

THERMAL ENERGY INTERNATIONAL INC.

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

As at	August 31, 2016	May 31, 2016
	\$	\$
ASSETS		
Current assets		
Cash and cash equivalents (Note 5)	836,014	1,143,148
Trade and other receivables (Note 6)	2,028,436	2,084,027
Current tax receivable	36,797	39,875
Inventory (Note 7)	415,118	450,514
Finance lease receivable (Note 8)	84,346	116,560
	3,400,711	3,834,124
Non-current assets		
Property, plant and equipment (Note 9)	69,350	78,437
Intangible assets (Note 10)	640,277	705,930
Goodwill (Note 11)	1,216,572	1,341,316
Deferred tax assets	20,912	20,902
	1,947,111	2,146,585
Total assets	5,347,822	5,980,709
LIABILITIES		
Current liabilities		
Trade payables (Note 13)	668,494	974,724
Current tax liabilities	22,136	83,507
Pensions and other employer obligations	90,533	97,617
Other liabilities (Note 14)	863,985	772,199
Deferred revenue (Note 15)	642,277	714,703
Provisions (Note 16)	215,000	215,000
	2,502,425	2,857,750
Non-current liabilities		
Deferred tax liabilities	49,777	17,457
Total liabilities	2,552,202	2,875,207
EQUITY		
Capital stock (Note 17)	32,069,073	32,069,073
Contributed surplus	3,879,593	3,853,739
Accumulated other comprehensive income	305,491	554,990
Deficit	(33,472,832)	(33,389,814)
Equity attributable to owners of the parent	2,781,325	3,087,988
Non-controlling interest	14,295	17,514
Total equity	2,795,620	3,105,502
Total liabilities and equity	5,347,822	5,980,709

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

On behalf of the Board:



Director



Director

THERMAL ENERGY INTERNATIONAL INC.

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

Three months ended August 31	2016 \$	2015 \$
Revenue	2,134,753	2,556,614
Cost of sales	679,068	1,456,844
Gross profit	1,455,685	1,099,770
Expenses:		
Administration	600,953	682,792
Selling, marketing and business development	855,736	805,107
Research and development	34,279	79,521
	1,490,968	1,567,420
Operating loss	(35,283)	(467,650)
Finance revenue	3,786	7,821
Loss before income taxes	(31,497)	(459,829)
Income taxes (charge) recovery	(48,233)	7,232
Net loss for the period	(79,730)	(452,597)
Other comprehensive loss for the period		
Items that may be reclassified subsequently to profit or loss:		
Exchange differences arising on translation of overseas operations	(256,006)	144,941
Total comprehensive loss for the period	(335,736)	(307,656)
Net income (loss) for the period attributable to:		
Owners of the parent	(83,018)	(456,621)
Non-controlling interest	3,288	4,024
Net loss for the period	(79,730)	(452,597)
Total comprehensive income (loss) for the period attributable to:		
Owners of the parent	(332,517)	(313,776)
Non-controlling interest	(3,219)	6,120
Total comprehensive loss for the period	(335,736)	(307,656)
Net income (loss) per share - basic and diluted (Note 21)	(0.001)	(0.003)

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

THERMAL ENERGY INTERNATIONAL INC.

UNAUDITED CONDENSED CONSOLIDATED INTERIM STATEMENTS OF CHANGES IN EQUITY
(EXPRESSED IN CANADIAN DOLLARS)

	Capital Stock \$	Contributed Surplus \$	Deficit \$	Accumulated Other Comprehensive Income \$	Total Attributable to Owners of the Parent \$	Non- controlling Interest \$	Total Equity \$
Balance at June 1, 2015	32,308,827	3,497,359	(33,643,663)	559,149	2,721,672	12,367	2,734,039
Stock-based compensation (Note 19)	-	50,828	-	-	50,828	-	50,828
Repurchase of Class A common shares (Note 17)	-	-	-	-	-	-	-
Transactions with owners	-	50,828	-	-	50,828	-	50,828
Net income (loss) for the period	-	-	(456,621)	-	(456,621)	4,024	(452,597)
Other comprehensive income: exchange differences							
arising on translation of overseas operations	-	-	-	142,845	142,845	2,096	144,941
Total comprehensive income (loss) for the period	-	-	(456,621)	142,845	(313,776)	6,120	(307,656)
Balance at August 31, 2015	32,308,827	3,548,187	(34,100,284)	701,994	2,458,724	18,487	2,477,211
Balance at June 1, 2016	32,069,073	3,853,739	(33,389,814)	554,990	3,087,988	17,514	3,105,502
Stock-based compensation (Note 19)	-	25,855	-	-	25,855	-	25,855
Repurchase of Class A common shares (Note 17)	-	-	-	-	-	-	-
Transactions with owners	-	25,855	-	-	25,855	-	25,855
Net income (loss) for the period	-	-	(83,018)	-	(83,018)	3,288	(79,730)
Other comprehensive income: exchange differences							
arising on translation of overseas operations	-	-	-	(249,499)	(249,499)	(6,507)	(256,006)
Total comprehensive income (loss) for the period	-	-	(83,018)	(249,499)	(332,517)	(3,219)	(335,736)
Balance at August 31, 2016	32,069,073	3,879,593	(33,472,832)	305,491	2,781,325	14,295	2,795,620

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

THERMAL ENERGY INTERNATIONAL INC.

