse in the foreseeable future.

Deferred tax assets and liabilities are measured, without discounting, at the tax rates that have been enacted or substantively enacted by the end of the reporting period and applicable in the period in which the liability is expected to be settled or the asset realized.

Deferred tax assets and liabilities are offset when there is a legally enforceable right to offset current tax assets against current tax liabilities and when they relate to income taxes levied by the same taxation authority and the Company intends to settle its current tax assets and liabilities on a net basis.

Changes in deferred tax assets or liabilities are recognized as a component of tax income or expense in profit or loss, except where they relate to items that are recognized in other comprehensive income or directly in equity, in which case the related deferred tax is also recognized in other comprehensive income or equity, respectively.

2.21. Income (loss) per share

The Company presents basic and diluted income (loss) per share data for its common shares. Basic income (loss) per share is calculated by dividing the income (loss) attributable to owners of the parent by the weighted average number of common shares outstanding during the year. The diluted income (loss) per share is determined by adjusting the income (loss) attributable to owners of the parent and the weighted average number of common shares outstanding for the effects of all dilutive potential common shares, which comprise options outstanding. The diluted income (loss) per share is equal to the basic income (loss) per share because of the antidilutive effect of the outstanding options as explained in Note 23.

2.22. Financial instruments

Financial assets and financial liabilities are recognized when the Company becomes a party to the contractual provisions of the financial instrument. Financial assets are derecognized when the contractual rights to the cash flows from the financial asset expire, or when the financial asset and all substantial risks and rewards are transferred. A financial liability is derecognized when it is extinguished, discharged, cancelled or expires.

On initial recognition, all financial assets and liabilities are measured and recognized at their fair value plus transaction costs, except for financial assets and financial liabilities carried at fair value through profit or loss, which are measured initially at fair value. Subsequently, financial assets and liabilities are measured and recognized as described below.

Financial assets

For the purpose of subsequent measurement, financial assets of the Company are classified into the loans and receivables category upon initial recognition.

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The category determines subsequent measurement and whether any resulting income and expense is recognized in net income (loss) or in other comprehensive income (loss).

All financial assets except for those at fair value through profit or loss are subject to review for impairment at least at each reporting date. Financial assets are impaired when there is any objective evidence that impairment exists. Different criteria to determine impairment are applied for each category of financial assets, as described below.

All income and expenses relating to financial assets that are recognized in profit or loss are presented within 'finance revenue' or 'other financial items', which the Company has not incurred to date, except for impairment of trade receivables which is presented within 'administration' expenses.

Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Cash and cash equivalents, trade receivables and other miscellaneous receivables are classified as loans and receivables. Loans and receivables are measured at amortized cost less any allowance for doubtful debts. An allowance for trade receivables is made when the Company has obtained an objective indication that it will not be able to collect the amount due according to the original terms and conditions agreed to with customers. Indications that loans and receivables are impaired include customers experiencing significant financial difficulties, the increasing possibility of a customer going bankrupt or undergoing a financial restructuring and payment default or delays. Individual receivables are considered for impairment when they are past due or when other objective evidence is received that a specific counterparty will default.

Financial liabilities

The Company's financial liabilities include trade payables and accruals which are subsequently measured at amortized cost using the effective interest method.

Fair value hierarchy

Financial instruments measured at fair value on the statement of financial position are classified using a fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy has the following levels: Level 1 – valuation based on quoted prices unadjusted in active markets for identical assets or liabilities; Level 2 – valuation techniques based on inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); Level 3 – valuation techniques using inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The finance lease receivable was measured at fair value initially, but is measured at amortized costs subsequent to initial valuation. The Company currently has no financial instruments measured at fair value on the statement of financial position. Therefore, a fair value hierarchy is not presented.

2.23. Significant accounting judgements and estimates

The preparation of these consolidated financial statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets and liabilities, income and expenses. The judgements, estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of the valuation of assets and liabilities that are not readily apparent from other sources. The judgements, estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates and assumptions are recognized in the period in which they are revised and in any future periods affected. Actual results may differ from these estimates, judgements and assumptions.

The most significant estimates include, but are not limited to:

- Impairment

An impairment loss is recognized for the amount by which an asset's or cash-generating unit's carrying amount exceeds its recoverable amount. To determine the recoverable amount, management estimates expected future cash flows from each asset or cash-generating unit and determines a suitable interest rate in order to calculate the present value of those cash flows. In the process of measuring expected future cash flows management makes assumptions about future operating results. These assumptions relate to future events and circumstances. The

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actual results may vary, and may cause significant adjustments to the Company's assets within the next financial year.

In most cases, determining the applicable discount rate involves estimating the appropriate adjustment to market risk and the appropriate adjustment to asset-specific risk factors. Further information on the estimates used in determining the recoverable amount of goodwill is provided in Note 10.

An impairment to goodwill of \$2,166,000 and an impairment to other intangible assets of \$139,000 were recognized for the year ended May 31, 2013. No impairment was recognized for the year ended May 31, 2012.

- Future production outputs related to the finance lease

In determining minimum lease payments receivable, management makes estimates regarding monthly energy outputs of the leased asset based on assumptions regarding the efficiency of the asset, the operations of the plant in which it is located, penalty payments resulting from temporary plant shut-downs and residual value of the equipment. These assumptions relate to future events and circumstances. Actual results may vary from estimate. Further information on the future production outputs related to the finance lease is provided in Note 7.

- Assumptions used in the Black-Scholes fair value calculations

The estimation of share-based payment expense requires the selection of an appropriate valuation model and consideration as to the inputs necessary for the valuation model chosen. In calculating the share-based payment expense, key estimates such as the rate of forfeiture of options granted, the expected life of the option, the volatility of the Company's stock price and the risk free interest rate are used. Further details of inputs used in the measurement of fair values at grant date are provided in Note 18.

The most significant judgements include, but are not limited to:

- Lease classification

Judgements are made in determining whether the conditions of lease contracts indicate that substantially all of the risks and rewards incidental to ownership have been transferred to the customer. Management identifies the conditions indicating the ownership of the equipment at the end of the term, the option for the customer to purchase the equipment at the end of the term, the term of the lease versus the economic life of the equipment, and the present value of the minimum lease payments versus the fair value of the equipment among other conditions. When the risks and rewards of ownership are transferred, the transaction is accounted for as a finance lease and if not, the transaction is an operating lease.

