

THERMAL ENERGY INTERNATIONAL INC.

UNAUDITED CONDENSED CONSOLIDATED INTERIM STATEMENTS OF
FINANCIAL POSITION (EXPRESSED IN CANADIAN DOLLARS)

As at

	February 28, 2013	May 31, 2012
	\$	\$
ASSETS		
Current assets		
Cash and cash equivalents (Note 4)	700,704	1,371,951
Trade and other receivables (Note 5)	2,665,203	3,434,146
Current tax receivable	77,103	-
Inventory (Note 6)	361,797	439,493
Finance lease receivable (Note 7)	732,499	512,496
	4,537,306	5,758,086
Non-current assets		
Finance lease receivable (Note 7)	819,884	-
Property, plant and equipment (Note 8)	50,512	70,324
Other intangible assets (Note 9)	752,212	838,356
Goodwill (Note 10)	3,217,344	3,307,389
	4,839,952	4,216,069
Total assets	9,377,258	9,974,155
LIABILITIES		
Current liabilities		
Trade payables (Note 12)	707,189	1,017,557
Current tax liabilities	-	94,215
Pensions and other employer obligations	79,579	86,033
Other liabilities (Note 13)	767,132	1,074,778
Deferred revenue (Note 14)	992,664	703,056
Provisions (Note 15)	215,000	215,000
	2,761,564	3,190,639
Non-current liabilities		
Deferred tax liabilities	181,006	217,667
Total liabilities	2,942,570	3,408,306
EQUITY		
Capital stock (Note 16)	33,136,184	33,136,184
Contributed surplus	2,586,530	2,477,889
Accumulated other comprehensive income	137,942	214,096
Deficit	(29,433,847)	(29,294,251)
Equity attributable to owners of the parent	6,426,809	6,533,918
Non-controlling interest	7,879	31,931
Total equity	6,434,688	6,565,849
Total liabilities and equity	9,377,258	9,974,155

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

On behalf of the Board

President and C.E.O.

Director

THERMAL ENERGY INTERNATIONAL INC.

**UNAUDITED CONDENSED CONSOLIDATED INTERIM STATEMENTS OF
COMPREHENSIVE LOSS (EXPRESSED IN CANADIAN DOLLARS)**

	Three months ended		Nine months ended	
	February 28/29		February 28/29	
	2013	2012	2013	2012
	\$	\$	\$	\$
Sales	4,208,723	3,583,801	6,330,784	9,691,809
Cost of sales	1,302,309	2,170,536	2,099,690	5,351,845
Gross profit	2,906,414	1,413,265	4,231,094	4,339,964
Expenses:				
Administration	597,964	691,116	2,093,908	1,989,600
Selling, marketing and business development	800,680	780,643	2,260,956	2,158,164
Research and development	51,851	1,411	164,523	8,455
	1,450,495	1,473,170	4,519,387	4,156,219
Operating income (loss)	1,455,919	(59,905)	(288,293)	183,745
Finance revenue	39,489	23,461	57,004	86,041
Income (loss) before income taxes	1,495,408	(36,444)	(231,289)	269,786
Income taxes (expense) recovery	(23,440)	4,590	69,023	(158,714)
Net income (loss) for the period	1,471,968	(31,854)	(162,266)	111,072
Other comprehensive income (loss) for the period				
Exchange differences arising on translation of overseas operations	(83,061)	(89,625)	(77,536)	(64,846)
Total comprehensive income (loss) for the period	1,388,907	(121,479)	(239,802)	46,226
Net income (loss) for the period attributable to:				
Owners of the parent	1,476,814	(28,913)	(139,596)	122,370
Non-controlling interest	(4,846)	(2,941)	(22,670)	(11,298)
Net income (loss) for the period	1,471,968	(31,854)	(162,266)	111,072
Total comprehensive income (loss) for the period attributable to:				
Owners of the parent	1,394,923	(118,538)	(215,750)	57,524
Non-controlling interest	(6,016)	(2,941)	(24,052)	(11,298)
Total comprehensive income (loss) for the period	1,388,907	(121,479)	(239,802)	46,226
Net income (loss) per share - basic and diluted (Note 20)	0.009	0.000	(0.001)	0.001

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

THERMAL ENERGY INTERNATIONAL INC.

UNAUDITED CONDENSED CONSOLIDATED INTERIM 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)		76,554			76,554		76,554
Transactions with owners	(12,000)	76,554	(22,027)	-	42,527	-	42,527
Net income (loss) for the period			122,370		122,370	(11,298)	111,072
Other comprehensive income: exchange differences arising on translation of overseas operations				(64,864)	(64,864)	(294)	(65,158)
Total comprehensive income (loss) for the period	-	-	122,370	(64,864)	57,506	(11,592)	45,914
Balance at February 29, 2012	33,136,184	2,431,338	(29,273,310)	163,117	6,457,329	36,817	6,494,146
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)		108,641			108,641		108,641
Transactions with owners	-	108,641	-	-	108,641	-	108,641
Net loss for the period			(139,596)		(139,596)	(22,670)	(162,266)
Other comprehensive income: exchange differences arising on translation of overseas operations				(76,154)	(76,154)	(1,382)	(77,536)
Total comprehensive loss for the period	-	-	(139,596)	(76,154)	(215,750)	(24,052)	(239,802)
Balance at February 28, 2013	33,136,184	2,586,530	(29,433,847)	137,942	6,426,809	7,879	6,434,688

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

THERMAL ENERGY INTERNATIONAL INC.

