

Consolidated Financial Statements of

**THERMAL ENERGY
INTERNATIONAL INC.**

Years ended May 31, 2014 and 2013



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INDEPENDENT AUDITORS' REPORT

To the Shareholders of Thermal Energy International Inc.

We have audited the accompanying consolidated financial statements of Thermal Energy International Inc., which comprise the consolidated statement of financial position as at May 31, 2014, the consolidated statements of comprehensive income, changes in equity and cash flows for the year then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

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

Auditors' Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of Thermal Energy International Inc. as at May 31, 2014, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards.



Emphasis of Matter

Without modifying our opinion, we draw attention to Note 2(a) in the consolidated financial statements which indicates that Thermal Energy International Inc. experienced net losses in prior periods, including a net loss of \$2,848,822 for the year ended May 31, 2013. In addition, the Company has a deficit of \$31,492,278. These conditions, along with other matters as set forth in Note 2(a) in the consolidated financial statements, indicate the existence of a material uncertainty that may cast significant doubt about Thermal Energy International Inc.'s ability to continue as a going concern.

Comparative Information

The consolidated financial statements of Thermal Energy International Inc. as at and for the year ended May 31, 2013 were audited by another auditor who expressed an unmodified opinion on those statements on September 13, 2013.

A handwritten signature in black ink that reads 'KPMG LLP'. The signature is written in a cursive, slanted style. Below the signature is a horizontal line that starts under the 'K' and ends under the 'P'.

Chartered Professional Accountants, Licensed Public Accountants

September 23, 2014

Ottawa, Canada

THERMAL ENERGY INTERNATIONAL INC.

Consolidated Statements of Financial Position

May 31, 2014 and 2013
(Expressed in Canadian dollars)

	2014	2013
Assets		
Current assets:		
Cash and cash equivalents (note 5)	\$ 2,046,417	\$ 1,304,395
Trade and other receivables (note 6)	2,010,338	1,113,846
Current tax receivable	89,295	95,129
Inventory (note 7)	361,729	367,906
Finance lease receivable (note 8)	765,509	761,404
	<u>5,273,288</u>	<u>3,642,680</u>
Non-current assets:		
Finance lease receivable (note 8)	139,530	585,197
Property, plant and equipment (note 9)	62,590	45,470
Intangible assets (note 10)	675,594	593,784
Goodwill (note 11)	1,283,676	1,112,665
Deferred tax assets (note 24)	11,286	52,700
	<u>2,172,676</u>	<u>2,389,816</u>
Total assets	\$ 7,445,964	\$ 6,032,496
Liabilities		
Current liabilities:		
Trade payables (note 13)	\$ 918,817	\$ 681,656
Current tax liabilities	27,720	57,517
Pensions and other employer obligations	80,332	96,790
Other liabilities (note 14)	895,429	643,453
Deferred revenue (note 15)	365,710	396,243
Provisions (note 16)	215,000	215,000
	<u>2,503,008</u>	<u>2,090,659</u>
Non-current liabilities:		
Deferred tax liabilities (note 24)	136,405	118,757
Total liabilities	2,639,413	2,209,416
Equity:		
Capital stock (note 17)	32,717,630	33,136,184
Contributed surplus	3,054,624	2,630,866
Accumulated other comprehensive income	508,149	168,788
Deficit	(31,492,278)	(32,119,274)
Equity attributable to owners of the parent	<u>4,788,125</u>	<u>3,816,564</u>
Non-controlling interest (note 19)	18,426	6,516
Total equity	4,806,551	3,823,080
Total liabilities and equity	\$ 7,445,964	\$ 6,032,496

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

On behalf of the Board:



Director



Director

THERMAL ENERGY INTERNATIONAL INC.

Consolidated Statements of Comprehensive Income

Years ended May 31, 2014 and 2013

(Expressed in Canadian dollars)

	2014	2013
Revenue (note 21)	\$ 13,150,810	\$ 8,210,234
Cost of sales	6,177,190	3,232,782
Gross profit	6,973,620	4,977,452
Expenses:		
Administration	2,585,018	2,668,693
Selling, marketing and business development	3,601,944	2,968,699
Research and development	211,917	184,388
	6,398,879	5,821,780
Operating income (loss) before impairment	574,741	(844,328)
Impairment of goodwill (note 11)	-	(2,166,000)
Impairment of intangible assets (note 10)	-	(139,000)
Operating income (loss)	574,741	(3,149,328)
Finance revenue (note 21)	133,678	108,456
Income (loss) before income taxes	708,419	(3,040,872)
Income taxes (expense) recovery (note 24)	(74,396)	192,050
Net income (loss) for the year	634,023	(2,848,822)
Other comprehensive income (loss) for the year		
Items that may be reclassified subsequently to profit or loss:		
Exchange differences arising on translation of overseas operations	344,244	(46,924)
Total comprehensive income (loss) for the year	\$ 978,267	\$ (2,895,746)
Net income (loss) for the year attributable to:		
Owners of the parent	\$ 626,996	\$ (2,825,023)
Non-controlling interest (note 19)	7,027	(23,799)
Net income (loss) for the year	\$ 634,023	\$ (2,848,822)
Total comprehensive income (loss) for the year attributable to:		
Owners of the parent	\$ 966,357	\$ (2,870,331)
Non-controlling interest	11,910	(25,415)
Total comprehensive income (loss) for the year	\$ 978,267	\$ (2,895,746)
Net income (loss) per share - basic and diluted (note 25)	\$ 0.004	\$ (0.017)

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

THERMAL ENERGY INTERNATIONAL INC.

Consolidated Statements of Changes in Equity

Years ended May 31, 2014 and 2013

(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, 2012	\$ 33,136,184	\$ 2,477,889	\$ (29,294,251)	\$ 214,096	\$ 6,533,918	\$ 31,931	\$ 6,565,849
Stock-based compensation (note 20)	–	152,977	–	–	152,977	–	152,977
Transactions with owners	–	152,977	–	–	152,977	–	152,977
Net income (loss) for the year	–	–	(2,825,023)	–	(2,825,023)	(23,799)	(2,848,822)
Other comprehensive income:							
Exchange differences arising on translation of overseas operations	–	–	–	(45,308)	(45,308)	(1,616)	(46,924)
Total comprehensive income (loss) for the year	–	–	(2,825,023)	(45,308)	(2,870,331)	(25,415)	(2,895,746)
Balance at May 31, 2013	33,136,184	2,630,866	(32,119,274)	168,788	3,816,564	6,516	3,823,080
Balance at June 1, 2013	33,136,184	2,630,866	(32,119,274)	168,788	3,816,564	6,516	3,823,080
Stock-based compensation (note 20)	–	120,824	–	–	120,824	–	120,824
Repurchase of Class A common shares (note 17)	(418,554)	302,934	–	–	(115,620)	–	(115,620)
Transactions with owners	(418,554)	423,758	–	–	5,204	–	5,204
Net income for the year	–	–	626,996	–	626,996	7,027	634,023
Other comprehensive income:							
Exchange differences arising on translation of overseas operations	–	–	–	339,361	339,361	4,883	344,244
Total comprehensive income for the year	–	–	626,996	339,361	966,357	11,910	978,267
Balance at May 31, 2014	\$ 32,717,630	\$ 3,054,624	\$ (31,492,278)	\$ 508,149	\$ 4,788,125	\$ 18,426	\$ 4,806,551

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

THERMAL ENERGY INTERNATIONAL INC.