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

Three months ended August 31	2016 \$	2015 \$
OPERATING ACTIVITIES:		
Net loss for the period	(79,730)	(452,597)
Add items not involving cash:		
Depreciation of property, plant and equipment	7,862	7,566
Finance revenue	(3,786)	(7,821)
Stock-based compensation (Note 19)	25,855	50,828
Income tax charge (recovery)	48,233	(7,232)
Unrealized foreign exchange and translation adjustments	(48,827)	37,865
Changes in working capital :		
Trade and other receivables	55,591	983,332
Inventory	35,396	(20,884)
Trade payables	(305,148)	147,820
Deferred revenue	(72,426)	(733,486)
Other liabilities	84,702	(69,086)
Income taxes refunded (paid)	(63,272)	(147)
Interests received on finance lease	3,786	7,821
Other interests received	23	647
Interest paid	(1,105)	(1,198)
Net cash used in operating activities	(312,847)	(56,572)
INVESTING ACTIVITIES:		
Finance lease principal payments received	32,214	28,179
Additions to property, plant and equipment	(1,340)	(1,348)
Net cash provided by investing activities	30,874	26,831
FINANCING ACTIVITIES:		
Repurchase of Class A common shares	-	-
Net cash used by financing activities	-	-
Decrease in cash and cash equivalents for the period	(281,973)	(29,741)
Cash and cash equivalents, beginning of period	1,143,148	715,343
Exchange differences on cash and cash equivalents	(25,161)	(26,161)
Cash and cash equivalents, end of period	836,014	659,441

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements

Three months ended August 31, 2016 and 2015
(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 unaudited condensed consolidated interim financial statements were approved and authorized for issue by the Board of Directors on October 18, 2016. The consolidated financial statements comprise the financial results of the parent and its subsidiaries (collectively known as the “Company”) for the three months ended August 31, 2016 and 2015.

2. Basis of presentation:

(a) Going concern:

These 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, despite a net profit of \$258,868 in the year ended May 31, 2016, the Company has experienced a net loss in the current period. In addition, the Company has a deficit of \$33,472,832.

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 debt or equity 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 by achieving profitable operations through continuing to manage expenditures and concentrating on building upon the revenue level experienced in 2016. 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 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 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 statement of financial position.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

2. Basis of presentation (continued):

(b) Statement of compliance:

These condensed consolidated interim financial statements have been prepared in accordance with International Accounting Standard 34 "Interim Financial Reporting" ("IAS 34") as issued by the International Accounting Standards Board ("IASB"), utilizing the accounting policies the Company adopted in its May 31, 2016 audited annual consolidated financial statements. The accounting policies are based on the International Financial Reporting Standards ("IFRS"). These unaudited condensed consolidated interim financial statements do not include all of the information required for full annual financial statements and should be read in conjunction with the audited consolidated financial statements of the Company for the year ended May 31, 2016.

The significant accounting policies are summarized in note 3.

(c) Measurement basis:

The 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)

Three months ended August 31, 2016 and 2015
(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.

- 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 19.

- 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, significant estimates are made about milestones 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 judgement 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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

2. Basis of presentation (continued):

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

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:

Judgement 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.

(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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

2. Basis of presentation (continued):

(e) Functional currency and foreign currency translation (continued):

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

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

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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(a) Basis of consolidation (continued):

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%	CAD	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%	CAD	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.

All subsidiaries have a reporting date of August 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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(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.

(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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(e) Leases (continued):

(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.

(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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(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

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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(i) Impairment (continued):

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.

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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

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

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.

(k) 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.

(l) 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.

(m) 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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

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

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

All equity-settled share-based payments (except warrants to brokers) are ultimately recognized as an expense in 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.

(n) 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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(n) Revenue recognition (continued):

Sale of goods

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

Rendering of services

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

Contracts for heat recovery solutions

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

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

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(n) Revenue recognition (continued):

Multi-element arrangements

The Company provides its heat recovery solutions, GEM™ product, installation and servicing on a standalone 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.

(o) 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.

(p) 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)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(q) 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.

(r) 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 statements of comprehensive income (loss).

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(r) Income taxes (continued):

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.