- Allowance for doubtful accounts

The valuation of allowances for uncollectible trade receivables requires assumptions including estimated credit losses based on customer and industry concentrations and the Company's knowledge of the financial conditions of its customers.

- Heat recovery solutions contract revenue

The stage of completion of any heat recovery solutions contract is assessed by management by taking into consideration all information available at the reporting date. In this process, management exercises significant judgment about milestones, actual work performed and the estimated costs to complete work.

- Future tax assets

Deferred tax assets are recognized for unused tax losses and credits to the extent that it is probable that taxable income will be available against which the losses can be utilized. These estimates are reviewed at every reporting date. Significant management judgment is required to determine the amount of deferred tax assets that can be recognized, based upon the likely timing and the level of the reversal of existing timing differences, future taxable income and future tax planning strategies.

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2.24. Standards, amendments and interpretations to existing standards that are not yet effective and have not been adopted early by the Company

At the date of authorization of these consolidated financial statements, certain new standards, amendments and interpretations to existing standards have been published but are not yet effective, and have not been adopted early by the Company. These standards will be adopted at the effective date.

Management anticipates that all of the pronouncements will be adopted in the Company's accounting policy for the first period beginning after the effective date of the pronouncement. Information on new standards, amendments and interpretations that are expected to be relevant to the Company's consolidated financial statements is provided below. Certain other new standards and interpretations have been issued but are not expected to have an impact on the Company's consolidated financial statements.

IFRS 9, "Financial Instruments"

This new standard is part of the IASB's project to replace IAS 39, "Financial Instruments: Recognition and Measurement" and provides guidance on the recognition, classification and measurement of financial assets and liabilities and de-recognition. This standard is effective for annual periods beginning on or after January 1, 2015. Earlier application is permitted. Further chapters dealing with impairment methodology and hedge accounting are still being developed. The Company has not yet assessed the impact of this pronouncement on its consolidated financial statements.

IFRS 10, "Consolidated Financial Statements"

This new standard revised the definition of control together with accompanying guidance to identify an interest in a subsidiary. IFRS 10 supersedes SIC 12, "Consolidation – Special Purposes Entities" and IAS 27, "Consolidated and Separate Financial Statements". This standard is effective for annual periods beginning on or after January 1, 2013. This pronouncement is expected to have no impact on the Company's consolidated financial statements.

IFRS 12, "Disclosure of Interests in Other Entities"

This new standard provides disclosure guidance on interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities. This standard is effective for annual periods beginning on or after January 1, 2013. This pronouncement is not expected to have a material impact on the Company's consolidated financial statements.

IFRS 13, "Fair Value Measurement"

This new standard sets out a single IFRS definition and measurement framework for fair value. This standard is effective for annual periods beginning on or after January 1, 2013. This pronouncement is not expected to have a material impact on the Company's consolidated financial statements.

IAS 1 Amendments, "Presentation of Financial Statements"

The IAS 1 Amendments require an entity to group items presented in other comprehensive income into those that, in accordance with other IFRSs: (a) will not be reclassified subsequently to profit or loss and (b) will be reclassified subsequently to profit or loss when specific conditions are met. It is applicable for annual periods beginning on or after July 1, 2012. These amendments will change the current presentation of items in other comprehensive income, however they will not affect the measurement or recognition of such items.

3. SEGMENT REPORTING

In fiscal 2013 and 2012, the Company operated in the energy efficiency industry in North America, Europe, China and Rest of the World. The Company markets, sells, engineers, fabricates, constructs, installs and supports two technology lines – heat recovery solutions and condensate return system solutions. The Company is also developing a third technology line - low temperature biomass drying systems. Assets are located in Canada, Europe and China.

Management reporting comprises analysis of revenue and gross profit within two distinct geographical areas. All other items of revenue and expenses are considered on a geographical and/or global basis in making strategic decisions regarding the Company's future. The Company has two operational bases ("reporting units"), one in Ottawa, Canada covering North America and China, and the other in Bristol, United Kingdom, covering Europe and the rest of the world. These areas are determined by proximity of the region to the reporting unit, plus the location of the contracts in existence with agents and distributors in the respective areas and the historical relationships with those agents and distributors. Corporate costs that cannot easily be attributed to either of the two reporting units are included in reconciling items. The chief operating decision maker focuses on revenues and costs by geographical segments, but manages assets and liabilities on a global basis.

Segment information for the year ended May 31, 2013 and the comparative year are detailed in the table below:

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	North America and China		Europe and Rest of World		Reconciling Items		Total	
	2013 \$	2012 \$	2013 \$	2012 \$	2013 \$	2012 \$	2013 \$	2012 \$
Total revenue from external customers	3,124,092	7,235,139	5,086,142	5,917,548	-	-	8,210,234	13,152,687
Cost of sales	(781,190)	(5,095,752)	(2,451,592)	(2,408,564)	-	-	(3,232,782)	(7,504,316)
Gross profit	2,342,902	2,139,387	2,634,550	3,508,984	-	-	4,977,452	5,648,371
Amortization of intangible assets	-	-	(98,295)	(99,126)	-	-	(98,295)	(99,126)
Impairment of goodwill	-	-	(2,166,000)	-	-	-	(2,166,000)	-
Impairment of other intangible assets	-	-	(139,000)	-	-	-	(139,000)	-
Other expenses	(2,048,389)	(1,738,315)	(2,452,556)	(2,323,389)	(1,222,540)	(1,467,215)	(5,723,485)	(5,528,919)
Finance revenue	108,456	102,956	-	-	-	-	108,456	102,956
Income (loss) before taxation	402,969	504,028	(2,221,301)	1,086,469	(1,222,540)	(1,467,215)	(3,040,872)	123,282
Tax (expense) recovery	(57,517)	-	105,892	(174,337)	143,675	135,786	192,050	(38,551)
Profit (loss) after taxation	345,452	504,028	(2,115,409)	912,132	(1,078,865)	(1,331,429)	(2,848,822)	84,731
Attributable to:								
Owners of the parent	374,050	529,695	(2,120,208)	903,163	(1,078,865)	(1,331,429)	(2,825,023)	101,429
Non-controlling interest	(28,598)	(25,667)	4,799	8,969	-	-	(23,799)	(16,698)

Reconciling items comprise the following:

	Year ended May 31	
	2013 \$	2012 \$
Corporate administration costs	832,155	873,650
Stock-based compensation	152,977	123,105
Professional fees	141,325	324,496
Depreciation of property, plant and equipment	45,623	45,851
Bank charges and interest	39,346	43,304
Foreign exchange differences	11,114	56,809
Total	1,222,540	1,467,215

During the year ended May 31, 2013, the Company had one customer in Europe and Rest of World that accounted for 17% of total revenue for the year.