Consolidated Statements of Cash Flows

Years ended May 31, 2014 and 2013

(Expressed in Canadian dollars)

	2014	2013
Operating activities:		
Net income (loss) for the year	\$ 634,023	\$ (2,848,822)
Add items not involving cash:		
Depreciation of property, plant and equipment (note 9)	38,401	45,623
Amortization of intangible assets (note 10)	8,303	98,295
Impairment of intangible assets and goodwill (notes 10 and 11)	-	2,305,000
Net investment in finance lease (note 8)	-	(1,546,318)
Finance revenue	(133,678)	(108,456)
Stock-based compensation (note 20)	120,824	152,977
Income tax expense (recovery) (note 24)	74,396	(192,050)
Unrealized foreign exchange and translation adjustments	78,399	(25,923)
Changes in working capital:		
Trade and other receivables	(896,492)	2,320,300
Inventory	6,177	71,587
Trade payable	240,458	(335,940)
Deferred revenue	(30,533)	(306,813)
Other liabilities	235,518	(416,586)
Income taxes paid	(43,487)	(81,311)
Interests received on finance lease	133,678	108,456
Other interests received	1,453	39
Interest paid	(4,750)	(3,982)
Net cash provided (used) in operating activities	462,690	(763,924)
Investing activities:		
Finance lease principal payments received	441,562	712,213
Additions to property, plant and equipment	(54,659)	(21,078)
Net cash provided by investing activities	386,903	691,135
Financing activities:		
Repurchase of Class A common shares (note 17)	(115,620)	-
Net cash provided (used) by investing activities	(115,620)	-
Increase (decrease) in cash and cash equivalents for the year	733,973	(72,789)
Cash and cash equivalents, beginning of year	1,304,395	1,371,951
Exchange differences on cash and cash equivalents	8,049	5,233
Cash and cash equivalents, end of year	\$ 2,046,417	\$ 1,304,395

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

1. Nature of operations:

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 audited consolidated financial statements were approved and authorized for issue by the Board of Directors on September 23, 2014. The consolidated financial statements comprise the financial results of the parent and its subsidiaries (collectively known as “the Company”) for the years ended May 31, 2014 and 2013.

2. Basis of presentation:

(a) Going concern:

These consolidated financial statements have been prepared assuming the Company will continue as a going concern. The going concern basis of presentation assumes the Company will continue in operation for the foreseeable future and be able to realize its assets and discharge its liabilities and commitments in the normal course of business. However, the Company experienced net losses in prior years, including a net loss of \$2,848,822 for the year ended May 31, 2013. In addition, the Company has a deficit of \$31,492,278.

The above conditions raise significant doubt about the Company’s ability to continue as a going concern. The Company’s ability to realize its assets and discharge its liabilities in the normal course of business is dependent upon its ability to generate sufficient cash from operations or its ability to arrange financing. No assurance can be given that any such additional funding will be available or that, if available, it can be obtained on terms favorable to the Company.

Management is of the opinion that sufficient working capital will be obtained from future cash flows through concentrating on building upon the revenue growth experienced in the years ended May 31, 2010 through May 31, 2014 and continuing to manage expenditures. The Company earned net income from operations in the year ended May 31, 2014. The Company cannot be certain that cash generated from its operations will be sufficient to satisfy its liquidity requirements and it may need to raise capital by obtaining financing.

The consolidated financial statements do not reflect adjustments that would be necessary if the going concern assumption was not appropriate. If the going concern basis was not appropriate for these consolidated financial statements, then adjustments would be necessary to the carrying amount of assets and liabilities, the reported revenues and expenses, and the classifications used in the consolidated statements of financial position.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

2. Basis of presentation (continued):

(b) Statement of compliance:

These consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"). The significant accounting policies are summarized in note 3.

The policies applied in these consolidated financial statements are based on IFRS issued and effective as of September 23, 2014, the date the Board of Directors approved the consolidated financial statements.

(c) Measurement basis:

The consolidated financial statements have been prepared on a historical cost basis except as permitted by IFRS and as otherwise indicated within these notes.

(d) 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 year in which they are revised and in any future years affected. Actual results may differ from these estimates, judgements and assumptions.

The critical estimates include:

- 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 and, in the case of other intangible assets, determines an applicable royalty rate. 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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

2. Basis of presentation (continued):

(d) Significant accounting judgements and estimates (continued):

- Impairment (continued):

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 other intangible assets and goodwill is provided in notes 10 and 11 respectively.

No impairment was recognized for the year ended May 31, 2014. An impairment to goodwill of \$2,166,000 and an impairment to intangible assets of \$139,000 were recognized for the year ended May 31, 2013.

- Future production outputs related to the finance lease:

When a new finance lease or amendment is signed, 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 8.

- 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 20.

- Allowance for doubtful accounts:

The valuation of allowances for uncollectable 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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

2. Basis of presentation (continued):

(d) Significant accounting judgements and estimates (continued):

- 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 estimate about milestones, actual work performed and the estimated costs to complete work.

- Deferred tax assets:

Deferred tax assets are recognized for unused tax losses, tax credits and deductible temporary differences, to the extent that it is probable that future taxable income will be available against which they 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 temporary differences, future taxable income and future tax planning strategies.

The critical judgements include:

- 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.

- Multi-element arrangements:

Judgment is applied in determining the components of a multiple element revenue arrangement. In allocating the consideration received among the multiple elements of a revenue arrangement, management must make estimates as to the fair value of each individual element. The selling price of the element on a stand-alone basis is used to determine the fair value. Where stand-alone sales do not exist, various inputs as detailed in note 3(m) are used to determine the fair value. Changes to these inputs may result in different estimates of fair value for an element and impact the allocation of consideration and timing of revenue recognition.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

2. Basis of presentation (continued):

(e) 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 year: 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 year-end are recognized in profit or loss.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the end of each reporting year. 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 year for assets and liabilities and the average exchange rate for the year for consolidated statements of comprehensive income items. Such exchange differences, including differences that arise relating to long-term inter-company balances that form part of the net investment in the foreign operation, are recognized in other comprehensive income or loss. On disposal of a foreign entity, the related cumulative translation differences recognized in equity are reclassified to profit or loss and are recognized as part of the gain or loss on disposal.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

3. Significant accounting policies:

(a) Basis of consolidation:

The consolidated financial statements incorporate the financial statements of the parent, which is the ultimate parent, and its subsidiaries. Subsidiaries are consolidated from the date on which the parent company obtains control, and continue to be consolidated until control ceases. Control is established when the parent company is exposed to, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the entity. 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.

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

Name of subsidiary	Place of incorporation	Ownership interest	Functional currency	Principal activity
Thermal Energy International (UK) 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	Sale of heat recovery and condensate return solutions
2003356 Ontario Inc.	Ontario, Canada	100%	CAD	Non-operating
2153639 Ontario Inc. ⁽²⁾	Ontario, Canada	100%	CAD	Holding company
GEMchem Ltd. ⁽¹⁾	United Kingdom	67%	GBP	Sale of water treatment products and services
Thermal Energy International (Guangzhou) Ltd. ⁽²⁾	Guangzhou, China	55%	Chinese Renminbi	Sale of heat recovery and condensate return solutions

⁽¹⁾Thermal Energy International (UK) Ltd owns 67% of GEMchem Ltd., a company incorporated in the United Kingdom.

⁽²⁾ 2153639 Ontario Inc. owns 55% of Thermal Energy International (Guangzhou) Ltd., a company incorporated in China.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(a) Basis of consolidation (continued):

All subsidiaries have a reporting date of May 31.

Information relating to each of the Company's subsidiaries that have non-controlling interest can be found in note 19.

(b) Business combinations:

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

(c) 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.