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

	Three months ended		Nine months ended	
	February 28/29		February 28/29	
	2013	2012	2013	2012
	\$	\$	\$	\$
OPERATING ACTIVITIES				
Net income (loss) for the period	1,471,968	(31,854)	(162,266)	111,072
Add items not involving cash:				
Stock-based compensation (Note 18)	40,559	44,170	108,641	76,554
Loss from asset disposition	1,399	-	1,399	-
Depreciation of property, plant and equipment	11,848	11,084	34,906	33,014
Amortization of intangible assets	24,663	24,664	74,044	74,295
Deferred income taxes (recovery)	(24,642)	(11,100)	(36,661)	(26,447)
Write-down of financial lease receivable	-	-	-	54,758
Unrealized foreign exchange and translation adjustments	26,364	(18,448)	24,609	(12,031)
Other non-cash equity items	-	-	-	(34,027)
Changes in working capital :				
Trade and other receivables	4,847	900,356	768,943	(578,494)
Income tax receivable	(77,103)	(123,319)	(77,103)	61,817
Inventory	47,497	4,648	77,696	(40,258)
Trade payables	(197,484)	(887,903)	(310,368)	352,095
Deferred revenue	(14,739)	408,637	289,608	449,721
Other liabilities	203,250	44,319	(408,315)	61,416
Net cash provided (used) in operating activities	1,518,427	365,254	385,133	583,485
INVESTING ACTIVITIES				
Finance lease payments received (receivable)	(1,340,546)	193,108	(1,039,887)	356,634
Additions to property, plant and equipment	(829)	-	(25,061)	(28,703)
Proceeds from disposal of property, plant and equipment	100	-	8,106	-
Net cash provided by investing activities	(1,341,275)	193,108	(1,056,842)	327,931
Increase (decrease) in cash and cash equivalents for the period	177,152	558,362	(671,709)	911,416
Cash and cash equivalents, beginning of period	523,084	1,325,695	1,371,951	972,163
Exchange differences on cash and cash equivalents	468	(55)	462	423
Cash and cash equivalents, end of period	700,704	1,884,002	700,704	1,884,002

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

Supplemental information related to operating activities:

Income taxes paid	80,751	-	80,751	-
Interest paid	920	828	3,063	2,370

Non-cash supplemental information:

Interest on cancelled shareholder loans	-	-	-	22,027
---	---	---	---	--------

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

1. NATURE OF OPERATIONS AND GOING CONCERN

Thermal Energy International Inc. (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 unaudited condensed consolidated interim financial statements were approved and authorized for issue by the Board of Directors on April 29, 2013. The condensed consolidated interim financial statements comprise the financial results of the parent and its subsidiaries (collectively known as "the Company") for the three months and nine months ended February 28, 2013 and February 29, 2012.

The condensed consolidated interim 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 losses from operations in the nine months ended February 28, 2013 and has significant accumulated deficits as at that date.

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 FY 2011 and 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. Consequently, management is of the opinion that there is no significant doubt concerning the Company's ability to continue as a going concern.

These condensed consolidated interim 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 condensed consolidated interim financial statements have been prepared in accordance with Amended IAS 34 "Interim Financial Reporting", utilizing the accounting policies the Company adopted in its May 31, 2012 audited annual consolidated financial statements. The accounting policies are based on the International Financial Reporting Standards ("IFRS") guidelines. These unaudited condensed consolidated interim financial statements do not include all of the information required for full annual financial statements and should be read in conjunction with the audited consolidated financial statements of the Company for the year ended May 31, 2012.

These condensed consolidated interim financial statements are prepared using the historical cost method.

2.2. Basis of consolidation

The consolidated financial statements incorporate the financial statements of the Company, 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 UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(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.	Ontario, Canada	100%	CAD	Finance leasing
2003356 Ontario Inc.	Ontario, Canada	100%	CAD	Non-operating
2153639 Ontario Inc.	Ontario, Canada	100%	CAD	Holding company
Gardner Energy Management Ltd. ⁽¹⁾	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⁾Gardner Energy Management Ltd. owns 67% of GEMchem Ltd., a company incorporated in the United Kingdom.

All subsidiaries have a quarter-end reporting date of February 28.

2.3. Business combinations

For acquisitions made on or after June 1, 2010, 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.

As part of its transition to IFRS, the Company elected to restate only those business combinations that occurred on or after June 1, 2010, the date of transition. In respect of acquisitions that arose prior to June 1, 2010, goodwill represents the amount recognized under the Company's previous accounting framework.