During the year ended May 31, 2012, the Company had one customer in North America and China that accounted for 44%, and one customer in Europe and the rest of world that accounted for 16% of total revenue for the year.

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Further geographical analysis:

	Revenues for the year ended		Property, plant and equipment		Goodwill and other intangibles assets		Finance lease receivable (non-current)	
	2013 \$	2012 \$	2013 \$	2012 \$	2013 \$	2012 \$	2013 \$	2012 \$
Canada	1,873,417	6,042,926	22,301	28,448	-	-	585,197	-
U.S.A.	1,198,950	1,130,002	-	-	-	-	-	-
U.K.	4,358,514	4,934,749	23,169	40,512	1,706,449	4,145,745	-	-
Italy	199,060	541,255	-	-	-	-	-	-
Ireland	103,841	77,857	-	-	-	-	-	-
Netherlands	91,683	116,665	-	-	-	-	-	-
Germany	13,863	31,809	-	-	-	-	-	-
Rest of Europe	45,397	31,999	-	-	-	-	-	-
India	156,970	35,193	-	-	-	-	-	-
China	51,725	62,211	-	1,364	-	-	-	-
Kenya	44,311	2,140	-	-	-	-	-	-
Turkey	23,531	6,647	-	-	-	-	-	-
Pakistan	22,874	19,427	-	-	-	-	-	-
Singapore	6,960	63,316	-	-	-	-	-	-
Rest of world	19,138	56,491	-	-	-	-	-	-
Total	8,210,234	13,152,687	45,470	70,324	1,706,449	4,145,745	585,197	-

4. CASH AND CASH EQUIVALENTS

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

	May 31, 2013 \$	May 31, 2012 \$
Cash	1,304,191	1,370,830
Cash equivalents	204	1,121
Cash and cash equivalents	1,304,395	1,371,951

5. TRADE AND OTHER RECEIVABLES

	May 31, 2013 \$	May 31, 2012 \$
Trade receivables, gross	959,390	2,992,211
Allowance for doubtful accounts	(14,325)	(56,753)
Trade receivables, net	945,065	2,935,458
Contracts for heat recovery solutions (see Note 5.1)	-	103,756
Unbilled product and service revenue (see Note 5.2)	8,696	-
Prepayments	70,622	282,908
Other miscellaneous receivables	89,463	112,024
Total	1,113,846	3,434,146

The net carrying value of trade receivables is considered a reasonable approximation of fair value. Other miscellaneous receivables include \$88,861 (2012 - \$96,431) due from a Chinese distributor receiving payments on the Company's behalf from a Chinese customer.

At May 31, 2013, \$90,057 (9.5%) of the Company's trade receivables balance is over 90 days past due, but not impaired (\$197,689 (6.7%) at May 31, 2012).

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The change in allowance for doubtful accounts was as follows:

	May 31, 2013	May 31, 2012
	\$	\$
Balance, beginning of period	56,753	232,155
Amounts written off (uncollectable)	(56,753)	(232,155)
Provisions	14,325	56,753
Balance, end of period	14,325	56,753

All of the Company's trade and other receivables have been reviewed for indicators of impairment. A provision of \$14,325 was made during the year and was recorded under administration expenses.

5.1. Contracts for heat recovery solutions

The amounts recognized in the statements of financial position relate to contracts in progress at the end of the reporting period. The amounts are calculated as the net amounts of costs incurred plus recognized profits, less recognized losses and progress billings. The carrying amounts of assets and liabilities are analysed as follows:

	May 31, 2013	May 31, 2012
	\$	\$
Aggregate amount of costs incurred and recognized profits and losses for all contracts in progress	723,682	11,089,255
Less progress billings	(1,061,725)	(11,501,958)
	(338,043)	(412,703)
Recognized as:		
Due from customers for contract work, recognized in trade and other receivables	-	103,756
Customer deposits paid on order before commencement of project, recognized in deferred revenue (Note 14)	-	(441,328)
Due to customers for contract work, recognized in deferred revenue (Note 14)	(338,043)	(75,131)
	(338,043)	(412,703)

5.2. Unbilled product and service revenue

The amounts recognized in the statements of financial position relate to orders in progress at the end of the reporting period. Ordinarily sales of GEM product are invoiced upon dispatch of goods, however, one customer agreed to a staged payments arrangement due to the relatively high value of numerous orders and another customer was billed after goods were sent pending agreement of payment method. The amounts are calculated as the net amounts of costs incurred plus recognized profits, less recognized losses and progress billings. The carrying amounts of assets and liabilities are analysed as follows:

	May 31, 2013	May 31, 2012
	\$	\$
Aggregate amount of costs incurred and recognized profits and losses for all contracts in progress	8,696	1,136,298
Less progress billings	(6,332)	(1,318,006)
	2,364	(181,708)
Recognized as:		
Due from customer for service performed, recognized in trade and other receivables	8,696	-
Due to customer for product not yet sent, recognized in deferred revenue (Note 14)	(6,332)	(181,708)
	2,364	(181,708)

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6. INVENTORY

	May 31, 2013 \$	May 31, 2012 \$
Inventory	367,906	439,493

Inventory is comprised of partly finished products purchased from suppliers and held in inventory pending finishing to the customers' requirements.

For the year ended May 31, 2013, a total of \$515,081 of inventories was expensed to cost of sales (2012 - \$455,143). A total of \$13,041 of inventories (2012 - \$11,068) were written off as slow-moving. No reversal of previous write-downs has been recorded during the years ended May 31, 2013 and 2012.

