Raymond Chabot
Grant Thornton

Independent Auditor's Report

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To the Shareholders of
Thermal Energy International Inc.

We have audited the accompanying consolidated financial statements of Thermal Energy International Inc., which comprise the consolidated statements of financial position as at May 31, 2012 and 2011 and June 1, 2010 and the consolidated statements of comprehensive income, the consolidated statement of changes in equity and the consolidated statements of cash flows for the years ended May 31, 2012 and May 31, 2011, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the financial statements present fairly, in all material respects, the financial position of Thermal Energy International Inc. as at May 31, 2012 and 2011 and June 1, 2010 and its financial performance and its cash flows for the years ended May 31, 2012 and May 31, 2011 in accordance with International Financial Reporting Standards (IFRS).

Raymond Chabot Grant Thornton LLP

Chartered Accountants,
Licensed Public Accountants

Ottawa, Canada
September 27, 2012

THERMAL ENERGY INTERNATIONAL INC.

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
(EXPRESSED IN CANADIAN DOLLARS)

	May 31, 2012 $	May 31, 2011 $	June 1, 2010 $
ASSETS			
Current assets			
Cash and cash equivalents (Note 5)	**1,371,951**	972,163	433,493
Trade and other receivables (Note 6)	**3,434,146**	1,851,377	1,919,440
Inventory (Note 7)	**439,493**	420,999	394,507
Finance lease receivable (Note 8)	**512,496**	653,807	534,281
	5,758,086	3,898,346	3,281,721
Non-current assets			
Property, plant and equipment (Note 9)	**70,324**	74,527	95,684
Finance lease receivable (Note 8)	**-**	467,523	1,159,060
Other intangible assets (Note 10)	**838,356**	940,047	995,448
Goodwill (Note 11)	**3,307,389**	3,318,520	3,163,356
	4,216,069	4,800,617	5,413,548
Total assets	**9,974,155**	8,698,963	8,695,269
LIABILITIES			
Current liabilities			
Short-term borrowings (Note 12)	**-**	-	11,093
Trade payables (Note 13)	**1,017,557**	618,121	507,022
Current tax liabilities	**94,215**	124,113	77,983
Pensions and other employer obligations	**86,033**	62,173	36,058
Other liabilities (Note 14)	**1,074,778**	603,299	434,031
Deferred consideration	**-**	854	19,377
Deferred revenue (Note 15)	**703,056**	343,699	769,801
Provisions (Note 16)	**215,000**	265,000	265,000
	3,190,639	2,017,259	2,120,365
Non-current liabilities			
Deferred tax liabilities (Note 23)	**217,667**	275,999	365,970
Total liabilities	**3,408,306**	2,293,258	2,486,335
EQUITY			
Capital stock (Note 17)	**33,136,184**	33,148,184	33,148,184
Contributed surplus	**2,477,889**	2,354,784	2,292,153
Accumulated other comprehensive income	**214,096**	227,981	-
Deficit	**(29,294,251)**	(29,373,653)	(29,232,826)
Equity attributable to owners of the parent	**6,533,918**	6,357,296	6,207,511
Non-controlling interest	**31,931**	48,409	1,423
Total equity	**6,565,849**	6,405,705	6,208,934
Total liabilities and equity	**9,974,155**	8,698,963	8,695,269

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

On behalf of the Board

President and C.E.O. Director

THERMAL ENERGY INTERNATIONAL INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(EXPRESSED IN CANADIAN DOLLARS)