(s) 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.

(t) 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.

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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(t) Financial instruments (continued):

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.

Fair value hierarchy

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(u) 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.

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

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

Amendments to IFRS 2, "Share-based Payments"

In December 2013, the IASB issued amendments to IFRS 2 Share-based payments, which clarify vesting conditions by separately defining a performance condition and a service condition, both of which were previously incorporated within the definition of a vesting condition. These amendments became effective for annual periods beginning on or after July 1, 2014 and interim periods within those annual periods. The Company adopted the amendments on June 1, 2015. The adoption of the amendments to IFRS 2 did not have a material impact on the consolidated financial statements.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

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

Amendments to IFRS 13, "Fair Value Measurements"

In December 2013, the IASB issued amendments to IFRS 13 Fair Value Measurements, which relate to the measurement of short-term receivables and payables, and the scope of the portfolio exemption. Short-term receivables and payables with no stated interest rate can still be measured at the invoice amount without discounting if the effect of discounting is immaterial. The portfolio exemption permits an entity to measure the fair value of a group of financial assets and financial liabilities on a net basis. The amendment clarifies that the portfolio exemption applies to all contracts within the scope of IAS 39 Financial Instruments: Recognition and Measurement (or IFRS 9 Financial Instruments if this has been adopted early), regardless of whether they meet the definition of financial assets or financial liabilities within IAS 32 Financial Instruments: Presentation. These amendments became effective for annual periods beginning on or after July 1, 2014. The Company adopted the amendments on June 1, 2015. The adoption of the amendments to IFRS 13 did not have a material impact on the consolidated financial statements.

Amendments to IAS 16 "Property, Plant and Equipment" and IAS 38 "Intangible Assets"

In May 2014, the IASB issued amendments to IAS 16 Property, Plant and Equipment and IAS 38 Intangible Assets. These amendments prohibit entities from using a revenue-based depreciation method for items of property, plant and equipment. They also introduce a rebuttable presumption that revenue is not an appropriate basis for amortization of an intangible asset. The amendments explain that an expected future reduction in selling prices could be indicative of a reduction of the future economic benefits embodied in an asset. These amendments are to be applied prospectively for annual periods beginning on or after January 1, 2016. The Company adopted the amendments on June 1, 2016. The adoption of the amendments to IAS 16 and IAS 38 did not have a material impact on the consolidated financial statements.

New standards and amendments yet to be adopted:

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.

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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

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

IFRS 9, "Financial Instruments"

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. This standard simplifies the classification of a financial asset as either at amortized cost or at fair value as opposed to the multiple classifications which were permitted under IAS 39. This standard also requires the use of a single impairment method as opposed to the multiple methods in IAS 39. The approach in IFRS 9 is based on how an entity manages its financial instruments in the context of its business model and the contractual cash flow characteristics of the financial assets. The standard also adds guidance on the classification and measurement of financial liabilities. IFRS 9 is to be applied retrospectively for annual periods beginning on or after January 1, 2018. Early application is permitted. 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.

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. The IASB recently confirmed a one year deferral of the effective date of IFRS 15 to January 1, 2018. Earlier application of IFRS 15 continues to be permitted. 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.

IFRS 16, "Leases"

In January 2016, the IASB issued IFRS 16, Leases, which specifies how to recognize, measure present and disclose leases. The standard provides a single lessee accounting model, requiring lessees to recognize all assets and liabilities for all leases unless the lease term is 12 months or less or the underlying asset has a low value. Consistent with its predecessor, IAS 17, the new lease standard continues to require lessors to classify leases as operating or finance. IFRS 16 is to be applied retrospectively for annual periods beginning on or after January 1, 2019. Earlier application is permitted if IFRS 15 Revenue from Contracts with Customers has also been applied. 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)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

4. Segment reporting:

In quarters ended August 31, 2016 and August 31, 2015, the Company operated in the energy efficiency industry in North America, Europe, China and Rest of the World. The Company markets, sells, engineers, fabricates, constructs, installs and supports two technology lines - heat recovery solutions and condensate return system solutions. The Company is also developing a third technology line - low temperature biomass drying systems. Assets are located in Canada, Europe and China.

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

Segment information for the quarter ended August 31, 2016 and the comparative period are detailed in the table below.