7. FINANCE LEASE RECEIVABLE

The Company's finance lease receivable includes the following:

	May 31, 2013 \$	May 31, 2012 \$
Total estimated minimum lease payments receivable	1,507,952	530,779
Less: unearned income	(161,351)	(18,283)
	1,346,601	512,496
Less: current portion	(761,404)	(512,496)
	585,197	-

Finance lease receivable relates to one arrangement. The estimated minimum lease payments receivable in this lease 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. On December 31, 2012, the existing lease expired. On November 27, 2012 an agreement was signed whereby the customer agreed to purchase the recovered energy for a further two years, after which the customer has the option to renew for an additional 24 months on substantially the same terms or purchase the asset from the Company. This new agreement has been recorded in accordance with the previous lease, resulting in an increase to net investment in lease. The estimated minimum lease payments receivable in this lease represent the estimated monthly energy outputs of the leased asset and are based on assumptions regarding the efficiency of the asset and the operations of the plant in which it is located.

The Company recognizes finance income over the period of the lease, reflecting a constant periodic return on the Company's net investment in the lease. Lease payments consist of blended monthly payments of principal and interest. The interest rate inherent in the lease is 14%.

Future estimated minimum lease payments receivable under the finance lease are as follows:

	\$
Less than one year	898,921
Between two and five years	469,501
Residual value	139,530
	1,507,952

The finance lease receivable at the end of the reporting period is neither past due nor impaired.

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8. PROPERTY, PLANT AND EQUIPMENT

	Plant and Equipment	Furniture and Fixtures	Laboratory Equipment	Computers	Leasehold Improve- ments	Motor Vehicles	Total
	\$	\$	\$	\$	\$	\$	\$
Cost, May 31, 2011	95,239	114,117	52,857	321,271	14,934	20,554	618,972
Additions	5,680	5,212	-	30,707	-	-	41,599
Translation adjustments	(286)	(87)	-	(269)	-	(56)	(698)
Cost, May 31, 2012	100,633	119,242	52,857	351,709	14,934	20,498	659,873
Additions	-	6,217	-	6,918	7,943	-	21,078
Translation adjustments	(495)	(25)	-	(400)	-	(178)	(1,098)
Cost, May 31, 2013	100,138	125,434	52,857	358,227	22,877	20,320	679,853
Accumulated depreciation, May 31, 2011	70,664	108,083	50,787	302,269	5,362	7,280	544,445
Depreciation for the year	8,582	1,973	1,761	23,816	4,597	5,122	45,851
Translation adjustments	(219)	(83)	-	(429)	-	(16)	(747)
Accumulated depreciation, May 31, 2012	79,027	109,973	52,548	325,656	9,959	12,386	589,549
Depreciation for the year	8,736	2,931	309	21,385	7,182	5,080	45,623
Translation adjustments	(316)	(18)	-	(348)	-	(107)	(789)
Accumulated depreciation, May 31, 2013	87,447	112,886	52,857	346,693	17,141	17,359	634,383
Net book value, May 31, 2012	21,606	9,269	309	26,053	4,975	8,112	70,324
Net book value, May 31, 2013	12,691	12,548	-	11,534	5,736	2,961	45,470

The motor vehicles included in property, plant and equipment are held under a finance lease. At the end of the lease, full title to the motor vehicle may pass to the Company upon payment of a sundry fee. No other assets are held under finance leases. Other than the motor vehicles held under a finance lease, there are no items of property, plant or equipment subject to restrictions of title or pledged as security.

Capital commitments relating to motor vehicles held under finance leases, as at May 31, 2013 were as follows:

	<u>\$</u>
Year 1	2,963
Year 2 – Year 5	-
Total	2,963

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9. OTHER INTANGIBLE ASSETS

	Trade Names & Trademarks \$	Non- compe- te Agreement \$	Industrial Know- how \$	Designs & Drawings \$	Customer Relationships \$	Total \$
Cost, May 31, 2011	732,918	95,598	111,531	122,684	262,895	1,325,626
Translation adjustments	(1,978)	(258)	(301)	(331)	(710)	(3,578)
Cost, May 31, 2012	730,940	95,340	111,230	122,353	262,185	1,322,048
Translation adjustments	(6,348)	(828)	(964)	(1,063)	(2,276)	(11,479)
Cost, May 31, 2013	724,592	94,512	110,266	121,290	259,909	1,310,569
Accumulated amortization, May 31, 2011	-	95,598	65,060	71,566	153,355	385,579
Amortization for the year	-	-	22,240	24,464	52,422	99,126
Translation adjustments	-	(258)	(170)	(186)	(399)	(1,013)
Accumulated amortization, May 31, 2012	-	95,340	87,130	95,844	205,378	483,692
Amortization for the year	-	-	22,053	24,259	51,983	98,295
Translation adjustments	-	(828)	(756)	(833)	(1,785)	(4,202)
Impairments	139,000	-	-	-	-	139,000
Accumulated amortization and impairments, May 31, 2013	139,000	94,512	108,427	119,270	255,576	716,785
Net book value, May 31, 2012	730,940	-	24,100	26,509	56,807	838,356
Net Book Value, May 31, 2013	585,592	-	1,839	2,020	4,333	593,784

Trade Names and Trademarks are intangible assets with indefinite lives and are not subject to amortization. Trade Names and Trademarks relate specifically to the GEM™ product. They were tested for impairment as at May 31, 2013, as a result of which a \$139,000 impairment charge has been recognized within the "Europe and Rest of World" reporting segment. The growth rates attributed by Management to the GEM™ product line are 38% in 2014, followed by 10% in each of the subsequent four years. All other assumptions relating to the calculation of the pre-tax discount rate are as detailed in Goodwill (Note 10). The impairment charge in the current year is the result of lower revenues over the last two years caused by a re-organization of the UK based sales group plus the global recession which continues to impact the European economy particularly hard.