2.4. Investments in joint ventures

Entities whose economic activities are controlled jointly by the Company and other venturers independent of the Company (joint ventures) are accounted for using the proportionate consolidation method, whereby the Company's share of the assets, liabilities, income and expenses is included line by line in the consolidated financial statements.

The Company discontinues the use of proportionate consolidation from the date on which it ceases to have joint control over a jointly controlled entity.

2.5. 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.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

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.

2.6. 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 admin costs, stock-based compensation, professional fees, depreciation of property, plant and equipment, bank charges and interest and foreign exchange differences. Corporate admin 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.

2.7. 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.

2.8. 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.

2.9. 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

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

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

In accordance with IAS 17 "Leases", 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 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.

2.10. 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.

2.11. 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 2.13 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.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

Amortization and impairment charges are include within administrative expenses.

2.12. 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 2.13 for a description of impairment testing procedures. Impairment losses on goodwill are not reversed.

2.13. 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.

2.14. 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. In a business combination, contingent liabilities are recognized on the acquisition date when there is a present obligation that arises from past events and the fair value can be measured reliably, even if the outflow of economic resources is not probable. They are subsequently measured at the higher amount of a comparable provision as described above and the amount initially recognized, less any amortization.

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

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

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.

2.15. 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.

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.

2.16. 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.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

2.17. 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.

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.

Finance leases

Finance leases are those where substantially all of the benefits and risks of ownership of the equipment are transferred to the customer. Amounts due from lessees under finance leases are recorded as finance lease receivables at the amount of the Company's net investment in the leases. The finance lease income is recognized in profit or loss over the lease term to produce a constant rate of return on the investment in the lease.

Interest revenue and expenses

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

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

2.18. Operating expenses

Expenditure for warranties is recognized and charged against the associated provision when the related revenue is recognized. Depreciation of property, plant and equipment, amortization of intangible assets and gains or losses on disposals of property, plant and equipment are included within administration expenses.

2.19. 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.

2.20. 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.

2.21. 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.

2.22. 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.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

The measurement of deferred tax liabilities and assets reflects the tax consequences that would follow from the manner in which the Company expects, at the reporting date, to recover or settle the carrying amount of its assets and liabilities. The carrying amount of deferred tax assets is reviewed at each reporting date and reduced to the extent that it is no longer probable that sufficient taxable income will be available to allow the benefit of all or part of the asset to be utilized. At the end of each reporting period, an entity reassesses unrecognized deferred tax assets. The entity recognizes a previously unrecognized deferred tax asset to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

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.

2.23. 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 of the Company 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 20.

2.24. 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 other than those designated and effective as hedging instruments are classified into the following categories upon initial recognition:

- Loans and receivables
- Financial assets at fair value through profit or loss
- Held-to-maturity investments
- Available-for-sale financial assets

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, related party and other miscellaneous receivables are

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

classified as loans and receivables. Trade 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 trade 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. Other loans and receivables are recognized at amortized cost using the effective interest method, less any impairment. Impairment occurs when they are past due or when other objective evidence is received that a specific counterparty will default. Discounting is omitted where the effect of discounting is immaterial.

Financial assets at fair value through profit or loss

A financial asset is classified at fair value through profit or loss if it is classified as held for trading or is designated as such upon initial recognition. Financial assets are designated at fair value through profit or loss if the Company manages such investments and makes purchase and sale decisions based on their fair value in accordance with the Company's documented risk management or investment strategy. Attributable transaction costs are recognized in profit or loss when incurred. Financial assets at fair value through profit or loss are measured at fair value, and changes therein are recognized in the statements of comprehensive income.

The Company currently has no financial assets at fair value through profit or loss.

Held-to-maturity investments

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity other than loans and receivables. Investments are classified as held-to-maturity if the Company has the intention and ability to hold them until maturity.

Held-to-maturity investments are measured subsequently at amortised cost using the effective interest method. If there is objective evidence that the investment is impaired, determined by reference to external credit ratings, the financial asset is measured at the present value of estimated future cash flows. Any changes to the carrying amount of the investment, including impairment losses, are recognized in profit or loss.

The Company currently has no held-to-maturity investments.

Available-for-sale financial assets

Available-for-sale financial assets are non-derivative financial assets that are either designated to this category or do not qualify for inclusion in any of the other categories of financial assets. Available-for-sale investments are measured at fair value. Gains and losses are recognized in other comprehensive income, except for impairment losses and foreign exchange differences on monetary assets, which are recognized in profit or loss. When the asset is disposed of or is determined to be impaired, the cumulative gain or loss recognized in other comprehensive income is reclassified from the equity reserve to profit or loss and presented as a reclassification adjustment within other comprehensive income. Interest calculated using the effective interest method and dividends are recognized in profit or loss within finance revenue.

The Company currently has no available-for-sale financial assets.

Financial liabilities

The Company's financial liabilities include short-term borrowings, trade payables, accruals and finance leases payables, classified as other financial liabilities. They are measured initially at fair value. Subsequent measurements are 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).

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

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.

2.25. 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 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.

No impairment was recognized in either of the three months ended August 31, 2012 or August 31, 2011.

- 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.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

- 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.