	North America & China		Europe & Rest of World		Reconciling items		Total	
	2016	2015	2016	2015	2016	2015	2016	2015
	\$	\$	\$	\$	\$	\$	\$	\$
Total revenue	681,375	1,253,030	1,453,378	1,303,584	-	-	2,134,753	2,556,614
Cost of sales	(198,626)	(886,549)	(480,442)	(570,295)	-	-	(679,068)	(1,456,844)
Gross profit	482,749	366,481	972,936	733,289	-	-	1,455,685	1,099,770
Other expenses	(593,349)	(593,588)	(661,612)	(646,692)	(236,007)	(327,140)	(1,490,968)	(1,567,420)
Finance revenue	3,786	7,821	-	-	-	-	3,786	7,821
Profit (loss) before taxation	(106,814)	(219,286)	311,324	86,597	(236,007)	(327,140)	(31,497)	(459,829)
Taxation	24	493	(51,461)	(249)	3,204	6,988	(48,233)	7,232
Profit (loss) after taxation	(106,790)	(218,793)	259,863	86,348	(232,803)	(320,152)	(79,730)	(452,597)
Attributable to:								
Owners of the parent	(101,259)	(216,794)	251,044	80,325	(232,803)	(320,152)	(83,018)	(456,621)
Non-controlling interest	(5,531)	(1,999)	8,819	6,023	-	-	3,288	4,024

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

4. Segment reporting (continued):

Other expenses within reconciling items comprise the following:

	Quarter ended Aug 31	
	2016	2015
	\$	\$
Corporate admin costs	194,869	188,025
Stock-based compensation	25,855	50,828
Professional fees	95,502	91,936
Depreciation of property, plant and equipment	7,862	7,566
Bank charges and interest	8,373	8,654
Foreign exchange differences	(96,454)	(19,869)
Total	236,007	327,140

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.

During the quarter ended August 31, 2016 the company had one customer within Europe and the rest of the world that accounted for 20% of total revenue for the period.

During the quarter ended August 31, 2015 the company had two customers within North America and China that accounted for 21% and 12%, and two customers within Europe and the rest of the world that accounted for 14% and 11% of total revenue respectively.

Further geographical analysis:

	Revenue for the three months ended		Property, Plant and Equipment as at		Goodwill and other Intangible assets as at	
	August 31, 2016	August 31, 2015	August 31, 2016	May 31, 2016	August 31, 2016	May 31, 2016
	\$	\$	\$	\$	\$	\$
Canada	55,031	47,944	46,161	50,380	-	-
U.S.A.	626,344	1,205,086	-	-	-	-
U.K.	1,149,757	1,153,790	23,189	28,057	1,856,849	2,047,246
Italy	166,350	32,418	-	-	-	-
Netherlands	14,896	25,206	-	-	-	-
Ireland	26,836	-	-	-	-	-
Germany	46,562	82,420	-	-	-	-
Rest of Europe	7,438	273	-	-	-	-
India	18,308	2,754	-	-	-	-
China	-	-	-	-	-	-
Kenya	23,231	-	-	-	-	-
Rest of world	-	6,723	-	-	-	-
Total	2,134,753	2,556,614	69,350	78,437	1,856,849	2,047,246

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

5. Cash and cash equivalents:

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

	August 31, 2016	May 31, 2016
Cash	\$ 835,514	\$ 1,142,648
Cash equivalents	500	500
Cash and cash equivalents	\$ 836,014	\$ 1,143,148

6. Trade and other receivables:

	August 31, 2016	May 31, 2016
Trade receivables, gross	\$ 1,646,542	1,577,446
Allowance for doubtful accounts	(11,026)	(12,157)
Trade receivables, net	1,635,516	1,565,289
Contracts for heat recovery solutions (see note 6(a))	133,567	80,085
Unbilled product and service revenue (see note 6(b))	65,279	59,057
Prepayments	194,074	65,428
Sales tax and other miscellaneous receivables		314,168
	\$ 2,028,436	\$ 2,084,027

The net carrying value of trade receivables is considered a reasonable approximation of fair value. Other miscellaneous receivables include \$103,640 (\$104,960 at May 31, 2016) due from a Chinese distributor receiving payments on the Company's behalf from a Chinese customer.

At Aug 31, 2016, \$2,588 (0.18%) of the Company's trade receivables balance was over 90 days past due, but not impaired (\$1,611 (0.1%) at May 31, 2016).

The change in allowance for doubtful accounts was as follows:

	August 31, 2016	May 31, 2016
Balance, beginning of period	\$ 12,157	\$ -
Provisions	-	11,952
Foreign exchange adjustments	(1,131)	205
Balance, end of period	\$ 11,026	\$ 12,157

The Company's trade and other receivables have been reviewed for indicators of impairment. For the quarters ended Aug 31, 2016 and August 31, 2015, no provisions were made.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

6. Trade and other receivables (continued):

(a) Contracts for heat recovery solutions:

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

	August 31, 2016	May 31, 2016
Aggregate amount of costs incurred and recognized profits and losses for all contracts in progress	\$ 1,873,381	\$ 2,663,127
Less progress billings	(2,326,107)	(3,240,052)
	\$ (452,726)	\$ (576,925)

Recognized as:

	August 31, 2016	May 31, 2016
Due from customers for contract work, recognized in trade and other receivables	\$ 133,567	\$ 80,085
Customer deposits paid on order before commencement of project, recognized in deferred revenue (note 15)	(296,380)	-
Due to customers for contract work, recognized in deferred revenue (note 15)	(289,913)	(657,010)
	\$ (452,726)	\$ (576,925)

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

6. Trade and other receivables (continued):

(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:

	August 31, 2016	May 31, 2016
Aggregate amount of costs incurred and recognized profits and losses for all contracts in progress	\$ 143,673	\$ 239,632
Less progress billings	(134,378)	(238,268)
	<u>\$ 9,295</u>	<u>\$ 1,364</u>
Recognized as:		
Due from customer for service performed, recognized in trade and other receivables	\$ 65,279	\$ 59,057
Due to customer for products and services not delivered yet, recognized in deferred revenue (note 15)	(55,984)	(57,693)
	<u>\$ 9,295</u>	<u>\$ 1,364</u>

7. Inventory:

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

For the quarter ended August 31, 2016, a total of \$174,121 of inventories was expensed to cost of sales (2016 - \$120,818). A total of \$Nil of inventories (2016 - \$Nil) were written off or provided for as slow-moving. No reversal of previous write-downs has been recorded during the quarters ended August 31, 2016 and 2015.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

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8. Finance lease receivable:

The Company's finance lease receivable includes the following:

	August 31, 2016	May 31, 2016
Total estimated minimum lease payments receivable	\$ 89,054	\$ 125,054
Less: unearned income	(4,708)	(8,494)
	84,346	116,560
Less: current portion	(84,346)	(116,560)
	\$ -	\$ -

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 had the option to renew for an additional 24 months on substantially the same terms or purchase the asset from the Company.

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 mid-May 2015.

On May 1, 2015, the customer signed a further extension for 24 months to May 1, 2017. Pursuant to this new extension, the customer has agreed to pay up to \$12,000 per month over two years, at the end of which the customer has the option to purchase the asset from the Company.

As part of calculating the impact of the new lease extension, the existing net residual value of the equipment was re-assessed. The estimated value of any re-sale value or scrap value of the equipment less removal and re-sale costs was assessed as \$nil and so a write-down of the \$139,530 net residual value was taken. This write-down, combined with the write-down of the May 2015 expected payment under the terms of the previous lease, which was expected to expire in mid-May 2015, reduced the net revenue recognized on renewal of the lease to \$69,791.

Until the expiry of the new lease on May 1, 2017, finance revenue will be recognized within the consolidated statements of comprehensive income at the interest rate implicit in the lease.

The estimated minimum lease payments receivable in this lease represent the estimated monthly energy outputs of the leased asset and are based on assumptions regarding the efficiency of the asset and the operations of the plant in which it is located.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

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8. Finance lease receivable (continued):

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	\$ 89,054
Residual value	-
	\$ 89,054

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

9. Property, plant and equipment:

	Plant and Equipment	Furniture and Fixtures	Laboratory Equipment	Computers	Leasehold Improve- ments	Motor Vehicles	Total
	\$	\$	\$	\$	\$	\$	\$
Cost, May 31, 2015	110,449	103,083	52,857	338,544	22,877	24,524	652,334
Additions	29,900	-	-	18,833	-	8,632	57,365
Disposals	-	-	-	(33,067)	-	(26,046)	(59,113)
Translation adjustments	(3,040)	(3)	-	(425)	-	1,008	(2,460)
Cost, May 31, 2016	137,309	103,080	52,857	323,885	22,877	8,118	648,126
Additions	-	-	-	1,340	-	-	1,340
Disposals	-	-	-	-	-	-	-
Translation adjustments	(7,934)	(312)	-	(5,062)	-	(755)	(14,063)
Cost, August 31, 2016	129,375	102,768	52,857	320,163	22,877	7,363	635,403
Accumulated depreciation, May 31, 2015	77,206	97,562	52,857	315,386	22,436	24,524	589,971
Depreciation for the year	12,265	2,285	-	21,234	441	2,119	38,344
Disposals	-	-	-	(33,067)	-	(26,046)	(59,113)
Translation adjustments	(203)	(3)	-	(741)	-	1,434	487
Accumulated depreciation, May 31, 2016	89,268	99,844	52,857	302,812	22,877	2,031	569,689
Depreciation for the period	3,479	571	-	3,346	-	466	7,862
Disposals	-	-	-	-	-	-	-
Translation adjustments	(6,882)	(312)	-	(4,108)	-	(196)	(11,498)
Accumulated depreciation, August 31, 2016	85,865	100,103	52,857	302,050	22,877	2,301	566,053
Net book value, May 31, 2016	48,041	3,236	-	21,073	-	6,087	78,437
Net book value, August 31, 2016	43,510	2,665	-	18,113	-	5,062	69,350