(d) 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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(e) 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 years 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 year end. Any indication of impairment of the net investment in lease will result in a write-down to the revised estimated recoverable amount. Indications that a finance lease receivable may be impaired include customers experiencing significant financial difficulties, the increasing possibility of a customer going bankrupt or undergoing a financial restructuring and payment default or delays.

(ii) The Company as a lessee:

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(f) 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:

Asset	Method
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 year 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.

(g) Intangible assets:

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

Asset	Method
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

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(g) Intangible assets (continued):

Amortization methods, useful lives and residual values are reviewed at each reporting year and adjusted if appropriate. Intangible assets with indefinite lives are subject to annual impairment testing. See note 3(i) for a description of impairment testing procedures.

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

Amortization is included within administrative expenses.

(h) Goodwill:

Goodwill represents the future economic benefits arising from a business combination that are not individually identified and separately recognized. See note 3(b) for information on how goodwill is initially determined. Goodwill is carried at cost less accumulated impairment losses. See note 3(i) for a description of impairment testing procedures. Impairment losses on goodwill are not reversed.

(i) Impairment:

The carrying values of all property and equipment and intangible assets with a finite useful life are reviewed for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. The carrying values of goodwill and intangible assets with an indefinite useful life are reviewed for impairment on an annual basis.

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.

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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(i) Impairment (continued):

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.

Impairment testing of indefinite-lived intangible assets is performed using the relief from royalty method, which requires management to estimate expected future revenue from sales of the product to which the indefinite-lived intangible assets relate and determine an appropriate royalty rate to apply to the future revenue. The royalty rate is subject to estimation uncertainty and reflects company and product specific factors as assessed by management.

(j) Provisions, contingent liabilities and contingent assets:

A provision is recognized if, as a result of a past event, the Company has a present legal or constructive obligation that can be estimated reliably, and it is probable that an outflow of economic benefits will be required to settle the obligation.

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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(j) Provisions, contingent liabilities and contingent assets (continued):

Warranties:

The Company warrants its condensate return solution product against defects for 10 years and does not offer extended warranties beyond 10 years. A provision for warranty expense is recorded when the revenue for the related product is recognized. The provision is based upon the terms of the warranty, the Company's historical experience and management estimates of future expense for replacement or repairs. The provision is charged to cost of sales.

(k) 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 year retained losses.

Accumulated other comprehensive income 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.

(l) Equity-settled stock-based compensation:

The Company offers an equity-settled stock-based compensation plan for its directors, employees and certain contractors. 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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(l) Equity-settled stock-based compensation (continued):

All equity-settled share-based payments (except warrants to brokers) are ultimately recognized as an expense in profit or loss with a corresponding credit to contributed surplus. 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.

If vesting years 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 year. No adjustment is made to any expense recognized in prior years 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 year 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 relating to those options.

(m) 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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(m) Revenue recognition (continued):

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 year 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 compared 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 are recorded as unbilled revenue.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(m) Revenue recognition (continued):

Multi-element arrangements

The Company provides its heat recovery solutions, GEM product, installation and servicing on a stand-alone basis or as part of a multiple element arrangement. Stand-alone sales include sales of heat recovery solution systems or GEM steam traps. When sold in a multiple element arrangement, the heat recovery solution systems or GEM steam traps are considered separate units of accounting as they have stand-alone value to the customer. The total consideration for the arrangement is allocated to the separate units of accounting based on their relative fair value and the revenue is recognized for each unit when the requirements for revenue recognition have been met. The Company determines the fair value of each unit of accounting based on the selling price when they are sold separately. When the fair value cannot be determined based on when it was sold separately, the Company determines a value that most reasonably reflects the selling price that might be achieved in a stand-alone transaction. Inputs considered in making this determination include the specific parameters and model used in determining the contract price, price lists and historical pricing for stand-alone sales of the same goods or services.

Interest revenue and expenses

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

(n) 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 vacation 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.

(o) 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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(p) Investment tax credits:

Credits claimed in connection with research and development activities are accounted for using the cost reduction method. Under this method, assistance and credits relating to the acquisition of equipment is deducted from the cost of the related assets, and those relating to current expenditures, which are primarily salaries and related benefits, are included in the determination of profit or loss as a reduction of the research and development expenses.

(q) 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 years, 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 year reported in the Company's consolidated 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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(q) Income taxes (continued):

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 year and applicable in the year in which the liability is expected to be settled or the asset realized.

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

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

(r) Earnings (loss) per share:

The Company presents basic and diluted earnings (loss) per share data for its common shares. Basic earnings (loss) per share is calculated by dividing the earnings (loss) attributable to owners of the parent by the weighted average number of common shares outstanding during the year. The diluted earnings (loss) per share is determined by adjusting the earnings (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.

(s) Financial instruments:

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

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

Financial assets

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(s) Financial instruments (continued):

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, other miscellaneous receivables and finance lease receivable are classified as loans and receivables. Loans and receivables are recognized initially at fair value plus any directly attributable transaction costs and subsequently measured at amortized cost using the effective interest method, less any allowance for doubtful debts. An allowance for trade receivables is made when the Company has obtained an objective indication that it will not be able to collect the amount due according to the original terms and conditions agreed to with customers. Indications that loans and receivables are impaired include customers experiencing significant financial difficulties, the increasing possibility of a customer going bankrupt or undergoing a financial restructuring and payment default or delays. Individual receivables are considered for impairment when they are past due or when other objective evidence is received that a specific counterparty will default.

Financial liabilities

The Company's financial liabilities include trade payables and accruals which are initially recognized at fair value plus any directly attributable transaction costs. Subsequent to initial recognition, these financial liabilities are measured at amortized cost using the effective interest method.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(s) Financial instruments (continued):

Fair value hierarchy

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

The Company currently has no financial instruments measured at fair value on the consolidated statements of financial position. Therefore, a fair value hierarchy is not presented.

(t) Segment reporting:

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

The two main operating units are as follows:

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(u) New standards, amendments and interpretations to existing standards:

The Company has adopted the following new or amended accounting standards.

Amendments to IAS 1, "Presentation of Financial Statements"

Effective June 1, 2013, the Company adopted the amendments to International Accounting Standards ("IAS") 1, Presentation of Financial Statements, issued in June 2011, which requires an entity to group items presented in other comprehensive income on the basis of whether they might be reclassified to profit or loss in subsequent years and items that will not be reclassified to profit or loss. The amendments to IAS 1 were applied retrospectively and did not have a material impact on the financial position, cash flows or profit or loss of the Company.

IFRS 10, "Consolidated Financial Statements"

In May 2011, the International Accounting Standards Board ("IASB") issued IFRS 10 to replace IAS 27 "Consolidated and Separate Financial Statements" and SIC 12 "Consolidation – Special Purpose Entities". The new consolidation standards result in a revised definition of control applicable to all entities. Under IFRS 10, control is identified as the single basis of consolidation for all types of entities. IFRS 10 is effective for annual years beginning on or after January 1, 2013, which was June 1, 2013 for the Company, and have been applied retrospectively to the consolidated financial statements. On June 1, 2013, the adoption of IFRS 10 did not result in any change in the consolidation status of any of our subsidiaries.