Years ended May 31	**2012** **$**	2011 $
Sales (Note 20)	**13,152,687**	9,700,596
Cost of sales	**7,504,316**	5,025,978
Gross profit	**5,648,371**	4,674,618
Expenses:		
Administration	**2,651,725**	2,358,929
Selling, marketing and business development	**2,967,865**	2,613,120
Research and development	**8,455**	3,837
	5,628,045	4,975,886
Operating income (loss)	**20,326**	(301,268)
Finance revenue (Note 20)	**102,956**	192,007
Income (loss) before income taxes	**123,282**	(109,261)
Income taxes (Note 23)	**(38,551)**	(2,135)
Net income (loss) for the year	**84,731**	(111,396)
Other comprehensive income (loss) for the year		
Exchange differences arising on translation of overseas operations (net of tax of $3,000 (2011- ($13,978))	**(13,665)**	231,310
Total comprehensive income for the year	**71,066**	119,914
Net income (loss) for the year attributable to:		
Owners of the parent	**101,429**	(142,582)
Non-controlling interest	**(16,698)**	31,186
Net income (loss) for the year	**84,731**	(111,396)
Total comprehensive income for the year attributable to:		
Owners of the parent	**87,544**	85,399
Non-controlling interest	**(16,478)**	34,515
Total comprehensive income for the year	**71,066**	119,914
Net income (loss) per share - basic and diluted (Note 2.23 & Note 24)	**0.001**	(0.001)

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

THERMAL ENERGY INTERNATIONAL INC.

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

	Capital Stock $	Contributed Surplus $	Deficit $	Accumulated Other Comprehensive Income $	Total Attributable to Owners of the Parent $	Non -controlling Interest $	Total Equity $
Balance at June 1, 2010	33,148,184	2,292,153	(29,232,826)	-	6,207,511	1,423	6,208,934
Changes in ownership interests in subsidiaries						12,471	12,471
Interest on loans to acquire common shares			1,755		1,755		1,755
Stock-based compensation (Note 19)		62,631			62,631		62,631
Transactions with owners	-	62,631	1,755	-	64,386	12,471	76,857
Net income (loss) for the year			(142,582)		(142,582)	31,186	(111,396)
Other comprehensive income: exchange differences arising on translation of overseas operations				227,981	227,981	3,329	231,310
Total comprehensive income for the year	-	-	(142,582)	227,981	85,399	34,515	119,914
Balance at May 31, 2011	33,148,184	2,354,784	(29,373,653)	227,981	6,357,296	48,409	6,405,705
Cancelled shares (Note 17)	**(12,000)**				**(12,000)**		**(12,000)**
Interest on cancelled loans			**(22,027)**		**(22,027)**		**(22,027)**
Stock-based compensation (Note 19)		**123,105**			**123,105**		**123,105**
Transactions with owners	**(12,000)**	**123,105**	**(22,027)**	**-**	**89,078**	**-**	**89,078**
Net income (loss) for the year			**101,429**		**101,429**	**(16,698)**	**84,731**
Other comprehensive income: exchange differences arising on translation of overseas operations				**(13,885)**	**(13,885)**	**220**	**(13,665)**
Total comprehensive income for the year	**-**	**-**	**101,429**	**(13,885)**	**87,544**	**(16,478)**	**71,066**
Balance at May 31, 2012	**33,136,184**	**2,477,889**	**(29,294,251)**	**214,096**	**6,533,918**	**31,931**	**6,565,849**

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

THERMAL ENERGY INTERNATIONAL INC.

CONSOLIDATED STATEMENT OF CASH FLOWS
(EXPRESSED IN CANADIAN DOLLARS)