2.26. 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 condensed consolidated interim 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. Earlier application is permitted. The Company is currently evaluating the impact of this pronouncement on its consolidated financial statements.

IFRS 11, "Joint Arrangements"

This new standard supersedes IAS 31 "Interest in Joint Ventures" and provides guidance on how to account for interests in jointly controlled entities. This standard is effective for annual periods beginning on or after January 1, 2013. Earlier application is permitted. This pronouncement is not expected to have a material 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. Earlier application is permitted. This pronouncement is not expected to have a material impact on the Company's consolidated financial statements.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

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. Earlier application is permitted. The Company is currently evaluating the impact of this pronouncement on its 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. The Company's management expects this will change the current presentation of items in other comprehensive income; however, it will not affect the measurement or recognition of such items.

IAS 28, "Investments in Associates and Joint Ventures"

This amendment contains new standards related to investments in associates and joint ventures. This amendment is effective for annual periods beginning on or after January 1, 2013. Earlier application is permitted. The Company is currently evaluating the impact of this pronouncement on its consolidated financial statements.

3. SEGMENT REPORTING

In the three and nine months ended February 28, 2013 and February 29, 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 three months ended February 28, 2013 and the comparative period are detailed in the table below:

	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	1,824,828	2,693,482	2,383,895	890,319	-	-	4,208,723	3,583,801
Cost of sales	(119,830)	(1,915,835)	(1,182,479)	(254,701)	-	-	(1,302,309)	(2,170,536)
Gross profit	1,704,998	777,647	1,201,416	635,618	-	-	2,906,414	1,413,265
Amortization of intangible assets	-	-	(24,664)	(24,664)	-	-	(24,664)	(24,664)
Other expenses	(482,869)	(526,043)	(679,854)	(523,809)	(263,108)	(398,654)	(1,425,831)	(1,448,506)
Finance revenue	39,489	23,461	-	-	-	-	39,489	23,461
Profit (loss) before taxation	1,261,618	275,065	496,898	87,145	(263,108)	(398,654)	1,495,408	(36,444)
Tax (expense) recovery	-	-	(18,778)	(18,640)	(4,662)	23,230	(23,440)	4,590
Profit (loss) after taxation	1,261,618	275,065	478,120	68,505	(267,770)	(375,424)	1,471,968	(31,854)
Attributable to:								
Owners of the parent	1,269,339	282,074	475,245	64,437	(267,770)	(375,424)	1,476,814	(28,913)
Non-controlling interest	(7,721)	(7,009)	2,875	4,068	-	-	(4,846)	(2,941)

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

Segment information for the nine months ended February 28, 2013 and the comparative period are detailed in the table below:

	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	2,538,227	5,185,258	3,792,557	4,506,551	-	-	6,330,784	9,691,809
Cost of sales	(412,384)	(3,591,558)	(1,687,306)	(1,760,287)	-	-	(2,099,690)	(5,351,845)
Gross profit	2,125,843	1,593,700	2,105,251	2,746,264	-	-	4,231,094	4,339,964
Amortization of intangible assets	-	-	(74,044)	(74,295)	-	-	(74,044)	(74,295)
Other expenses	(1,564,139)	(1,364,465)	(1,914,241)	(1,679,630)	(966,963)	(1,037,829)	(4,445,343)	(4,081,924)
Finance revenue	57,004	86,041	-	-	-	-	57,004	86,041
Income (loss) before taxation	618,708	315,276	116,966	992,339	(966,963)	(1,037,829)	(231,289)	269,786
Tax (expense) recovery	-	-	31,603	(231,120)	37,420	72,406	69,023	(158,714)
Profit (loss) after taxation	618,708	315,276	148,569	761,219	(929,543)	(965,423)	(162,266)	111,072
Attributable to:								
Owners of the parent	644,729	335,807	145,218	751,986	(929,543)	(965,423)	(139,596)	122,370
Non-controlling interest	(26,021)	(20,531)	3,351	9,233	-	-	(22,670)	(11,298)

Reconciling items comprise the following:

	Three months ended February 28		Nine months ended February 28	
	2013 \$	2012 \$	2013 \$	2012 \$
Corporate admin costs	205,644	202,621	647,451	580,370
Stock-based compensation	40,559	44,170	108,641	76,554
Professional fees	7,806	109,652	134,819	280,872
Depreciation of property, plant and equipment	11,848	11,084	34,906	33,014
Bank charges and interest	11,133	11,091	30,606	34,021
Foreign exchange differences	(13,882)	20,036	10,540	32,998
Total	263,108	398,654	966,963	1,037,829

During the three months ended February 28, 2013, the company had one customer in Europe and Rest of World that accounted for 33%; and one customer in North America and China that accounted for 37% of total revenue for the period.

During the three months ended February 29, 2012, the company had one customer in North America and China that accounted for 61% of total revenue for the period.

During the nine months ended February 28, 2013, the company had one customer in Europe and Rest of World that accounted for 22%; and one customer in North America and China that accounted for 25% of total revenue for the period.