IFRS 12, "Disclosure of Interests in Other Entities"

In May 2011, the IASB issued IFRS 12 which integrates and enhances the disclosure requirements for entities that have an interest in a subsidiary, a joint arrangement, an associated or an unconsolidated structured entity. IFRS 12 is effective for annual years beginning on or after January 1, 2013, which was June 1, 2013 for the Company, and have been applied retrospectively. The adoption of IFRS 12 did not result in any change to the consolidated financial statements. However, the standard results in additional and enhanced disclosures which have been included in our annual consolidated financial statements for the year ended May 31, 2014.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(u) New standards, amendments and interpretations to existing standards (continued):

IFRS 13, "Fair Value Measurement"

In May 2011, the IASB issued IFRS 13 which establishes a single source of guidance for fair value measurement under IFRS. IFRS 13 defines fair value, provides guidance on measurement and introduces certain disclosure requirements. It does not affect which items are required to be fair-valued. IFRS 13 is effective for annual years beginning on or after January 1, 2013, which was June 1, 2013 for the Company. The Company has adopted IFRS 13 prospectively effective June 1, 2013. As the Company currently has no financial instruments measured at fair value on the statement of financial positions, the adoption of IFRS 13 did not result in any measurement adjustments or additional disclosures on its consolidated financial statements.

Amendments to IAS 36 "Recoverable Amount Disclosures for Non-Financial Assets"

In May 2013, the IASB issued Recoverable Amount Disclosures for Non-Financial Assets (Amendments to IAS 36). The IASB has issued amendments to reverse the unintended requirement in IFRS 13, *Fair Value Measurement*, to disclose the recoverable amount of every CGU to which significant goodwill or indefinite-lived intangible assets have been allocated. Under the amendments, recoverable amount is required to be disclosed only when an impairment loss has been recognized or reversed. The amendments impact certain disclosure requirements only, and the amendments did not have a material impact on the Consolidated Financial Statements.

Amendments to IFRS 7, "Financial Instruments: Disclosure"

In December 2011, the IASB issued the amendments to IFRS 7 which provides common disclosure requirements intended to help investors and other users to better assess the effect or potential effect of offsetting arrangements on a company's financial position. The amendments to IFRS 7 are effective for annual years beginning on or after January 1, 2013, which was June 1, 2013 for the Company, and have been applied retrospectively. As the Company currently has no financial instruments measured at fair value on the statement of financial positions, the adoption of the amendments to IFRS 7 did not result in any additional disclosures on its consolidated financial statements.

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(u) New standards, amendments and interpretations to existing standards (continued):

Management anticipates that all of the pronouncements will be adopted in the Company's accounting policy for the first year 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.

Amendments to IAS 32, "Financial Instruments: Presentation"

In December 2011, the IASB issued amendments to IAS 32, which clarifies the existing requirements for offsetting financial assets and financial liabilities. These amendments are effective for annual years beginning on or after January 1, 2014, which will be June 1, 2014 for the Company. The adoption of the amendments to IAS 32 is not expected to have a material impact on the consolidated financial statements.

IFRS 9, "Financial Instruments"

In November 2009 the IASB issued IFRS 9, Financial Instruments (IFRS 9 (2009)), and in October 2010, the IASB published amendments to IFRS 9 (IFRS 9 (2010)).

In November 2013, the IASB issued a new general hedge accounting standard, which forms part of IFRS 9 Financial Instruments (2013). The new standard removes the January 1, 2015 effective date of IFRS 9.

In July 2014, the IASB issued the final version of IFRS 9, bringing together the classification and measurement, impairment and hedge accounting phases of the project to replace IAS 39, "Financial Instruments: Recognition and Measurement. IFRS 9 is applied retrospectively for annual years beginning on or after January 1, 2018. Early application is permitted.

IFRS 15, "Revenue from Contracts with Customers"

In May 2014, the IASB issued IFRS 15, "Revenue from Contracts with Customers", which provides a single, principles-based five-step model for revenue recognition to be applied to all customer contracts, and requires enhanced disclosures. This standard is effective January 1, 2017 and allows early adoption. The Company does not intend to adopt this standard early and is currently evaluating the impact of adopting this standard on the consolidated financial statements.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(u) New standards, amendments and interpretations to existing standards (continued):

IFRIC 21, "Levies"

In May 2013, the IASB issued IFRIC 21, *Levies* which provides guidance on accounting for levies in accordance with the requirements of IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. The interpretation defines a levy as an outflow from an entity imposed by a government in accordance with legislation. It also notes that levies do not arise from executor contracts of other contractual arrangements. The interpretation also confirms that an entity recognizes a liability for a levy only when the triggering event specified in the legislation occurs. This IFRIC is effective for annual years beginning on or after January 1, 2014 and is required to be applied retrospectively. The Company does not expect the amendment to have a material impact on the consolidated financial statements.

4. Segment reporting:

In fiscal 2014 and 2013, 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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

4. Segment reporting (continued):

Segment information for the year ended May 31, 2014 and the comparative year are detailed in the table below:

	North America and China		Europe and Rest of World		Reconciling Items		Total	
	2014 \$	2013 \$	2014 \$	2013 \$	2014 \$	2013 \$	2014 \$	2013 \$
Total revenue from external customers	6,487,172	3,124,092	6,663,638	5,086,142	–	–	13,150,810	8,210,234
Cost of sales	(3,595,556)	(781,190)	(2,581,634)	(2,451,592)	–	–	(6,177,190)	(3,232,782)
Gross profit	2,891,616	2,342,902	4,082,004	2,634,550	–	–	6,973,620	4,977,452
Amortization of intangible assets	–	–	(8,303)	(98,295)	–	–	(8,303)	(98,295)
Impairment of goodwill	–	–	–	(2,166,000)	–	–	–	(2,166,000)
Impairment of other intangible assets	–	–	–	(139,000)	–	–	–	(139,000)
Other expenses	(2,336,212)	(2,048,389)	(2,861,207)	(2,452,556)	(1,193,157)	(1,222,540)	(6,390,576)	(5,723,485)
Finance revenue	133,678	108,456	–	–	–	–	133,678	108,456
Income (loss) before taxation	689,082	402,969	1,212,494	(2,221,301)	(1,193,157)	(1,222,540)	708,419	(3,040,872)
Tax (expense) recovery	(8,662)	(57,517)	(90,672)	105,892	24,938	143,675	(74,396)	192,050
Profit (loss) after taxation	680,420	345,452	1,121,822	(2,115,409)	(1,168,219)	(1,078,865)	634,023	(2,848,822)
Attributable to:								
Owners of the parent	685,743	374,050	1,109,472	(2,120,208)	(1,168,219)	(1,078,865)	626,996	(2,825,023)
Non-controlling interest	(5,323)	(28,598)	12,350	4,799	–	–	7,027	(23,799)

Reconciling items comprise the following:

	2014	2013
Corporate administration costs	\$ 874,646	\$ 832,155
Stock-based compensation	120,824	152,977
Professional fees	137,465	141,325
Depreciation of property, plant and equipment	38,401	45,623
Bank charges and interest	44,921	39,346
Foreign exchange differences	(23,100)	11,114
Total	\$ 1,193,157	\$ 1,222,540

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

4. Segment reporting (continued):

Corporate administration costs include directors' fees, all costs relating to both the CEO and CFO, directors and officers insurance, corporate legal costs, public relations costs, professional fees relating to group tax planning and corporate filing costs as well as the Annual General Meeting.

During the year ended May 31, 2014, the Company had one customer in North America and China that accounted for 25.7% and one customer in Europe and Rest of World that accounted for 9.9% of total revenue for the year.