Years ended May 31	**2012** **$**	2011 $
OPERATING ACTIVITIES		
Net income (loss) for the year	**84,731**	(111,396)
Add items not involving cash:		
Stock-based compensation (Note 19)	**123,105**	62,631
Depreciation of property, plant and equipment	**45,851**	50,022
Loss on disposal of property, plant and equipment	**-**	973
Amortization of intangible assets	**99,126**	103,246
Write-down of finance lease receivable (Note 8)	**54,758**	-
Deferred income taxes (recovery) (Note 23)	**(58,332)**	(89,971)
Unrealized foreign exchange and translation adjustments	**(2,534)**	76,146
Other non-cash equity items	**(34,027)**	14,226
Changes in working capital :		
Trade and other receivables	**(1,582,769)**	68,063
Inventory	**(18,494)**	(26,492)
Trade payables	**399,436**	111,099
Deferred revenue	**359,357**	(426,102)
Other liabilities	**414,587**	222,990
Net cash provided by (used in) operating activities	**(115,205)**	55,435
INVESTING ACTIVITIES		
Finance lease payments received	**554,076**	572,011
Additions to property, plant and equipment	**(41,599)**	(25,382)
Net cash used in investing activities	**512,477**	546,629
FINANCING ACTIVITIES		
Decrease in short-term borrowings	**-**	(11,093)
Net cash provided by financing activities	-	(11,093)
Increase in cash and cash equivalents for the year	**397,272**	590,971
Cash and cash equivalents, beginning of year	**972,163**	433,493
Exchange differences on cash and cash equivalents	**2,516**	(52,301)
Cash and cash equivalents, end of year	**1,371,951**	972,163

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

Supplemental information related to operating activities:		
Income taxes paid	**118,850**	70,418
Interest paid	**3,169**	3,556
Interest received	**149**	114
Non-cash supplemental information:		
Interest on cancelled shareholder loans	**22,027**	4,162

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

For the years ended May 31, 2012 and 2011

(Expressed in Canadian Dollars)

1. NATURE OF OPERATIONS AND GOING CONCERN

Thermal Energy International Inc. (the "parent") was incorporated under the Ontario Business Corporations Act on May 22, 1991 and is primarily engaged in the development, engineering and supply of pollution control, heat recovery systems, and condensate return solutions. The Company's common shares are listed on the TSX Venture Exchange ("TSX.V") under the symbol TMG. The primary office is located at 36 Bentley Avenue, Ottawa, Ontario, Canada, K2E 6T8.

These audited consolidated financial statements were approved and authorized for issue by the Board of Directors on September 27, 2012. The consolidated financial statements comprise the financial results of the parent and its subsidiaries (collectively known as "the Company") for the years ended May 31, 2012 and 2011.

The consolidated financial statements have been prepared on the going concern basis which assumes the realization of assets and the satisfaction of liabilities in the normal course of business. The Company incurred a loss in the year ended May 31, 2011 and the Company has significant accumulated deficits at the year ended May 31, 2012.

There is doubt about the Company's ability to continue as a going concern. The Company's ability to realize its assets and discharge its liabilities depends on any combination of the following: the continued financial support of its shareholders, its ability to arrange long-term financing and its ability to generate sufficient cash from operations.

Management is concentrating on building upon the revenue growth experienced in FY 2011 and FY 2012 and continuing to manage expenditures in order to produce positive cash flows from operations in order to meet the Company's obligations. The Company earned an income from operations in the year ended May 31, 2012. Consequently, management is of the opinion that there is no significant doubt concerning the Company's ability to continue as a going concern.

These consolidated financial statements do not include any adjustments to the carrying value or classification of assets and liabilities, nor to the results of operations, should the Company not continue to operate as a going concern.

2. SUMMARY OF ACCOUNTING POLICIES

2.1. Statement of compliance with IFRS and basis of presentation

The consolidated financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") that are in effect at May 31, 2012. These are the Company's first annual consolidated financial statements prepared in accordance with IFRS and IFRS 1 "First-time Adoption of International Financial Reporting Standards" has been applied. An explanation of how the transition from Canadian Generally Accepted Accounting Principles ("Canadian GAAP"), applicable before the changeover to IFRS has affected the reported financial position, financial performance and cash flows of the Company is provided in Note 28.

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

2.2. Basis of consolidation

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

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

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

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

[1]Gardner Energy Management Ltd. owns 67% of GEMchem Ltd., a company incorporated in the United Kingdom.

All subsidiaries have a reporting date of May 31.