During the nine months ended February 29, 2012, the company had one customer in North America and China that accounted for 43%; and one customer in Europe and Rest of World that accounted for 20% of total revenue for the period.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

Further geographical analysis:

	Revenues for the nine months ended		Property, plant and equipment as at		Goodwill and other intangibles assets as at		Finance lease receivable as at	
	Feb 28, 2013 \$	May 31, 2012 \$	Feb 28, 2013 \$	May 31, 2012 \$	Feb 28, 2013 \$	May 31, 2012 \$	Feb 28, 2013 \$	May 31, 2012 \$
Canada	1,814,729	4,370,839	21,181	28,448	-	-	1,552,383	512,496
U.S.A.	685,395	763,840	-	-	-	-	-	-
U.K.	3,142,398	3,660,149	29,049	40,512	3,969,556	4,145,745	-	-
Italy	180,232	482,679	-	-	-	-	-	-
Netherlands	91,683	74,918	-	-	-	-	-	-
Ireland	94,037	72,474	-	-	-	-	-	-
Germany	11,588	29,810	-	-	-	-	-	-
Rest of Europe	26,612	27,714	-	-	-	-	-	-
India	140,773	13,571	-	-	-	-	-	-
Kenya	44,311	2,140	-	-	-	-	-	-
China	37,679	50,579	282	1,364	-	-	-	-
Turkey	23,531	6,647	-	-	-	-	-	-
Pakistan	22,874	19,427	-	-	-	-	-	-
Singapore	4,005	63,316	-	-	-	-	-	-
Rest of world	10,938	53,706	-	-	-	-	-	-
Total	6,330,784	9,691,809	50,512	70,324	3,969,556	4,145,745	1,552,383	512,496

4. CASH AND CASH EQUIVALENTS

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

	Feb 28, 2013 \$	May 31, 2012 \$
Cash	700,500	1,370,830
Cash equivalents	204	1,121
Cash and cash equivalents	700,704	1,371,951

5. TRADE AND OTHER RECEIVABLES

	Feb 28, 2013 \$	May 31, 2012 \$
Trade receivables, gross	1,214,153	2,992,211
Allowance for doubtful accounts	(55,502)	(56,753)
Trade receivables, net	1,158,651	2,935,458
Contracts for heat recovery solutions (see Note 5.1)	852,175	103,756
Unbilled product revenue (see Note 5.2)	265,633	-
Prepayments	268,296	282,908
Other miscellaneous receivables	120,448	112,024
Total	2,665,203	3,434,146

The net carrying value of trade receivables is considered a reasonable approximation of fair value. Other miscellaneous receivables include \$96,431 (\$96,431 at May 31, 2012) due from a Chinese distributor receiving payments on the Company's behalf from a Chinese customer.

At February 28, 2013, \$367,151 (31.7%) of the Company's trade receivables balance is over 90 days past due, but not impaired (\$197,689 (6.7%) at May 31, 2012).

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

The change in allowance for doubtful accounts was as follows:

	Feb 28, 2013	May 31, 2012
	\$	\$
Balance, beginning of period	56,753	232,155
Amounts written off (uncollectable)	-	(232,155)
Provisions	-	56,753
Foreign exchange adjustments	(1,251)	-
Balance, end of period	55,502	56,753

All of the Company's trade and other receivables have been reviewed for indicators of impairment. No trade receivables were found to be impaired.

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:

	Feb 28, 2013	May 31, 2012
	\$	\$
Aggregate amount of costs incurred and recognized profits and losses for all contracts in progress	1,750,077	11,089,255
Less progress billings	(1,708,575)	(11,501,958)
	41,502	(412,703)
Recognized as:		
Due from customers for contract work, recognized in trade and other receivables	852,175	103,756
Customer deposits paid on order before commencement of project, recognized in deferred revenue (Note 14)	(325,984)	(441,328)
Due to customers for contract work, recognized in deferred revenue (Note 14)	(484,689)	(75,131)
	41,502	(412,703)

5.2. Unbilled product 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:

	Feb 28, 2013	May 31, 2012
	\$	\$
Aggregate amount of costs incurred and recognized profits and losses for all contracts in progress	1,505,532	1,136,298
Less progress billings	(1,361,040)	(1,318,006)
	144,492	(181,708)
Recognized as:		
Due from customer for product sent, recognized in trade and other receivables	265,633	-
Due to customer for product not yet sent, recognized in deferred revenue	(121,141)	(181,708)
	144,492	(181,708)

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

6. INVENTORY

	Feb 28, 2013	May 31, 2012
	\$	\$
Inventory	361,797	439,493

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

For the three months ended February 28, 2013, a total of \$112,814 of inventories was expensed to cost of sales (2012- \$110,678). For the nine months ended February 28, 2013, a total of \$337,121 of inventories was expensed to cost of sales (2012 - \$332,816). There was no write-down of inventories during the nine months ended February 28, 2013 or February 29, 2012. No reversal of previous write-downs has been recorded during the nine months ended February 28, 2013 or February 29, 2012.