10. GOODWILL

Goodwill arose as a result of the acquisition of Gardner Energy Management Limited on July 1, 2008. Goodwill consists of the following amounts:

	May 31, 2013 \$	May 31, 2012 \$
Balance, beginning of period	3,307,389	3,318,520
Translation adjustments	(28,724)	(11,131)
Impairments	(2,166,000)	-
Balance, end of period	1,112,665	3,307,389

Goodwill was tested for impairment as at May 31, 2013, which resulted in an impairment charge of \$2,166,000 in the Thermal Energy International (UK) Ltd cash-generating unit, which is included in the "Europe and Rest of World" reporting segment. There was no impairment charge in the year ended May 31, 2012. For the purpose of annual impairment testing, goodwill is allocated to the following cash-generating units, which are the units expected to benefit from the synergies of the business combinations in which the goodwill arises: Thermal Energy International (UK) Limited (formerly Gardner Energy Management Limited) and GEMchem Limited, a 67% owned subsidiary of Thermal Energy International (UK) Limited.

The carrying amount of each cash-generating unit as at May 31 was as follows:

	May 31, 2013 \$	May 31, 2012 \$
Thermal Energy International (UK) Limited	948,732	3,142,020
GEMchem Limited	163,933	165,369
	1,112,665	3,307,389

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The recoverable amounts of the cash-generating units were determined based on value-in-use calculations, covering a one year budget, followed by an extrapolation over four further years of expected cash flows to be derived from the cash-generating units assuming growth rates as set out below, and applying a pre-tax discount rate of 20% for both cash-generating units. The pre-tax discount rate used represents the weighted average cost of capital ("WACC") of each cash-generating unit, which includes the cost of equity and the cost of debt. The cost of equity was computed as 23% for each cash-generating unit, incorporating the following factors: market risk premium adjusted for the target levered beta, based upon comparable companies, the risk-free rate of return and a size and company specific risk premium. The cost of debt was assumed as the risk free rate plus a premium of 3%. In computing the WACC, a capital structure comprising 18% debt and 82% equity was assumed, after considering the capital structure of comparable companies.

Thermal Energy International (UK) Limited's growth in the first year was assumed to be 47%, as per the detailed budget prepared with 10% growth per annum thereafter. The seemingly aggressive growth in 2014 reflects both orders received in the first quarter of FY 2014, plus a focus on corporate sales as well as an increased contribution from sales staff added during the year ended May 31, 2013. As at the end of the first quarter of FY 2014, 35% of the 2014 revenue forecast was already received in orders. The subsequent growth of 10% per annum over the following four years represents further increases in corporate sales and individual sales staff, while allowing for little improvement in the global economic climate.

The impairment charge of \$2,166,000 in the year ended May 31, 2013 is the result of lower revenues over the last two years caused by a re-organization of the UK based sales group, including two key UK sales managers relocating to North America, plus the global recession which continues to impact the European economy particularly hard. The relocation of sales staff to North America was part of a strategy to boost sales within a hugely under-serviced area. While this strategy has served to provide ever-increasing revenues for the parent company, it has resulted in two years of reduced UK revenues. This is being addressed with further investment in new experienced sales staff. Considering the difficulty in predicting the timing of the end of the current global recession, management is cautiously predicting slower growth than originally anticipated at the time of acquisition or in the subsequent few years.

GEMchem Limited's growth in the first year was assumed to be 6%, as per the detailed budget prepared with subsequent growth of 10%, 15%, 17% and 14% in 2015 through to 2018. This is based on a combination of historical results, which demonstrate steady increases year on year, plus anticipated additions to sales staff.

Summary of rates used:

Cash Generating Unit		Average Revenue Growth rates		Discount rates	
		2013	2012	2013	2012
Thermal Energy International (UK)	Year 1	47%	55%	20%	20%
	Year 2	10%	31%		
	Year 3	10%	34%		
	Year 4	10%	10%		
	Year 5	10%	10%		
GEMchem	Year 1	6%	8%	20%	20%
	Year 2	10%	37%		
	Year 3	15%	3%		
	Year 4	17%	20%		
	Year 5	14%	18%		

Apart from the considerations described above in determining value-in-use of the cash-generating units, management is not currently aware of any other factors that would necessitate changes in its key estimates.

Management's key assumptions include stable gross profit margins, based on past experience in the market. The Company's management believes that this is the best available input for forecasting. Cash flow projections reflect stable gross profit margins achieved immediately before the budget period. No expected efficiency improvements have been taken into account and prices and wages reflect forecasts of inflation for the industry.

11. SHORT-TERM BORROWINGS

The Company has an authorized credit facility of up to approximately \$390,000 dependent on the level of certain UK accounts receivable balances. The available facility as at May 31, 2013 was in the amount of \$55,000 (2012 - \$241,000), of which \$nil was utilized as at May 31, 2013 and 2012. The Company has continued access to this short term financing facility.

THERMAL ENERGY INTERNATIONAL INC.**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****For the years ended May 31, 2013 and 2012****(Expressed in Canadian Dollars)****12. TRADE PAYABLES**

Trade payables recognized in the statements of financial position can be analysed as follows:

	May 31, 2013	May 31, 2012
	\$	\$
Trade payables	681,656	1,017,557

All amounts are short-term. The carrying values of trade payables are considered to be a reasonable approximation of fair value.

13. OTHER LIABILITIES

Other liabilities can be summarized as follows:

	May 31, 2013	May 31, 2012
	\$	\$
Finance leases payable	2,963	8,113
Accruals	311,774	823,130
Other government remittances payable	328,716	243,535
	643,453	1,074,778

Included in accruals is \$27,500 due to directors (\$12,134 at May 31, 2012)

14. DEFERRED REVENUE

	May 31, 2013	May 31, 2012
	\$	\$
Customer deposits relating to heat recovery solutions (Note 5.1)	-	441,328
Deferred revenue relating to heat recovery solutions (Note 5.1)	338,043	75,131
Deferred revenue relating to GEM product (Note 5.2)	6,332	181,708
Deferred revenue relating to services	51,868	4,889
	396,243	703,056

15. PROVISIONS

	May 31, 2013	May 31, 2012
	\$	\$
Balance, beginning of period	215,000	265,000
Amounts utilized	-	(50,000)
Balance, end of period	215,000	215,000

On October 25, 2005, the Company was served with a statement of claim from its past President. Among other things, the lawsuit alleges that the former president was wrongfully dismissed from his employment. Damages are claimed in the approximate 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 approximately \$5 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.