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

Further geographical analysis:

	Sales for the year ended May 31,		Property, plant and equipment as at May 31,		Goodwill and intangibles assets as at May 31,		Finance lease receivable (non-current) as at May 31,	
	2014	2013	2014	2013	2014	2013	2014	2013
	\$	\$	\$	\$	\$	\$	\$	\$
Canada	3,480,287	1,873,417	48,964	22,301	-	-	139,530	585,197
U.S.A.	2,985,040	1,198,950	-	-	-	-	-	-
U.K.	5,731,390	4,358,514	13,626	23,169	1,959,270	1,706,449	-	-
Italy	336,648	199,060	-	-	-	-	-	-
Netherlands	109,127	91,683	-	-	-	-	-	-
Ireland	105,925	103,841	-	-	-	-	-	-
Germany	67,761	13,863	-	-	-	-	-	-
Rest of Europe	13,695	45,397	-	-	-	-	-	-
India	203,583	156,970	-	-	-	-	-	-
Kenya	70,258	44,311	-	-	-	-	-	-
China	21,846	51,725	-	-	-	-	-	-
Turkey	8,723	23,531	-	-	-	-	-	-
Pakistan	-	22,874	-	-	-	-	-	-
Rest of world	16,527	26,098	-	-	-	-	-	-
Total	13,150,810	8,210,234	62,590	45,470	1,959,270	1,706,449	139,530	585,197

5. Cash and cash equivalents:

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

	2014	2013
Cash	\$ 2,046,213	\$ 1,304,191
Cash equivalents	204	204
Cash and cash equivalents	\$ 2,046,417	\$ 1,304,395

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
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6. Trade and other receivables:

	2014	2013
Trade receivables, gross	\$ 1,602,847	\$ 959,390
Allowance for doubtful accounts	(26,765)	(14,325)
Trade receivables, net	1,576,082	945,065
Contracts for heat recovery solutions (see note 6(a))	105,439	–
Unbilled product and service revenue (see note 6(b))	60,145	8,696
Prepayments	87,675	70,622
Sales tax and other miscellaneous receivables	180,997	89,463
	\$ 2,010,338	\$ 1,113,846

The net carrying value of trade receivables is considered a reasonable approximation of fair value. Other miscellaneous receivables include \$95,790 (\$88,861 at May 31, 2013) due from a Chinese distributor receiving payments on the Company's behalf from a Chinese customer.

At May 31, 2014, \$100,984 (6.4%) of the Company's trade receivables balance was over 90 days past due, but not impaired (\$90,057 (9.5%) at May 31, 2013).

The change in allowance for doubtful accounts was as follows:

	2014	2013
Balance, beginning of year	\$ 14,325	\$ 56,753
Amounts written off (uncollectable)	(10,468)	(56,753)
Provisions	20,730	14,325
Foreign exchange adjustments	2,178	–
Balance, end of year	\$ 26,765	\$ 14,325

All of the Company's trade and other receivables have been reviewed for indicators of impairment. A provision of \$20,730 was made during the year and was recorded under administration expenses. No trade receivables were found to be impaired.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

6. Trade and other receivables (continued):

(a) Contracts for heat recovery solutions:

The amounts recognized in the consolidated statements of financial position relate to contracts in progress at the end of the reporting year. 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 analyzed as follows:

	2014	2013
Aggregate amount of costs incurred and recognized profits and losses for all contracts in progress	\$ 7,113,586	\$ 723,682
Less progress billings	(7,349,762)	(1,061,725)
	\$ (236,176)	\$ (338,043)
Recognized as:		
Due from customers for contract work, recognized in trade and other receivables	\$ 105,439	\$ –
Due to customers for contract work, recognized in deferred revenue (note 15)	(341,615)	(338,043)
	\$ (236,176)	\$ (338,043)

(b) Unbilled product and service revenue:

The amounts included within unbilled product and services revenue 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 analyzed as follows:

	2014	2013
Aggregate amount of costs incurred and recognized profits and losses for all contracts in progress	\$ 70,193	\$ 8,696
Less progress billings	(34,143)	(6,332)
	\$ 36,050	\$ 2,364
Recognized as:		
Due from customer for service performed, recognized in trade and other receivables	\$ 60,145	\$ 8,696
Due to customer for product not yet sent, recognized in deferred revenue (note 15)	(24,095)	(6,332)
	\$ 36,050	\$ 2,364

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

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7. Inventory:

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

For the year ended May 31, 2014, a total of \$690,259 of inventories was expensed to cost of sales (2013 - \$515,081). A total of \$Nil of inventories (2013 - \$13,041) were written off as slow-moving. No reversal of previous write-downs has been recorded during the years ended May 31, 2014 and 2013.

8. Finance lease receivable:

The Company's finance lease receivable includes the following:

	2014	2013
Total estimated minimum lease payments receivable	\$ 962,274	\$ 1,507,952
Less: unearned income	(57,235)	(161,351)
	905,039	1,346,601
Less: current portion	(765,509)	(761,404)
	\$ 139,530	\$ 585,197

Finance lease receivable relates to one arrangement. The estimated minimum lease payments receivable in this lease represent the estimated monthly energy outputs of the leased asset and are based on assumptions regarding the efficiency of the asset, the operations of the plant in which it is located and penalty payments resulting from temporary plant shut-downs. On December 31, 2012, the lease with Fortress Specialty Cellulose, as signed on June 29, 2010, 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 was recorded in accordance with the previous lease, resulting in an increase to net investment in lease of \$1,546,318. In subsequent years, until the expiry of the new lease on December 31, 2014, finance revenue will be recognized within the income statement at the interest rate implicit in the lease.

On December 22, 2013, the site commenced a market downtime for a period of ten weeks, following the imposition of an interim duty in China on the import of Canadian dissolving pulp, further to which on April 11, 2014, an agreement was made to further extend the existing lease by five months to May 2015.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

8. Finance lease receivable (continued):

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.

Future estimated minimum lease payments receivable, and expected residual value of equipment at the end of the lease, under the sales-type lease are as follows:

Less than one year	\$ 822,744
Residual value	139,530
	\$ 962,274

The estimated residual value of the equipment at the end of the new lease has been determined by assigning depreciation rates to various pieces of the equipment in order to derive a reasonable expected selling price or re-use value for the equipment upon the termination of the agreement. The residual value of the equipment is not guaranteed.

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

9. Property, plant and equipment:

	Plant and Equipment	Furniture and Fixtures	Laboratory Equipmen	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	-	6,217	-	6,918	7,943	-	21,078
Translation adjustments	(495)	(25)	-	(400)	-	(178)	(1,098)
Cost, May 31, 2013	100,138	125,434	52,857	358,227	22,877	20,320	679,853
Additions	17,794	-	-	36,865	-	-	54,659
Disposals	(43,067)	(22,925)	-	(77,134)	-	-	(143,126)
Translation adjustments	8,768	428	-	6,327	-	3,123	18,646
Cost, May 31, 2014	83,633	102,937	52,857	324,285	22,877	23,443	610,032
Accumulated depreciation, May 31, 2012	79,027	109,973	52,548	325,656	9,959	12,386	589,549
Depreciation for the year	8,736	2,931	309	21,385	7,182	5,080	45,623
Translation adjustments	(316)	(18)	-	(348)	-	(107)	(789)
Accumulated depreciation, May 31, 2013	87,447	112,886	52,857	346,693	17,141	17,359	634,383
Depreciation for the year	10,277	4,001	-	18,366	2,647	3,110	38,401
Disposals	(43,067)	(22,925)	-	(77,134)	-	-	(143,126)
Translation adjustments	7,257	395	-	7,158	-	2,974	17,784
Accumulated depreciation, May 31, 2014	61,914	94,357	52,857	295,083	19,788	23,443	547,442
Net book value, May 31, 2013	12,691	12,548	-	11,534	5,736	2,961	45,470
Net book value, May 31, 2014	21,719	8,580	-	29,202	3,089	-	62,590

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

9. Property, plant and equipment (continued):

During the year ended May 31, 2014, the Company disposed of fully depreciated assets of \$143,126 with \$Nil proceeds.