7. FINANCE LEASE RECEIVABLE

The Company's finance lease receivable includes the following:

	Feb 28, 2013	May 31, 2012
	\$	\$
Total estimated minimum lease payments receivable	1,765,187	530,779
Less: unearned income	(212,804)	(18,283)
	1,552,383	512,496
Less: current portion	(732,499)	(512,496)
	819,884	-

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	726,736
Residual value	139,530
	1,765,187

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

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

8. PROPERTY, PLANT AND EQUIPMENT

	Plant and Equipment	Furniture and Fixtures	Laboratory Equipment	Computers	Leasehold Improve- ments	Motor Vehicles	Total
	\$	\$	\$	\$	\$	\$	\$
Cost, May 31, 2012	100,633	119,242	52,857	351,709	14,934	20,498	659,873
Additions for the three months ended August 31, 2012	-	-	-	4,231	15,949	-	20,180
Translation adjustments	(877)	(43)	-	(789)	-	(313)	(2,022)
Cost, August 31, 2012	99,756	119,199	52,857	355,151	30,883	20,185	678,031
Additions for the three months ended November 30, 2012	1,564	1,499	-	989	-	-	4,052
Disposals for the three months ended November 30, 2012	-	-	-	-	(8,006)	-	(8,006)
Translation adjustments	990	48	-	843	-	351	2,232
Cost, November 30, 2012	102,310	120,746	52,857	356,983	22,877	20,536	676,309
Additions for the three months ended February 28, 2013	-	-	-	829	-	-	829
Disposals for the three months ended February 28, 2013	-	(1,499)	-	-	-	-	(1,499)
Translation adjustments	(1,020)	(49)	-	(809)	-	(354)	(2,232)
Cost, February 28, 2013	101,290	119,198	52,857	357,003	22,877	20,182	673,407
Accumulated depreciation, May 31, 2012	79,027	109,973	52,548	325,656	9,959	12,386	589,549
Depreciation for the three months ended August 31, 2012	2,191	682	309	4,517	1,655	1,273	10,627
Translation adjustments	(568)	(32)	-	(580)	-	(201)	(1,381)
Accumulated depreciation, August 31, 2012	80,650	110,623	52,857	329,593	11,614	13,458	598,795
Depreciation for the three months ended November 30, 2012	2,353	681	-	5,904	2,213	1,280	12,431
Translation adjustments	663	37	-	646	-	239	1,585
Accumulated depreciation, November 30, 2012	83,666	111,341	52,857	336,143	13,827	14,977	612,811
Depreciation for the three months Ended February 28, 2013	2,270	682	-	5,466	2,154	1,276	11,848
Translation adjustments	(724)	(40)	-	(727)	-	(273)	(1,764)
Accumulated depreciation, February 28, 2013	85,212	111,983	52,857	340,882	15,981	15,980	622,895
Net book value, May 31, 2012	21,606	9,269	309	26,053	4,975	8,112	70,324
Net book value, February 28, 2013	16,078	7,215	-	16,121	6,896	4,202	50,512

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 February 28, 2013 were as follows:

	\$
Year 1	4,205
Year 2	-
Total	4,205

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

9. OTHER INTANGIBLE ASSETS

	Trade Names & Trademarks \$	Non- compete Agreement \$	Industrial Know- how \$	Designs & Drawings \$	Customer Relationships \$	Total \$
Cost, May 31, 2012	730,940	95,340	111,230	122,353	262,185	1,322,048
Translation adjustments	(11,178)	(1,458)	(1,701)	(1,871)	(4,010)	(20,218)
Cost, August 31, 2012	719,762	93,882	109,529	120,482	258,175	1,301,830
Translation adjustments	12,512	1,632	1,904	2,094	4,489	22,631
Cost, November 30, 2012	732,274	95,514	111,433	122,576	262,664	1,324,461
Translation adjustments	(12,604)	(1,644)	(1,918)	(2,110)	(4,521)	(22,797)
Cost, February 28, 2013	719,670	93,870	109,515	120,466	258,143	1,301,664
Accumulated amortization, May 31, 2012	-	95,340	87,130	95,844	205,378	483,692
Amortization for the three months ended August 31, 2012	-	-	5,529	6,083	13,034	24,646
Translation adjustments	-	(1,458)	(1,385)	(1,525)	(3,266)	(7,634)
Accumulated amortization, August 31, 2012	-	93,882	91,274	100,402	215,146	500,704
Amortization for the three months ended November 30, 2012	-	-	5,550	6,104	13,081	24,735
Translation adjustments	-	1,632	1,609	1,770	3,792	8,803
Accumulated amortization, November 30, 2012	-	95,514	98,433	108,276	232,019	534,242
Amortization for the three months ended February 28, 2013	-	-	5,533	6,087	13,043	24,663
Translation adjustments	-	(1,644)	(1,752)	(1,927)	(4,130)	(9,453)
Accumulated amortization, February 28, 2013	-	93,870	102,214	112,436	240,932	549,452
Net book value, May 31, 2012	730,940	-	24,100	26,509	56,807	838,356
Net Book Value, February 28, 2013	719,670	-	7,301	8,030	17,211	752,212

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:

	Feb 28, 2013 \$	May 31, 2012 \$
Balance, beginning of period	3,307,389	3,318,520
Translation adjustments	(90,045)	(11,131)
Balance, end of period	3,217,344	3,307,389

Goodwill was tested for impairment as at 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: Gardner Energy Management Limited and GEMchem Limited, a 67% owned subsidiary of Gardner Energy Management Limited.