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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

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10. Intangible assets:

	Trade Names & Trademarks \$	Non- compete Agreement \$	Industrial Know- how \$	Designs & Drawings \$	Customer Relationships \$	Total \$
Cost, May 31, 2015	874,506	114,066	133,079	146,385	313,683	1,581,719
Translation adjustments	(1,011)	(132)	(54)	(169)	(363)	(1,729)
Cost, May 31, 2016	873,495	113,934	133,025	146,216	313,320	1,579,990
Translation adjustments	(81,237)	(10,596)	(12,362)	(13,598)	(29,139)	(146,932)
Cost, August 31, 2016	792,258	103,338	120,663	132,618	284,181	1,433,058
Accumulated amortization, May 31, 2015	167,758	114,066	133,079	146,385	313,683	874,971
Translation adjustments	(193)	(132)	(54)	(169)	(363)	(911)
Accumulated amortization, May 31, 2016	167,565	113,934	133,025	146,216	313,320	874,060
Translation adjustments	(15,584)	(10,596)	(12,362)	(13,598)	(29,139)	(81,279)
Accumulated amortization, August 31, 2016	151,981	103,338	120,663	132,618	284,181	792,781
Net Book Value, May 31, 2016	705,930	-	-	-	-	705,930
Net Book Value, August 31, 2016	640,277	-	-	-	-	640,277

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 three months ended August 31, 2016 or August 31, 2015. The growth rates attributed by Management to the GEM™ product line are 53% in 2017, followed by positive 5% in each of the subsequent four years. The first year growth is the result of relatively low sales within Europe and the rest of the world in FY 2016. 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).

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:

	August 31, 2016	May 31, 2016
Balance, beginning of period	\$ 1,341,316	\$ 1,342,869
Translation adjustments	(124,744)	(1,553)
Balance, end of period	\$ 1,216,572	\$ 1,341,316

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11. Goodwill (continued):

Goodwill was tested for impairment as at each year end, resulting in no impairment charge as at May 31, 2016. 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 and GEMchem Limited, a 67% owned subsidiary of Thermal Energy International (UK) Limited.

The recoverable amounts of the cash-generating units were determined based on value-in-use calculations, covering a one year budget, followed by an extrapolation over 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 19% (2015 - 19%) 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 18% (2015 - 18%) for each cash-generating unit, incorporating the following factors: market risk premium adjusted for the target levered beta, based upon comparable companies, the risk-free rate of return and a size and company specific risk premium. The cost of debt was assumed as the risk free rate plus a premium of 3%. In computing the WACC, a capital structure comprising 15% (2015 - 15%) debt and 85% (2015 - 85%) equity was assumed, after considering the capital structure of comparable companies.

For purposes of the May 31, 2016 impairment testing, Thermal Energy International (UK) Limited's growth from 2016 to 2017 was assumed to be 43%, as per the detailed budget prepared with 5% growth per annum thereafter. The growth in 2017 is the direct result of lower than expected GEM™ 2016 revenues, plus expected growth in the number of heat recovery projects within Europe and the rest of the world. The subsequent growth of 5% per annum over the following four years is a conservative estimate which includes revenues resulting from intended additional sales representation in Europe, while allowing for unknown changes in the global economic climate following the decision of the UK to leave the European Union.

GEMchem Limited's growth from 2016 to 2017 was assumed to be 4%, as per the detailed budget prepared with subsequent growth of 9%, 10%, 10% and 10% in 2018 through to 2020. This is based on a combination of historical results, which demonstrate steady increases year on year, plus anticipated additional sales from existing sales staff.

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

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12. Short-term borrowings:

The Company has an authorized credit facility of up to approximately \$430,000 dependent on the level of certain UK accounts receivable balances. The available facility as at August 31, 2016 was in the amount of \$369,000 (May 31, 2016 - \$156,000), of which \$Nil was utilized as at August 31, 2016 (May 31, 2016 - \$Nil). The Company has continued access to this short-term financing facility.

13. Trade payables:

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

	August 31, 2016	May 31, 2016
Trade payables	\$ 668,494	\$ 974,724

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:

	August 31, 2016	May 31, 2016
Accruals	\$ 857,977	\$ 428,640
Other government remittances payable	6,008	343,559
	\$ 863,985	\$ 772,199

Included in accruals is \$30,750 due to directors (\$18,937 at May 31, 2016).