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In May, 2010, the plaintiff brought a motion for summary judgment, seeking judgment in the amount of \$1,105,047 plus interest and costs. This amount is comprised of: i) \$398,737 allegedly owing as a result of wrongful dismissal and calculated as 24 months of salary, commissions, and related benefits; ii) \$618,810 in alleged unpaid loans and advances; and iii) \$87,500 in stock options which are alleged to have vested. The motion was heard on September 6 and 7, 2011 and on October 18, 2011 a decision was rendered. In its decision on the motion for summary judgment the court: i) Allowed the plaintiff's claim for wrongful dismissal assessing the damages for the plaintiff's wrongful dismissal at the equivalent of 18 months of pay in lieu of notice of termination; ii) Dismissed the plaintiff's claim for alleged unpaid loans and advances; iii) Permitted the remainder of the parties' claims and counterclaims to proceed to trial; iv) Declined to fix the amount of the damages for pay in lieu of notice of termination, suggesting instead that the parties try to agree on the amount; v) Stated that in the absence of the parties' agreement on the amount of damages for pay in lieu of notice of termination, the issue is to be referred to a Master; and vi) Stayed the execution of the partial summary judgment pending the determination of the outstanding claims at trial. The plaintiff has been awarded approximately \$37,000 in costs to date and the Company has paid this amount. The parties have not yet discussed or agreed on the amount of the damages for wrongful dismissal, and there has, as yet, been no reference to a Master.

The past President appealed from the dismissal of his claims for unpaid loans and advances. On September 25, 2012 the Court of Appeal for Ontario dismissed the appeal and ordered the appellant to pay the Company \$8,000 toward its legal costs. As such, the remainder of the parties' claims and counterclaims will proceed to trial. In the event the past President and the Company cannot agree on the damages for his wrongful dismissal claim, the matter will be determined by the court.

Until the remaining issues are determined, it is unclear what the net balance payable between the parties will be and to which party it is to be paid and the ultimate net impact of the partial judgment on the Company remains unknown at present. While the Company is confident in the merits of its own case, there is much that is still unknown about the past President's case and the basis for his damages claim. In November 2009, the Company recorded a charge of \$190,000 in its financial statements. This charge remains unchanged and is intended to account for possible future net liabilities resulting from the claim and the counterclaim.

Other than the charge of \$190,000 recorded in provision, the Company recorded another charge of \$25,000 in prior years for warranty provisions.

16. CAPITAL STOCK

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.

	Year ended May 31, 2013		Year ended May 31, 2012	
	# Shares	\$	# Shares	\$
Class A Common shares issued				
Balance, beginning of period	163,086,616	33,136,184	163,770,922	33,148,184
Cancelled shares (i)	-	-	(684,306)	(12,000)
Balance, end of period	163,086,616	33,136,184	163,086,616	33,136,184

(i) No payment was made for these shares cancelled as these shares were purchased through loans. An accounts receivable of \$12,000 for these shares was forgiven when the shares were cancelled in the year ended May 31, 2012.

Loans were extended to shareholders to acquire shares of the Company through the exercise of options. All loans issued previously for share purchases had been cancelled prior to May 31, 2012.

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17. 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 equity attributable to the owners of the parent, excluding accumulated other comprehensive income, which at May 31, 2013 totalled \$3,647,776 (May 31, 2012 - \$6,319,822). 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.

18. SHARE-BASED PAYMENTS

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.

Activity in stock options was as follows:

	Year ended May 31, 2013		Year ended May 31, 2012	
	# Options	Weighted Average Exercise Price \$	# Options	Weighted Average Exercise Price \$
Outstanding, beginning of period	11,002,500	0.10	5,881,250	0.12
Granted	5,480,000	0.10	5,870,000	0.10
Forfeited	(490,000)	0.10	(273,750)	0.10
Expired	-		(475,000)	0.29
Outstanding, end of period	15,992,500	0.10	11,002,500	0.10

There were no options exercised for the years ended May 31, 2013 and 2012.

The following share-based payment arrangements were in existence at May 31, 2013 and 2012:

At May 31, 2013:

Number outstanding	Grant date	Expiry date	Exercise price (\$)	Fair value at grant date (\$)	Number exercisable
2,750,000	04-May-2010	04-May-2015	0.10	0.03	2,750,000
2,562,500	10-May-2011	10-May-2016	0.10	0.03	1,708,333
500,000	12-Jul-2011	12-Jul-2016	0.10	0.03	166,667
4,820,000	01-Dec-2011	01-Dec-2016	0.10	0.03	1,606,667
5,360,000	22-Nov-2012	22-Nov-2017	0.10	0.05	-
15,992,500			0.10		6,231,667

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At May 31, 2012:

Number outstanding	Grant date	Expiry date	Exercise price (\$)	Fair value at grant date (\$)	Number exercisable
2,750,000	04-May-2010	04-May-2015	0.10	0.03	2,166,667
2,562,500	10-May-2011	10-May-2016	0.10	0.03	854,167
500,000	12-Jul-2011	12-Jul-2016	0.10	0.03	-
5,190,000	01-Dec-2011	01-Dec-2016	0.10	0.03	-
11,002,500			0.10		3,020,834

The fair value of services received in return for share options granted is based on the fair value of share options granted, measured using the Black-Scholes model. As at May 31, 2013 there was \$143,946 (May 31, 2012 – \$157,624) of total unrecognized share-based compensation costs related to unvested stock option awards granted under the Plan which are expected to be recognized over a weighted-average period of 3 years.

The following inputs were used in the measurement of the fair values at grant date of the share-based payment plans:

	Grant Date		
	12-Jul-11	01-Dec-11	22-Nov-12
Grant date share price (\$) ⁽¹⁾	0.06	0.06	0.05
Exercise price (\$)	0.10	0.10	0.10
Expected volatility (%) ⁽²⁾	93.27	92.12	89.96
Expected life (years)	4.00	4.00	4.00
Expected dividend yield (%)	0.00	0.00	0.00
Risk-free interest rate (%)	1.05	0.94	1.36
Forfeiture rate (%)	0.00	0.00	0.00

- (1) The closing market price of the shares on the TSX Venture Exchange on the date of grant or the first day of trading immediately following the date of grant if no shares traded on the grant date.
- (2) The expected volatility was based on historical volatility of the Company over a period of time that is commensurate with the expected life of the options.