2.3. Business combinations

For acquisitions made on or after June 1, 2010, the Company measures goodwill as the fair value of the consideration transferred including any contingent consideration to be transferred and the recognized amount of any non-controlling interest in the acquired entity, less the net recognized amount of the fair value of the identifiable assets acquired and liabilities assumed, all measured as of the acquisition date. When the excess is negative, a bargain purchase gain is recognized immediately in profit or loss. The Company elects on a transaction-by-transaction basis whether to measure non-controlling interest at fair value or at their proportionate share of the recognized amount of the identifiable net assets at the acquisition date. If the business combination is achieved in stages, the acquisition date fair value of the previously held interest in the acquired entity is re-measured to fair value as at the acquisition date through profit or loss. Transaction costs, other than those associated with the issue of debt or equity securities that the Company incurs in connection with a business combination, are expensed as incurred.

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

2.4. Investments in joint ventures

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

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

2.5. Functional currency and foreign currency translation

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

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

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

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 statement of comprehensive income items. Such exchange differences, including differences that arise relating to long-term inter-company balances that form part of the net investment in the foreign operation, are recognized in other comprehensive income or loss. On disposal of a foreign entity, the related cumulative translation differences recognized in equity are reclassified to profit or loss and are recognized as part of the gain or loss on disposal.

2.6. Segment reporting

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

The two main operating units are as follows:

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

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

2.7. Cash and cash equivalents

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

2.8. Inventories

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

2.9. Leases

(i) The Company as a lessor – finance leases

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

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

(ii) The Company as a lessee

In accordance with IAS 17 "Leases", the economic ownership of a leased asset is transferred to the lessee whenever the terms of the lease transfer substantially all the risks and rewards of ownership to the lessee. The related asset is then recognized at the inception of the lease at the fair value of the leased asset or, if lower, the present value of the lease payments plus incidental payments, if any. A corresponding amount is recognized as a finance leasing liability, irrespective of whether some of these lease payments are payable up-front at the date of inception of the lease. The corresponding finance leasing liability is reduced by lease payments less finance charges, which are expensed as part of administrative expenses. The interest element of leasing payments represents a constant proportion of the capital balance outstanding and is charged to profit or loss over the period of the lease.

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

2.10. Property, plant and equipment

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

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

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

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

2.11. Other intangible assets

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

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

Amortization methods, useful lives and residual values are reviewed at each reporting period and adjusted if appropriate. Other intangible assets with indefinite lives are subject to annual impairment testing. See Note 2.13 for a description of impairment testing procedures.

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

Amortization and impairment charges are include within administrative expenses.

2.12. Goodwill

Goodwill represents the future economic benefits arising from a business combination that are not individually identified and separately recognized. See Note 2.3 for information on how goodwill is initially determined. Goodwill is carried at cost less accumulated impairment losses. See Note 2.13 for a description of impairment testing procedures. Impairment losses on goodwill are not reversed.

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

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

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

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

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

2.14. Provisions, contingent liabilities and contingent assets

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

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

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

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

In those cases where the possible outflow of economic resources as a result of present obligations is considered improbable or remote, no liability is recognized, unless it was assumed in the course of a business combination. In a business combination, contingent liabilities are recognized on the acquisition date when there is a present obligation that arises from past events and the fair value can be measured reliably, even if the outflow of economic resources is not probable. They are subsequently measured at the higher amount of a comparable provision as described above and the amount initially recognized, less any amortization.

Warranties

The Company guarantees its condensate return solution product against defects for ten years and does not offer extended warranties. A provision for warranty expense is recorded when the revenue for the related product is

recognized. The provision is based upon the terms of the warranty, the Company's historical experience and management estimates of future expense for replacement or repairs. The provision is recorded in cost of sales.

2.15. Equity

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

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

Deficit includes all current and prior period retained losses.