15. Deferred revenue:

	August 31, 2016	May 31, 2016
Customer deposits relating to heat recovery solutions (note 6(a))	\$ 296,380	\$ -
Deferred revenue relating to heat recovery solutions (note 6(a))	289,913	657,010
Deferred revenue relating to GEM™ product and services (note 6(b))	55,984	57,693
	\$ 642,277	\$ 714,703

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

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Notes to Consolidated Financial Statements (continued)

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16. Provisions:

	Legal provision	Warranty provision	Total provisions
Balance, beginning and end of period	\$ 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.

In May, 2010, the plaintiff brought a motion for summary judgement, seeking judgement 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 judgement 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 judgement 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.

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Notes to Consolidated Financial Statements (continued)

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16. Provisions (continued):

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 judgement 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.

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:

	Three months ended August 31, 2016		Year ended May 31, 2016	
	# Shares	\$	# Shares	\$
Class A Common shares issued				
Balance, beginning of period				
Unrestricted shares	157,834,616	32,069,073	159,014,616	32,308,827
Shares held in escrow	-	-	250,000	-
		32,069,073	159,264,616	32,308,827
Shares held in escrow cancelled	-	-	(250,000)	-
Shares purchased and cancelled ⁽¹⁾	-	-	(1,180,000)	(239,754)
Balance, end of period	157,834,616	32,069,073	157,834,616	32,069,073
Unrestricted shares	157,834,616	32,069,073	157,834,616	32,069,073
Shares held in escrow			-	-
Balance, end of period	157,834,616	32,069,073	157,834,616	32,069,073

(1) For the three months ended August 31, 2016, no shares were purchased for cancellation by the Company. For the year ended May 31, 2016, 1,180,000 Class A common shares were purchased for cancellation by the Company for a total purchase price of \$51,448, resulting in a reduction to capital stock of \$239,754 and an increase in contributed surplus of \$188,306.

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Notes to Consolidated Financial Statements (continued)

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17. Capital stock (continued):

Normal Course Issuer Bid:

On February 17, 2016, the Company announced its intent to re-launch the Normal Course Issuer Bid ("NCIB") for a further period of twelve months. The NCIB was approved by the TSX Venture Exchange on February 12, 2016. During the 12-month period commencing February 15, 2016 and ending February 15, 2017, the Company is able to purchase on the TSX up to 12,758,701 common shares, representing approximately 8% 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 were purchased and cancelled directly under the NCIB for the year ended May 31, 2016.

The previously announced NCIB was approved by TSX Venture Exchange on November 3, 2014 and expired on November 3, 2015.

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 August 31, 2016 totalled \$2,475,834 (May 31, 2016 - \$2,532,998). 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. 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 33,661,584 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. The vesting term for options granted is at the discretion of the Board of Directors.

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19. Share-based payments (continued):

Activity in stock options was as follows:

	Three months ended August 31, 2016		Three months ended August 31, 2015	
	# Options	Weighted Average Exercise Price \$	# Options	Weighted Average Exercise Price \$
Outstanding, beginning of period	22,718,720	0.09	23,690,720	0.09
Granted	-	0.05	-	0.08
Forfeited	(444,000)	0.09	(85,000)	0.10
Expired	(250,000)	0.10	-	0.10
Outstanding, end of period	22,024,720	0.08	23,605,720	0.09

There were no options exercised for the three months ended August 31, 2016 and 2015.

The following share-based payment arrangements were in existence at August 31, 2016 and 2015:

At August 31, 2016:

Number outstanding	Grant date	Expiry date	Exercise price (\$)	Fair value at grant date (\$)	Number exercisable	Weighted average exercise price for exercisable options
3,860,000	01-Dec-2011	01-Dec-2016	0.10	0.03	3,860,000	0.10
4,340,000	22-Nov-2012	22-Nov-2017	0.10	0.03	4,340,000	0.10
2,924,000	18-Nov-2013	18-Nov-2018	0.05	0.03	1,949,334	0.05
3,149,360	28-May-2014	28-May-2019	0.10	0.06	2,099,574	0.10
250,000	01-Dec-2014	01-Dec-2019	0.09	0.05	83,333	0.09
4,076,360	29-May-2015	29-May-2020	0.08	0.04	1,358,787	0.08
3,425,000	30-May-2016	30-May-2021	0.05	0.04	-	-
22,024,720					13,691,028	0.09

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Notes to Consolidated Financial Statements (continued)

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19. Share-based payments (continued):

At May 31, 2016:

Number outstanding	Grant date	Expiry date	Exercise price (\$)	Fair value at grant date (\$)	Number exercisable	Weighted average exercise price for exercisable options
250,000	12-Jul-2011	12-Jul-2016	0.10	0.03	250,000	0.10
3,860,000	01-Dec-2011	01-Dec-2016	0.10	0.03	3,860,000	0.10
4,340,000	22-Nov-2012	22-Nov-2017	0.10	0.03	4,340,000	0.10
3,072,000	18-Nov-2013	18-Nov-2018	0.05	0.03	2,048,000	0.05
3,297,360	28-May-2014	28-May-2019	0.10	0.06	2,198,240	0.10
250,000	01-Dec-2014	01-Dec-2019	0.09	0.05	83,333	0.09
4,224,360	29-May-2015	29-May-2020	0.08	0.04	1,408,120	0.08
3,425,000	30-May-2016	30-May-2021	0.05	0.04	-	-
22,718,720					14,187,693	0.09

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 August 31, 2016, there was \$124,318 (May 31, 2016 - \$154,935) 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 term of three years.