Stock-based compensation expense related to the issuance of stock options is included in administration, and selling, marketing and business development expenses and is broken down as follows:

	2013	2012
	\$	\$
Administration	100,023	81,908
Selling, marketing and business development	52,954	41,197
	152,977	123,105

19. SALES

	2013	2012
	\$	\$
Sales of goods	2,610,308	2,711,016
Rendering of services	975,389	832,658
Contracts for heat recovery solutions	4,624,537	9,609,013
	8,210,234	13,152,687

Finance revenue comprises interest income earned from finance lease. See Note 7 "Finance lease receivable" for more details.

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20. EMPLOYEE BENEFITS EXPENSE

	2013 \$	2012 \$
Salaries and benefits	3,827,837	3,510,296
Stock-based compensation (Note 18)	152,977	123,105
Pension charge	38,777	40,284
	4,019,591	3,673,685

The Company contributes to defined contribution pension plans for permanent employees of one of its subsidiaries. The Company matches employee contributions. The plans and their assets are held by independent managers. The pension charge represents contributions paid by the Company.

21. OTHER SIGNIFICANT EXPENSES

Other significant expenses included in administration expense are as follows:

	2013 \$	2012 \$
Depreciation expense of property, plant and equipment (Note 8)	45,623	45,851
Amortization expense of other intangible assets (Note 9)	98,295	99,126
Foreign exchange loss	11,114	56,809

22. INCOME TAXES

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

	2013 \$	2012 \$
Income (loss) before income taxes	(3,040,872)	123,282
Income taxes calculated using combined federal and provincial income tax rates in Canada of 26.50% (2012 – 27.42%)	(805,831)	33,804
Stock-based compensation	40,539	33,757
Difference in tax rate of foreign subsidiaries	24,315	(7,157)
Difference in statutory and deferred tax rate	(19,066)	160
Tax effect of temporary difference for which no deferred tax asset is recorded	375,636	-
Use of temporary difference for which no deferred tax asset was recorded previously	(95,247)	(19,668)
Difference in future tax rates	(207,819)	-
Permanent differences and others	495,423	(2,345)
Current and deferred income tax provision	(192,050)	38,551
Current	(41,961)	93,883
Deferred	(150,089)	(55,332)
	(192,050)	38,551

Major components of the current tax expense are as follows:

Statutory income tax of the year	(6,952)	93,883
True-up of tax balances	(35,009)	-
	(41,961)	93,883

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Major components of the deferred tax expense (recovery) are as follows:

Origination and reversal of timing differences	(171,138)	(33,104)
Difference in statutory and deferred tax rate	(226,885)	160
True-up of tax balances	(32,455)	(2,720)
Use of temporary difference for which no deferred tax asset was recorded previously	(95,247)	(19,668)
Tax effect of temporary difference for which no deferred tax asset is recorded	375,636	-
	(150,089)	(55,332)

Change in deferred tax liabilities in 2013:

	June 1, 2012 \$	Recognized in income \$	May 31, 2013 \$
Provisions	-	50,350	50,350
Property, plant and equipment	35,157	227,114	262,271
Finance lease receivable	(137,861)	(218,988)	(356,849)
Non-capital losses	94,626	2,302	96,928
Intangible assets	(209,589)	90,832	(118,757)
	(217,667)	151,610	(66,057)
Impact on other comprehensive income		(1,521)	
Deferred income tax recovery recognized in comprehensive income		150,089	
Recognized as deferred tax asset			52,700
Recognized as deferred tax liability			(118,757)
			(66,057)

Change in deferred tax liabilities in 2012:

	June 1, 2011 \$	Recognized in income \$	May 31, 2012 \$
Provisions	-	-	-
Property, plant and equipment	95,647	(60,490)	35,157
Finance lease receivable	(301,638)	163,777	(137,861)
Non-capital losses	195,838	(101,212)	94,626
Intangible assets	(265,846)	56,257	(209,589)
	(275,999)	58,332	(217,667)
Impact on other comprehensive income		(3,000)	
Deferred income tax recovery recognized in comprehensive income		55,332	

At May 31, the Company had the following temporary differences for which no deferred tax asset was recorded:

	2013 \$	2012 \$
Property, plant and equipment	-	886,183
Share issue costs	-	380,640
Provisions	-	190,000
Non-capital losses	14,548,380	12,921,801
	14,548,380	14,378,624

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As at May 31, 2013, the Company had available non-capital income tax loss carry forwards in the following amounts which may be used to reduce federal and provincial taxable income:

Year of Expiry	Amount \$
2014	201,958
2015	532,623
2026	1,276,366
2027	1,692,621
2028	1,441,849
2029	3,486,435
2030	3,083,819
2031	864,328
2032	132,145
2033	1,716,171
Total	14,428,315

As at May 31, 2013, the Company had non-capital losses on foreign subsidiaries, for which no deferred tax asset was recorded in the amount of \$120,065. All losses expire in 2017 and 2018.

23. NET INCOME (LOSS) PER SHARE

The calculation of basic and diluted net income per share for the year ended May 31, 2013 was based on the net loss attributable to owners of the parent of \$2,825,023 (2012 – net income of \$101,429) and a weighted average number of shares outstanding of 163,086,616 (2012 – 163,086,616). Diluted income (loss) per share for the year ended May 31, 2013 and 2012 did not include the effect of outstanding stock options existing at these dates as they would have the effect of decreasing the (loss) income per share in 2013 and 2012.

24. OPERATING LEASE COMMITMENTS

Thermal Energy International Inc. and its UK subsidiary have entered into lease agreements for the use of land and buildings, motor vehicles, telecommunication systems and other office equipment. These leases range from one to five years with no renewal option included in the contracts. There are no restrictions placed upon the Company by entering into these leases. See Note 8 'Property, Plant and Equipment' for the details of finance lease commitments on certain motor vehicles.