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 five 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%. The pre-tax discount rate used represents the weighted average cost of capital ("WACC") of the Company, which includes the cost of equity and the cost of debt. The cost of equity was computed as 23%, 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 20% debt and 80% equity was assumed, after considering the capital structure of comparable companies. The resulting pre-tax discount rate was lower than the previous year rate as a result of a reduced risk-free rate of return plus lower income tax rates in the U.K.

Gardner Energy Management Limited's growth in the first year was assumed to be 55%, as per the detailed budget prepared with 31% in year 2, 34% in year 3 and 10% per annum thereafter. The seemingly aggressive growth in 2013 reflects GEM®

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

sales returning to the levels experienced in 2010 and 2011, plus continuing growth in sales of heat recovery solutions in the U.K. The following two years include increased sales as a result of the additional sales staff, agents and distributors who have already joined the team or who are being targeted to join in 2013. Sensitivity analysis revealed that a reduction of 20% in projected overall revenue across all future years would result in the same conclusion as shown below.

GEMchem Limited's growth in the first year was assumed to be 8%, as per the detailed budget prepared with subsequent growth of 37%, 3%, 20% and 18% in 2014 through to 2017. This is based on a combination of historical results, which demonstrate steady increases year on year, plus anticipated additions to sales staff.

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 believes that any reasonably possible change in the key assumptions on which the recoverable amount is based would not cause the aggregate carrying amount to exceed the aggregate recoverable amount of the cash generating unit.

Management's key assumptions include stable 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 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.

Based on the above conditions as at May 31, 2012, no impairment was necessary.

11. SHORT-TERM BORROWINGS

The Company has an authorized credit facility of up to approximately \$780,000 dependent on the level of certain UK accounts receivable balances. The available facility as at February 28, 2013 was in the amount of \$116,000, of which \$nil was utilized as at February 28, 2013 and May 31, 2012. The Company has continued access to this short term financing facility.

12. TRADE PAYABLES

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

	Feb 28, 2013	May 31, 2012
	\$	\$
Trade payables	707,189	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:

	Feb 28, 2013	May 31, 2012
	\$	\$
Finance leases payable	4,205	8,113
Accruals	632,518	942,175
Other	130,409	124,490
	767,132	1,074,778

Included in accruals is \$89,461 due to directors (\$12,134 at May 31, 2012)

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

14. DEFERRED REVENUE

	Feb 28, 2013 \$	May 31, 2012 \$
Customer deposits relating to heat recovery solutions (Note 5.1)	325,984	441,328
Deferred revenue relating to heat recovery solutions (Note 5.1)	484,689	75,131
Deferred revenue relating to GEM product	121,141	181,708
Deferred revenue relating to services	60,850	4,889
	992,664	703,056

All amounts are short-term and will generally be realized within the next reporting period.

15. PROVISIONS

	Feb 28, 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.

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.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

Other than the charge of \$190,000 recorded in provision, the Company recorded another charge of \$25,000 in prior periods 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.

	Nine months ended February 28, 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 for share purchases had been cancelled prior to May 31, 2012.

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 February 28, 2013 totalled \$6,288,867 (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.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

Activity in stock options was as follows:

	Three months ended February 28, 2013		Three months ended February 29, 2012	
	# Options	Weighted Average Exercise Price \$	# Options	Weighted Average Exercise Price \$
Outstanding, beginning of period	16,482,500	0.10	5,906,250	0.10
Granted	-	-	5,370,000	0.10
Forfeited	(250,000)	0.10	-	-
Outstanding, end of period	16,232,500	0.10	11,276,250	0.10

	Nine months ended February 28, 2013		Nine months ended February 29, 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	(250,000)	0.10	-	-
Expired	-	-	(475,000)	0.29
Outstanding, end of period	16,232,500	0.10	11,276,250	0.10
Exercisable, end of period	4,834,167	0.10	1,583,333	0.10

There were no options exercised in the nine months ended February 28, 2013 or February 29, 2012.