There are no property, plant and equipment held under finance leases and no items of property, plant or equipment are subject to restrictions of title or pledged as security. At May 31, 2014, the motor vehicles that were previously held under a finance lease were purchased by the Company at the end of the lease with the bargain purchase option.

10. 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	(6,348)	(828)	(964)	(1,063)	(2,276)	(11,479)
Cost, May 31, 2013	724,592	94,512	110,266	121,290	259,909	1,310,569
Translation adjustments	111,366	14,526	16,947	18,642	39,947	201,428
Cost, May 31, 2014	835,958	109,038	127,213	139,932	299,856	1,511,997
Accumulated amortization, May 31, 2012	–	95,340	87,130	95,844	205,378	483,692
Amortization for the year	–	–	22,053	24,259	51,983	98,295
Translation adjustments	–	(828)	(756)	(833)	(1,785)	(4,202)
Impairments	–	–	–	–	–	139,000
Accumulated amortization, May 31, 2013	139,000	94,512	108,427	119,270	255,576	716,785
Amortization for the year	–	–	1,863	2,049	4,391	8,303
Translation adjustments	21,364	14,526	16,923	18,613	39,889	111,315
Accumulated amortization, May 31, 2014	160,364	109,038	127,213	139,932	299,856	836,403
Net book value, May 31, 2013	585,592	–	1,839	2,020	4,333	593,784
Net Book Value, May 31, 2014	675,594	–	–	–	–	675,594

Trade Names and Trademarks are intangible assets with indefinite lives and are not subject to amortization. Trade Names and Trademarks relate specifically to the GEM™ product. They were tested for impairment at each year-end. No impairment was recognized for the year ended May 31, 2014. An impairment charge of \$139,000 was recognized on Trade Names and Trademarks for the year ended May 31, 2013. The growth rates attributed by Management to the GEM™ product line are negative 2% in 2015, followed by positive 10% in each of the subsequent four years. The royalty rate applied to the revenues for the purposes of impairment testing is 2.5%. All other assumptions relating to the calculation of the pre-tax discount rate are as detailed in Goodwill (note 11).

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

11. Goodwill:

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

	2014	2013
Balance, beginning of year	\$ 1,112,665	\$ 3,307,389
Translation adjustments	171,011	(28,724)
Impairments	-	(2,166,000)
Balance, end of year	\$ 1,283,676	\$ 1,112,665

Goodwill was tested for impairment as at May 31, 2014 and 2013, which resulted in no impairment charge as at May 31, 2014 and an impairment charge of \$2,166,000 as at May 31, 2013 in the Thermal Energy International (UK) Ltd cash-generating unit, which is included in the "Europe and Rest of World" reporting segment. For the purpose of annual impairment testing, goodwill is allocated to the following cash-generating units, which are the units expected to benefit from the synergies of the business combinations in which the goodwill arises: Thermal Energy International (UK) Limited (formerly Gardner Energy Management Limited) and GEMchem Limited, a 67% owned subsidiary of Thermal Energy International (UK) Limited.

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

	2014	2013
Thermal Energy International (UK) Limited	\$ 1,092,133	\$ 948,732
GEMchem Limited	191,543	163,933
	\$ 1,283,676	\$ 1,112,665

The recoverable amounts of the cash-generating units were determined based on value-in-use calculations, covering a one year budget, followed by an extrapolation over four further years of expected cash flows to be derived from the cash-generating units assuming growth rates as set out below, and applying a pre-tax discount rate of 20% for both cash-generating units. The pre-tax discount rate used represents the weighted average cost of capital ("WACC") of each cash-generating unit, which includes the cost of equity and the cost of debt. The cost of equity was computed as 22% (2013 - 23%) for each cash-generating unit, incorporating the following factors: market risk premium adjusted for the target levered beta, based upon comparable companies, the risk-free rate of return and a size and company specific risk premium.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
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11. Goodwill (continued):

The cost of debt was assumed as the risk free rate plus a premium of 3%. In computing the WACC, a capital structure comprising 15% (2013 - 18%) debt and 85% (2013 - 82%) equity was assumed, after considering the capital structure of comparable companies. For purposes of the May 31, 2014 impairment testing, Thermal Energy International (UK) Limited's growth from 2014 to 2015 was assumed to be 11%, as per the detailed budget prepared with 10% growth per annum thereafter. The growth in 2015 relates mainly to the heat recovery side of the business, while GEM sales are forecast to reduce marginally from 2014, as sales generally are expected to grow regionally, but with no significant individual orders forecast, such as that in 2014 from a major food manufacturer. The subsequent growth of 10% per annum over the following four years represents further increases from recently appointed sales staff, while allowing for some further improvement in the global economic climate.

The impairment charge of \$2,166,000 in the year ended May 31, 2013 was the result of lower revenues over the previous two years caused by a re-organization of the UK based sales group, including two key UK sales managers relocating to North America, plus the global recession which at the time continued to impact the European economy particularly hard. The relocation of sales staff to North America was part of a strategy to boost sales within an under-serviced area. While this strategy has served to provide increasing revenues for the parent company, it had resulted in two years of reduced UK revenues.

GEMchem Limited's growth from 2014 to 2015 was assumed to be 6%, as per the detailed budget prepared with subsequent growth of 10%, 11%, 10% and 11% in 2016 through to 2019. This is based on a combination of historical results, which demonstrate steady increases year on year, plus anticipated additions to sales staff.

Summary of rates used:

Cash Generating Unit		Average Revenue Growth rates		Discount rates	
		2014	2013	2014	2013
Thermal Energy International (UK)	Year 1	11%	47%		
	Year 2	10%	10%		
	Year 3	10%	10%	20%	20%
	Year 4	10%	10%		
	Year 5	10%	10%		
GEMchem	Year 1	6%	6%		
	Year 2	10%	10%		
	Year 3	11%	15%	20%	20%
	Year 4	10%	17%		
	Year 5	11%	14%		

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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
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11. Goodwill (continued):

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

12. Short-term borrowings:

The Company has an authorized credit facility of up to approximately \$454,000 dependent on the level of certain UK accounts receivable balances. The available facility as at May 31, 2014 was in the amount of \$186,000 (2013 - \$55,000), of which \$Nil was utilized as at May 31, 2014 (2013 - \$Nil). The Company has continued access to this short-term financing facility.

13. Trade payables:

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

	2014	2013
Trade payables	\$ 918,817	\$ 681,656

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

14. Other liabilities:

Other liabilities can be summarized as follows:

	2014	2013
Finance leases payable	\$ -	\$ 2,963
Accruals	756,684	311,774
Other government remittances payable	138,745	328,716
	\$ 895,429	\$ 643,453

Included in accruals is \$21,000 due to directors (\$27,500 at May 31, 2013).

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
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15. Deferred revenue:

	2014	2013
Deferred revenue relating to heat recovery solutions (note 6(a))	\$ 341,615	\$ 338,043
Deferred revenue relating to GEM product (note 6(b))	24,095	6,332
Deferred revenue relating to services	–	51,868
	\$ 365,710	\$ 396,243

All amounts are short-term and will generally be settled within the next reporting year.

16. Provisions:

	Legal provision	Warranty provision	Total provisions
Balance, beginning and end of year	\$ 190,000	\$ 25,000	\$ 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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
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16. Provisions (continued):

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 provision of \$190,000 in its financial statements. This provision remains unchanged and is intended to account for future net liabilities resulting from the claim and the counterclaim.

Other than the legal provision of \$190,000, the Company recorded another provision of \$25,000 for warranty.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
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17. 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.