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

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

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

2.16. Equity-settled stock-based compensation

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

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

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

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

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

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

2.17. Revenue recognition

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

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

Sale of goods

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

Contracts for heat recovery solutions

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

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

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

Finance leases

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

Interest revenue and expenses

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

2.18. Operating expenses

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

2.19. Post employee benefits and short term employee benefits

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

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

2.20. Research costs and government assistance

The Company carries on various research programs, and from time to time these are funded by the Government of Canada. Funding received is accounted for using the cost reduction approach and is netted against research costs. Research costs are expensed as incurred.

2.21. Investment tax credits

Investment tax credits are accounted for under the cost reduction method whereby they are presented against the cost of the property, plant and equipment to which they relate. Investment tax credits are recorded when the Company has incurred qualifying expenditures and there is reasonable assurance the tax credit will be realized. The investment tax credits must be examined and approved by the tax authorities and it is possible that the amounts granted will differ from the amounts recorded.

2.22. Income taxes

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

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

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

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

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

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

unrecognized deferred tax asset to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered.

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

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

2.23. Income (loss) per share

The Company presents basic and diluted income (loss) per share data for its common shares. Basic income (loss) per share is calculated by dividing the income (loss) attributable to common shareholders of the Company by the weighted average number of common shares outstanding during the year. The diluted income (loss) per share is determined by adjusting the income (loss) attributable to common shareholders and the weighted average number of common shares outstanding for the effects of all dilutive potential common shares, which comprise warrants and options outstanding. The diluted income (loss) per share is equal to the basic income (loss) per share because of the antidilutive effect of the outstanding options and warrants as explained in Note 24.

2.24. Financial instruments

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

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

Financial assets

For the purpose of subsequent measurement, financial assets other than those designated and effective as hedging instruments are classified into the following categories upon initial recognition:

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

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

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

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

Loans and receivables

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

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

Financial assets at fair value through profit or loss

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

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

Held-to-maturity investments

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

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

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

Available-for-sale financial assets

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

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

Financial liabilities

The Company's financial liabilities include short-term borrowings, trade payables, accruals and finance leases payables, classified as other financial liabilities. They are measured initially at fair value. Subsequent measurements are at amortized cost using the effective interest method.

Fair value hierarchy

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

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

2.25. Significant accounting judgements and estimates

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

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

- Impairment

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

  In most cases, determining the applicable discount rate involves estimating the appropriate adjustment to market risk and the appropriate adjustment to asset-specific risk factors. Further information on the estimates used in determining the recoverable amount of goodwill is provided in Note 11.

  No impairment was recognized in either of the years ended May 31, 2012 or May 31, 2011.

- Future production outputs related to the finance lease

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

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

- Lease classification

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

- Allowance for doubtful accounts

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

- Heat recovery solutions contract revenue

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

- Future tax assets

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

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

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

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

IFRS 9, "Financial Instruments"
This new standard is part of the IASB's project to replace IAS 39, "Financial Instruments: Recognition and Measurement" and provides guidance on the recognition, classification and measurement of financial assets and liabilities and de-recognition. This standard is effective for annual periods beginning on or after January 1, 2015. Earlier application is permitted. Further chapters dealing with impairment methodology and hedge accounting are still being developed. The Company has not yet assessed the impact of this pronouncement on its consolidated financial statements.

IFRS 10, "Consolidated Financial Statements"
This new standard revised the definition of control together with accompanying guidance to identify an interest in a subsidiary. IFRS 10 supersedes SIC 12, "Consolidation – Special Purposes Entities" and IAS 27, "Consolidated and Separate Financial Statements". This standard is effective for annual periods beginning on or after January 1, 2013. Earlier application is permitted. The Company is currently evaluating the impact of this pronouncement on its consolidated financial statements.

IFRS 11, "Joint Arrangements"
This new standard supersedes IAS 31 "Interest in Joint Ventures" and provides guidance on how to account for interests in jointly controlled entities. This standard is effective for annual periods beginning on or after January 1, 2013. Earlier application is permitted. This pronouncement is not expected to have a material impact on the Company's consolidated financial statements.