The following share-based payment arrangements were in existence at February 28, 2013, May 31, 2012 and February 29, 2012:

At February 28, 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	2,166,667
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	166,666
4,940,000	01-Dec-2011	01-Dec-2016	0.10	0.03	1,646,667
5,480,000	23-Nov-2012	23-Nov-2017	0.10	0.05	-
16,232,500			0.10		4,834,167

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

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

At February 29, 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	1,583,333
2,656,250	10-May-2011	10-May-2016	0.10	0.03	-
500,000	12-Jul-2011	12-Jul-2016	0.10	0.03	-
5,370,000	01-Dec-2011	01-Dec-2016	0.10	0.03	-
5,906,250			0.11		1,583,333

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 February 28, 2013 there was \$188,282 (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				
	04-May-10	10-May-11	12-Jul-11	01-Dec-11	23-Nov-12
Grant date share price (\$) ⁽¹⁾	0.06	0.05	0.06	0.06	0.05
Exercise price (\$)	0.10	0.10	0.10	0.10	0.10
Expected volatility (%) ⁽²⁾	85.67	91.01	93.27	92.12	89.96
Expected life (years)	4.00	4.00	4.00	4.00	4.00
Expected dividend yield (%)	0.00	0.00	0.00	0.00	0.00
Risk-free interest rate (%)	2.56	1.13	1.05	0.94	1.36
Forfeiture rate (%)	0.00	0.00	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:

	Three months ended February 28, 2013	Three months ended February 29, 2012
	\$	\$
Administration	25,788	28,950
Selling, marketing and business development	14,771	15,220
	40,559	44,170
	Nine months ended February 28, 2013	Nine months ended February 29, 2012
	\$	\$
Administration	69,918	50,121
Selling, marketing and business development	38,723	26,433
	108,641	76,554

19. PENSION PLAN

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 and amounted to \$10,102 for the three months ended February 28, 2013 (2012 - \$10,123) and \$29,422 for the nine months ended February 28, 2013 (2012 - \$29,397).

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

20. NET INCOME (LOSS) PER SHARE

The calculation of basic and diluted net income per share for the three months ended February 28, 2013 was based on the net income attributable to owners of the parent of \$1,476,814 (2012 – net loss of \$28,913) and a weighted average number of shares outstanding of 163,086,616 (2012 – 163,086,616). The calculation of basic and diluted net loss per share for the nine months ended February 28, 2013 was based on the net loss attributable to owners of the parent of \$139,596 (2012 – net income of \$122,370) and a weighted average number of shares outstanding of 163,086,616 (2012 - 163,086,616). Diluted income (loss) per share for the three months and nine months ended February 28, 2013 and February 29, 2012 did not include the effect of outstanding stock options existing at these dates as they are anti-dilutive.

21. 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 February 28, 2013, the Company has operating lease commitments as follows:

	Total \$	Less than 1 year \$	1-5 years \$	More than 5 years \$
Operating Leases	65,084	37,993	27,091	nil

Lease payments recognized as an expense for the three months ended February 28, 2013 totalled \$33,139 (\$35,250 for the three months ended February 29, 2012). For the nine months ended February 28, 2013, they were \$101,375 (\$106,526 for the nine months ended February 29, 2012).

22. FINANCIAL INSTRUMENTS

Categories of Financial Instruments

The Company's financial instruments comprise cash and cash equivalents, trade receivables, related party and other miscellaneous receivables, short-term borrowings, trade payables, accruals and finance leases payables. As at February 28, 2013 and May 31, 2012, all of the Company's financial instruments were classified as loan and receivables and other liabilities, and the fair value of these financial instruments approximated the carry value due to their short-term nature.

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.

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.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

	Net financial assets/(liabilities) in CAD\$			Total CAD \$
	US\$	£	Euro	
Functional currency of Company entity				
February 28, 2013				
Canadian Dollar	105,779	-	-	105,779
British Pound	(178,811)	n/a	117,972	(60,839)
	(73,032)	-	117,972	44,940
<u>May 31, 2012</u>				
Canadian Dollar	305,207	-	-	305,207
British Pound	(63,917)	n/a	391,799	327,882
	241,290	-	391,799	633,089
<u>February 29, 2012</u>				
Canadian Dollar	262,342	-	-	262,342
British Pound	37,871	n/a	663,446	701,317
	300,213	-	663,446	963,659

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

	Nine months ended February 28, 2013				Nine months ended February 29, 2012			
	US\$	£	Euros	Total	US\$	£	Euros	Total CAD \$
Net income (loss)	(7,303)	-	11,797	4,494	30,021	-	66,345	96,366
	As at February 28, 2013				As at May 31, 2012			
	US\$	£	Euros	Total	US\$	£	Euros	Total CAD\$
Equity	10,578	470,753	-	481,331	30,521	509,455	-	539,976

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, related party receivables and other miscellaneous receivables.

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.

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

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, related party receivables and other miscellaneous receivables (see Note 5).

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 February 28, 2013, the Company's financial liabilities, which consist of short-term borrowings, trade payables, accruals and finance leases payable, have a carrying value of \$1,343,912 (\$1,967,845 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 February 28, 2013 or May 31, 2012.

23. 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:

	Three months ended February 28, 2013 \$	Three months ended February 29, 2012 \$
Salaries and other short term employee benefits	233,117	226,271
Incentives	-	5,560
Directors' fees	32,250	42,000
Share-based payments	23,402	28,354
	288,769	302,185

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

February 28, 2013

(Expressed in Canadian Dollars)

	Nine months ended February 28, 2013 \$	Nine months ended February 29, 2012 \$
Salaries and other short term employee benefits	689,569	672,381
Incentives	-	60,559
Directors' fees	107,962	109,416
Share-based payments	65,541	49,602
	863,072	891,958

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.