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

	Grant Date			
	28-May-14	01-Dec-14	29-May-15	30-May-16
Grant date share price (\$) ⁽¹⁾	0.10	0.08	0.06	0.04
Exercise price (\$)	0.10	0.09	0.08	0.05
Expected volatility (%) ⁽²⁾	90.99	89.64	87.70	90.20
Expected life (years)	4.00	4.00	4.00	4.00
Expected dividend yield (%)	0.00	0.00	0.00	0.00
Risk-free interest rate (%)	1.50	1.38	0.88	0.79
Forfeiture rate (%)	0.00	0.00	13.00	17.00

(1) The closing market price of the shares on the TSX Venture Exchange on the date of grant or the first day of trading immediately following the date of grant if no shares traded on the grant date.

(2) The expected volatility was based on historical volatility of the Company over a period of time that is commensurate with the expected life of the options.

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Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
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19. Share-based payments (continued):

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

	Three months ended August 31, 2016	Three months ended August 31, 2015
Administration	\$ 15,428	\$ 35,502
Selling, marketing and business development	10,427	15,326
	\$ 25,855	\$ 50,828

20. Pension plan:

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 and amounted to \$18,796 in the three months ended August 31, 2016 (\$19,265 in the three months ended August 31, 2015)

21. Earnings (loss) per share:

The calculation of basic and diluted loss per share for the quarter ended August 31, 2016 was based on the net loss attributable to owners of the parent of (\$83,018) (2015 - net loss of \$456,621) and a weighted average number of shares outstanding of 157,834,616 (2015 - 159,014,616). As at August 31, 2016, 22,024,720 options (2015 - 23,605,720) 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:

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Notes to Consolidated Financial Statements (continued)

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21. Earnings (loss) per share (continued):

	Three months ended August 31, 2016	Three months ended August 31, 2015
Issued common shares at beginning of the period	157,834,616	159,014,616
Weighted average number of basic common shares at end of the period	157,834,616	159,014,616
Effect of stock options on issue	-	-
Weighted average number of diluted common shares at end of the period	157,834,616	159,014,616

22. 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 August 31, 2016, the Company had operating lease commitments as follows:

	Total	Less than 1 year	1-5 years	More than 5 years
Operating leases	\$ 320,425	\$ 136,411	\$ 184,014	\$ -

Lease payments recognized as an expense for the three months ended August 31, 2016 totalled \$35,036 (2015 - \$37,419).

23. 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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

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23. Financial instruments (continued):

(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 \$	Euros	Total CAD \$
Functional currency of Company entity			
August 31, 2016			
Canadian Dollar	16,017	–	16,017
British Pound	–	–	222,917
	16,017	222,917	238,934
<u>May 31, 2016</u>			
Canadian Dollar	304,536	–	304,536
British Pound	(1,039)	303,520	302,481
	303,497	303,520	607,017

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Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

23. 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:

	Three months ended August 31, 2016			Three months ended August 2015		
	US \$	Euros	Total	US \$	Euros	Total
Net income (loss)	1,602	22,292	23,894	41,747	19,081	60,828
Equity	1,602	22,292	23,894	41,747	19,081	60,828

The Company operates internationally with subsidiaries in the United Kingdom, China and 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 endeavour to keep its net exposure 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 August 31, 2016 or May 31, 2016.

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

23. 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 achieve 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 statement of financial position are net of allowances for doubtful accounts. The Company's maximum exposure to credit risk at the reporting date is the carrying value of its cash and cash equivalents (see note 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 August 31, 2016 was \$89,054.

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to Consolidated Financial Statements (continued)

Three months ended August 31, 2016 and 2015
(Expressed in Canadian dollars)

23. 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 an 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 August 31, 2016, the Company's financial liabilities, which consist of trade payables and accruals, have a carrying value of \$1,526,471 (\$1,403,364 at May 31, 2016) and are all due within one year.

24. Related party transactions:

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

Transactions with key management personnel

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

	Three months ended August 31, 2016	Three months ended August 31, 2015
Salaries and other short-term employee benefits	\$ 248,349	\$ 253,207
Share-based payments	11,815	33,750
	\$ 260,164	\$ 286,957

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.