Outstanding:

	Year ended May 31, 2014		Year ended May 31, 2013	
	# Shares	\$	# Shares	\$
Class A Common shares issued				
Balance, beginning of year				
Unrestricted shares	163,086,616	33,136,184	163,086,616	33,136,184
Shares held in escrow	250,000	–	250,000	–
	163,336,616	33,136,184	163,336,616	33,136,184
Shares purchased and cancelled ⁽¹⁾	(2,060,000)	(418,554)	–	–
Balance, end of year	161,276,616	32,717,630	163,336,616	33,136,184
Unrestricted shares	161,026,616	32,717,630	163,086,616	33,136,184
Shares held in escrow	250,000	–	250,000	–
Balance, end of year	161,276,616	32,717,630	163,336,616	33,136,184

⁽¹⁾ 2,060,000 Class A common shares were purchased for cancellation by the Company during the year ended May 31, 2014, for a total purchase price of \$115,620, resulting in a reduction to capital stock of \$418,554 and an increase in contributed surplus of \$302,934.

Normal Course Issuer Bid:

On October 28, 2013, the Company announced its intent to conduct a Normal Course Issuer Bid (“NCIB”). NCIB was approved by TSX Venture Exchange on October 30, 2013. During the 12-month year commencing October 31, 2013, and ending October 31, 2014, the Company may purchase on the TSX up to 13,513,869 common shares, representing approximately 10% of the then issued and outstanding common shares. The actual number of common shares purchased, if any, and the timing of such purchases will be determined by the Company by considering market conditions, share prices, its cash position, and other factors.

All of the Class A common shares purchased for cancellation were purchased directly under the NCIB for the year ended May 31, 2014.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

18. Capital management:

The Company's objectives when managing capital is to safeguard the Company's ability to continue as a going concern and to maintain flexible capital structure for its projects for the benefit of its stakeholders. In the management of capital, the Company includes the components of equity attributable to the owners of the parent, excluding accumulated other comprehensive income, which at May 31, 2014 totalled \$4,279,976 (May 31, 2013 - \$3,647,776). 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.

19. Non-controlling interest in subsidiaries:

The following table summarises the information relating to each of the Company's subsidiaries that has non-controlling interests (NCI), before any intra-group eliminations.

There are no significant restrictions on the ability to access or use assets and settle liabilities of the group. There are no contractual arrangements that could require the parent or its subsidiaries to provide financial support to a consolidated structured entity.

	GEMchem Ltd	TEI (Guangzhou) Ltd	Total	GEMchem Ltd	TEI (Guangzhou) Ltd	Total
		2014			2013	
	\$	\$	\$	\$	\$	\$
NCI percentage	33%	45%		33%	45%	
Non-current assets	3,551			3,475		
Current assets	288,456	169,329	461,336	191,947	190,134	385,556
Non-current liabilities	711	-	711	695	-	695
Current liabilities	146,698	234,420	381,118	103,554	242,516	346,070
Net assets (liabilities)	144,598	(65,091)	79,507	91,173	(52,382)	38,791
Carrying amount of NCI	47,717	(29,291)	18,426	30,087	(23,571)	6,516
Revenue	682,913	21,846	704,759	560,844	211,697	772,541
Profit (loss) after tax	37,422	(11,829)	25,593	14,542	(63,551)	(49,009)
Total comprehensive income (loss)	42,703	(12,225)	30,478	14,330	(64,917)	(50,587)
Profit (loss) allocated to NCI	12,349	(5,322)	7,027	4,799	(28,598)	(23,799)
Cash flows from operating activities	32,995	(28,001)	4,994	3,429	(35,126)	(31,697)
Cash flows from investing activities	(2,505)	-	(2,505)	-	-	-
Net increase (decrease) in cash and cash equivalents	30,490	(28,001)	2,489	3,429	(35,126)	(31,697)

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

19. Non-controlling interest in subsidiaries (continued):

At May 31, 2014, GEMchem Ltd had a loan balance outstanding to TEI (UK) Ltd of \$30,370 (\$24,134 at May 31, 2013). This loan relates to assistance with costs of setting up the company and is being repaid on a monthly basis.

20. 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 year for options granted is at the discretion of the Board of Directors.

Activity in stock options was as follows:

	Year ended May 31, 2014		Year ended May 31, 2013	
	# Options	Weighted Average Exercise Price \$	# Options	Weighted Average Exercise Price \$
Outstanding, beginning of year	15,992,500	0.10	11,002,500	0.10
Granted	7,894,360	0.08	5,480,000	0.10
Forfeited	(2,384,250)	0.09	(490,000)	0.10
Expired	-	-	-	-
Outstanding, end of year	21,502,610	0.09	15,992,500	0.10

There were no options exercised for the years ended May 31, 2014 and 2013.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
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20. Share-based payments (continued):

The following share-based payment arrangements were in existence at May 31, 2014 and 2013:

At May 31, 2014:

Number outstanding	Grant date	Expiry date	Exercise price (\$)	Fair value at grant date (\$)	Number exercisable	Weighted average exercise price for exercisable options
2,450,000	04-May-2010	04-May-2015	0.10	0.03	2,450,000	0.10
2,281,250	10-May-2011	10-May-2016	0.10	0.03	2,281,250	0.10
250,000	12-Jul-2011	12-Jul-2016	0.10	0.03	166,667	0.10
4,400,000	01-Dec-2011	01-Dec-2016	0.10	0.03	2,933,333	0.10
4,820,000	22-Nov-2012	22-Nov-2017	0.10	0.03	1,606,667	0.10
3,538,000	18-Nov-2013	18-Nov-2018	0.05	0.03	–	n/a
3,763,360	28-May-2014	28-May-2019	0.10	0.06	–	n/a
21,502,610			0.09		9,437,917	0.10

At May 31, 2013:

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

The fair value of services received in return for share options granted is based on the fair value of share options granted, measured using the Black-Scholes model. As at May 31, 2014 there was \$359,636 (May 31, 2013 - \$143,946) 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 year of three years.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
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20. Share-based payments (continued):

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

	Grant Date	
	18-Nov-13	28-May-14
Grant date share price (\$) ⁽¹⁾	0.05	0.10
Exercise price (\$)	0.05	0.10
Expected volatility (%) ⁽²⁾	91.70	90.99
Expected life (years)	4.00	4.00
Expected dividend yield (%)	0.00	0.00
Risk-free interest rate (%)	1.74	1.50
Forfeiture rate (%)	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 year 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:

	2014	2013
Administration	\$ 82,860	\$ 100,023
Selling, marketing and business development	37,964	52,954
	\$ 120,824	\$ 152,977

21. Revenue:

	2014	2013
Sales of goods	\$ 3,925,295	\$ 2,610,308
Rendering of services	970,244	975,389
Contracts for heat recovery solutions	8,255,271	4,624,537
	\$13,150,810	\$ 8,210,234

Finance revenue comprises interest income earned from the finance lease. See note 8 "Finance lease receivable" for more details.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

22. Employee benefits expense:

	2014	2013
Salaries and benefits	\$ 4,185,520	\$ 3,827,837
Stock-based compensation (note 20)	120,824	152,977
Pension charge	55,042	38,777
	\$ 4,361,386	\$ 4,019,591

The Company contributes to defined contribution pension plans for permanent employees of two 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.