At May 31, 2013, the Company has operating lease commitments as follows:

	Total \$	Less than 1 year \$	1-5 years \$	More than 5 years \$
Operating Leases	220,455	77,936	142,519	nil

Lease payments recognized as an expense for the year ended May 31, 2013 totalled \$135,127 (2012 - \$133,766).

25. FINANCIAL INSTRUMENTS

Financial Risk Management

In the normal course of business, the Company is exposed to financial risks that have the potential to negatively impact its financial performance. The Company does not use derivative financial instruments to manage these risks, as management believes the risks arising from the Company's financial instruments to be at an already acceptably low level. These risks are discussed in more detail below.

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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.

Foreign currency exchange risk sensitivity

Foreign currency exchange risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.

The following table shows the foreign currency exchange risk on the financial assets and liabilities of the Company's operations denominated in currencies other than the functional currency of the different Company entities.

Functional currency of Company entity	Net financial assets/(liabilities) in CAD\$		
	US\$	Euro	Total CAD \$
May 31, 2013			
Canadian Dollar	155,691	-	155,691
British Pound	(176,580)	168,646	(7,934)
	(20,889)	168,646	147,757
May 31, 2012			
Canadian Dollar	305,207	-	305,207
British Pound	(63,917)	391,799	327,882
	241,290	391,799	633,089

A 10% strengthening of the following currencies against the Canadian dollar would have had the following effect on operations and equity:

	2013			2012		
	US\$	Euros	Total	US\$	Euros	Total
Net income (loss)	(2,089)	16,865	14,776	24,129	39,180	63,309
Equity	(2,089)	16,865	14,776	24,129	39,180	63,309

The Company operates internationally with subsidiaries in the United Kingdom and China and operations in the United States. The Company earns revenues and incurs cost of sales, administration, selling, marketing and business development expenses in U.S. dollars, Euros and Chinese Renminbi. The majority of the foreign denominated transactions are in U.S. dollars, GBP and Euros.

The Company does not enter into arrangements to hedge its foreign exchange risk. The Company's policy is to ensure that its net exposure is kept to an acceptable level by buying or selling foreign currencies at spot rates when necessary to address short term imbalances.

Credit risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its obligations. The financial instruments that potentially expose the Company to credit risk are trade receivables, cash and cash equivalents, other miscellaneous receivables and finance lease receivable. Credit risk relating to the finance lease receivable is considered to be low, based upon the payment history of the customer.

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The Company's management considers that all of the above financial assets that are not impaired or past due at each of the reporting dates under review are of good credit quality.

Accounts receivable

Each new customer is assessed individually for creditworthiness before standard payment and delivery terms and conditions are offered. Consideration is given to the country and industry in which the customer operates, as well as maturity of the customer, existence of previous financial difficulties and general reputation. Within the US market for GEM products, a significant percentage of revenue is attributable to a small number of country-wide distributors with whom the Company has a trading history of at least two years. Within the European market for GEM products, credit insurance is available in accordance with the existing borrowing facility held by the UK subsidiary. In the case of refused credit insurance, a full or partial deposit is required from the customer which will at least cover the cost of producing the goods. Documentary credits may be requested for larger orders to geographical regions where credit insurance is not applicable. Goods are sold subject to retention of title clauses, so that in the event of non-payment, the Company may have a secured claim.

Contracts for heat recovery solutions are planned to ensure cash flow positivity throughout the life of the project. A project may be halted pending payment by a customer, thus preventing further commitments under the contract.

The amounts reported for trade receivables in the statement of financial position are net of allowances for doubtful accounts. The Company's maximum exposure to credit risk at the reporting date is the carrying value of its cash and cash equivalents (see Note 4), trade receivables, other miscellaneous receivables (see Note 5) and finance lease receivable. In determining the fair value of the finance lease, the Company uses the discounted cash future cash flows of the asset, being the minimum lease payments, discounted using a rate of 14.3% - rate implicit in the lease. The fair value of the finance lease receivable at May 31, 2013 was \$1,507,952.

The credit risk for cash and cash equivalents is considered negligible, since the counter-parties are reputable banks with high quality external credit ratings.

Liquidity risk

Liquidity risk is the risk that the Company will encounter difficulty in meeting the obligations of its financial liabilities that are settled by cash or another financial asset. Liquidity risk management serves to maintain a sufficient amount of cash and cash equivalents and to ensure that the Company has financing sources such as bank loans for a sufficient authorized amount. The Company continues to actively seek external financing to ensure it has the necessary funds to fulfill its obligations. In addition, a UK subsidiary of the Company has access to borrowings secured against certain accounts receivable.

As at May 31, 2013, the Company's financial liabilities, which consist of trade payables, accruals and finance leases payable, have a carrying value of \$996,393 (\$1,848,800 at May 31, 2012) and are all due within one year.

Interest rate risk

Interest rate risk is defined as the risk that the fair value or future cash flows of a financial instrument will fluctuate because of a change in market interest rates. The Company minimizes risk by investing only with credit worthy banking institutions or draws on its available facility with floating rate borrowings, as mentioned in liquidity risk above.

The Company currently does not use interest rate hedges or fixed interest rate contracts to manage the Company's exposure to interest rate fluctuations. There were no significant investments or borrowings to expose the Company to interest rate sensitivity either at May 31, 2013 or 2012.

26. RELATED PARTY TRANSACTIONS

Related parties include the members of the Board of Directors and key management personnel, as well as close family members and enterprises that are controlled by these individuals and shareholders.

Transactions with key management personnel

Key management personnel of the Company include members of the Company's Board of Directors as well as members of the Company's senior management team. Key management personnel remuneration includes the following expenses:

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	2013	2012
	\$	\$
Salaries and other short term employee benefits	920,244	897,695
Incentives	-	87,148
Directors' fees	140,213	146,419
Share-based payments	98,560	76,086
	1,159,017	1,207,348

Salaries and other short-term employee benefits include cash payments for base salaries and related social security costs and employee benefits, as well as payments made into defined contribution pension plans of the Company's UK based subsidiary. Incentives represent the amount expensed in the period as due to key management personnel under the Company's employee incentive plan. Directors' fees include meeting fees, committee chairman fees and retainers. Share-based payments include the fair value of equity settled share-based payment arrangements awarded during the period.