23. Other significant expenses:

Other significant expenses included in administration expense are as follows:

	2014	2013
Depreciation of property, plant and equipment (note 9)	\$ 38,401	\$ 45,623
Amortization of intangible assets (note 10)	8,303	98,295
Foreign exchange loss (gain)	(23,100)	11,114

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

24. Income taxes:

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

	2014	2013
Earnings (loss) before income taxes	\$ 708,419	\$ (3,040,872)
Income taxes calculated using combined federal and provincial income tax rates in Canada of 26.50% (2013 - 26.50%)	187,731	(805,831)
Stock-based compensation	32,018	40,539
Difference in tax rate of foreign subsidiaries	(43,934)	24,315
Tax effect of temporary difference for which no deferred tax asset is recorded	(125,831)	375,636
Use of temporary difference for which no deferred tax asset was recorded previously	-	(95,247)
Difference in future tax rates	542	(226,885)
Permanent differences and others	23,870	495,423
Current and deferred income tax provision	\$ 74,396	\$ (192,050)
Current	\$ 29,006	\$ (41,961)
Deferred	45,390	(150,089)
	\$ 74,396	\$ (192,050)

Major components of the current tax expense are as follows:

Statutory income tax of the year	\$ 50,655	\$ (6,952)
Adjustment for prior years	(21,649)	(35,009)
	\$ 29,006	\$ (41,961)

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

Origination and reversal of timing differences	\$ (20,614)	\$ (117,634)
Adjustment for prior years	66,004	(32,455)
	\$ 45,390	\$ (150,089)

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
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24. Income taxes (continued):

Change in deferred tax balances in 2014:

	June 1, 2013 \$	Recognized in income \$	Recognized in other comprehensive income \$	May 31, 2014 \$
Provisions	50,350	11,286	-	61,636
Property, plant and equipment	262,271	6,781	-	269,052
Finance lease receivable	(356,849)	117,014	-	(239,835)
Non-capital losses	96,928	(177,781)	-	(80,853)
Intangible assets	(118,757)	(2,690)	(13,672)	(135,119)
	(66,057)	(45,390)	(13,672)	(125,119)
Recognized as deferred tax assets				11,286
Recognized as deferred tax liabilities				(136,405)
				(125,119)

Change in deferred tax balances in 2013:

	June 1, 2012 \$	Recognized in income \$	Recognized in other comprehensive income \$	May 31, 2013 \$
Provisions	-	50,350	-	50,350
Property, plant and equipment	35,157	227,114	-	262,271
Finance lease receivable	(137,861)	(218,988)	-	(356,849)
Non-capital losses	94,626	2,302	-	96,928
Intangible assets	(209,589)	89,311	1,521	(118,757)
	(217,667)	150,089	1,521	(66,057)
Recognized as deferred tax assets				52,700
Recognized as deferred tax liabilities				(118,757)
				(66,057)

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

24. Income taxes (continued):

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

	2014	2013
Property, plant and equipment	\$ 117,554	\$ (342,620)
Intangible assets	2,739,157	2,739,157
Provisions	190,000	190,000
Non-capital losses	13,766,736	14,701,000
	\$ 16,813,447	\$ 17,287,537

As at May 31, 2014, the Company had available non-capital income tax loss carry forwards in the following amounts which may be used to reduce federal and provincial taxable income:

Year of expiry	Amount
2015	\$ 190,518
2026	1,276,366
2027	1,692,621
2028	1,441,849
2029	3,486,435
2030	3,032,173
2031	714,141
2032	43,753
2033	1,757,422
Total	\$ 13,635,278

As at May 31, 2014, the Company had non-capital losses in foreign subsidiaries, for which no deferred tax asset was recorded in the amount of \$131,458. All losses expire between 2017 and 2019.

Deferred tax liabilities have not been recognized for temporary differences associated with investments in subsidiaries as the parent is able to control the timing of the reversal of the temporary differences and it is probable that the temporary differences will not reverse in the foreseeable future. The aggregate amount of the temporary differences at May 31, 2014 was \$988,586 (2013 - \$316,601).

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
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25. Earnings (loss) per share:

The calculation of basic and diluted earnings (loss) per share for the year ended May 31, 2014 was based on the net income attributable to owners of the parent of \$626,996 (2013 - net loss of \$2,825,023) and a weighted average number of shares outstanding of 162,319,964 (2013 - 163,086,616). As at May 31, 2014, 21,388,870 options (2013 - 15,992,500) were excluded from the weighted average number of diluted common shares calculation as their effect would have been anti-dilutive.

The average market value of the Company's shares for purposes of calculating the dilutive effect of stock options was based on quoted market prices for the year during which options were outstanding.

The following table summarized the calculation of the weighted average number of basic and diluted common shares:

	2014	2013
Issued common shares at beginning of year	163,086,616	163,086,616
Effect of repurchase of shares	(766,652)	-
Weighted average number of basic common shares at end of year	162,319,964	163,086,616
Effect of stock options on issue	113,740	-
Weighted average number of diluted common shares at end of year	162,433,704	163,086,616

26. 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.

At May 31, 2014, the Company has operating lease commitments as follows:

	Total	Less than 1 year	1-5 years	More than 5 years
Operating leases	\$ 426,161	\$ 142,738	\$ 283,423	\$ -

Lease payments recognized as an expense for the year ended May 31, 2014 totalled \$140,066 (2013 - \$135,127).

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

27. Financial instruments:

Financial risk management:

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

(a) 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.

(i) Foreign currency risk:

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.

	Net financial assets/(liabilities) in CAD\$		
	US \$	Euro	Total CAD \$
Functional currency of Company entity			
May 31, 2014			
Canadian Dollar	1,001,078	–	1,001,078
British Pound	(8,470)	467,720	459,250
	992,608	467,720	1,460,328
May 31, 2013			
Canadian Dollar	155,691	–	155,691
British Pound	(176,580)	168,646	(7,934)
	(20,889)	168,646	147,757

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Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
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27. Financial instruments (continued):

Financial risk management (continued):

(a) Market risk (continued):

(i) Foreign currency risk (continued):

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

	2014			2013		
	US\$	Euros	Total	US\$	Euros	Total
Net income (loss)	99,261	46,772	146,033	(2,089)	16,865	14,776
Equity	99,261	46,772	146,033	(2,089)	16,865	14,776

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.

(ii) Interest rate risk:

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

The Company currently does not use interest rate hedges or fixed interest rate contracts to manage the Company's exposure to interest rate fluctuations. There were no significant investments or borrowings to expose the Company to interest rate sensitivity either at May 31, 2014 or 2013.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
(Expressed in Canadian dollars)

27. Financial instruments (continued):

Financial risk management (continued):

(b) Credit risk:

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

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

Accounts receivable

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

Contracts for heat recovery solutions are planned to help ensure positive cash flows 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 consolidated statements 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 5), trade receivables, other miscellaneous receivables (see note 6) and finance lease receivable. In determining the fair value of the finance lease, the Company uses the discounted cash future cash flows of the asset, being the minimum lease payments, discounted using a rate of 14.3% - rate implicit in the lease. The fair value of the finance lease receivable at May 31, 2014 was \$962,274.

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Years ended May 31, 2014 and 2013
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27. Financial instruments (continued):

Financial risk management (continued):

(c) Liquidity risk:

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

As at May 31, 2014, the Company's financial liabilities, which consist of trade payables, accruals and finance leases payable, have a carrying value of \$1,675,502 (\$996,393 at May 31, 2013) and are all due within one year.

28. 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:

	2014	2013
Salaries and other short-term employee benefits	\$ 1,254,784	\$ 1,060,457
Share-based payments	60,032	98,560
	\$ 1,314,816	\$ 1,159,017

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, amounts expensed in the year as due to key management personnel under the Company's employee incentive plan, and Directors' fees including meeting fees, committee chairman fees and retainers. Share-based payments include the fair value of equity settled share-based payment arrangements expensed during the year.