IFRS 12, "Disclosure of Interests in Other Entities"
This new standard provides disclosure guidance on interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities. This standard is effective for annual periods beginning on or after January 1, 2013. Earlier application is permitted. This pronouncement is not expected to have a material impact on the Company's consolidated financial statements.

IFRS 13, "Fair Value Measurement"
This new standard sets out a single IFRS definition and measurement framework for fair value. This standard is effective for annual periods beginning on or after January 1, 2013. Earlier application is permitted. The Company is currently evaluating the impact of this pronouncement on its consolidated financial statements.

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

IAS 28, "Investments in Associates and Joint Ventures"
This amendment contains new standards related to investments in associates and joint ventures. This amendment is effective for annual periods beginning on or after January 1, 2013. Earlier application is permitted. The Company is currently evaluating the impact of this pronouncement on its consolidated financial statements.

3. JOINTLY CONTROLLED ENTITY / ACQUISITION OF CONTROL

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

In September 2010, the Company took management control over the operations of the joint venture. Until this date, the results of the joint venture were included in the consolidated financial statements of the Company on a proportionate share basis. As the Company has since assumed management control, from the second quarter onwards the results of Thermal Energy International (Guangzhou) Ltd. are included in the Company's financial statements on a full consolidation basis. Thermal Energy International (Guangzhou) Ltd. is no longer considered a joint venture, but from the second quarter of fiscal year 2011 is included in the consolidated financial statements as a subsidiary of Thermal Energy International Inc.

These consolidated financial statements include the Company's proportionate share of the revenue, expenses, assets and liabilities of the joint venture for the first quarter of FY 2011 as follows:

	Quarter ended Aug 31, 2010 $
Current Assets	122,235
Current Liabilities	109,056
Sales	1,419
Cost of sales	(2,705)
Other expenses	(19,112)
Net loss	(20,398)
Cash flows provided in operating activities	1,272
Cash flows used in investing activities	-

The above figures represent the Company's 55% share in the joint venture. The results of the Chinese entity for the remainder of FY 2011 are fully consolidated within the financial statements of Thermal Energy International Inc.

4. SEGMENT REPORTING

In fiscal 2012 and 2011, 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. Segmented information was previously reported on a product line basis, rather than the geographical basis set out below. As a result, the Company has restated the corresponding items of segment information for the previous year.

Segment information for the years ended May 31 is detailed in the table below.

	North America and China		Europe and Rest of World		Reconciling items		Total	
	2012	2011	**2012**	2011	**2012**	2011	**2012**	2011
	$	$	**$**	$	**$**	$	**$**	$
Total revenue from external customers	**7,235,139**	4,888,103	**5,917,548**	4,812,493	**-**	-	**13,152,687**	9,700,596
Cost of sales	**5,095,752**	3,388,028	**2,408,564**	1,637,950	**-**	-	**7,504,316**	5,025,978
Gross profit	**2,139,387**	1,500,075	**3,508,984**	3,174,543	**-**	-	**5,648,371**	4,674,618
Amortization of intangible assets	**-**	-	**(99,126)**	(103,246)	**-**	-	**(99,126)**	(103,246)
Other expenses	**(1,738,315)**	(1,405,214)	**(2,323,389)**	(2,165,802)	**(1,467,215)**	(1,301,624)	**(5,528,919)**	(4,872,640)
Finance revenue	**102,956**	192,007	**-**	-	**-**	-	**102,956**	192,007
Profit (loss) before taxation	**504,028**	286,868	**1,086,469**	905,495	**(1,467,215)**	(1,301,624)	**123,282**	(109,261)
Taxation	**-**	-	**(174,337)**	(171,169)	**135,786**	169,034	**(38,551)**	(2,135)
Profit (loss) after taxation	**504,028**	286,868	**912,132**	734,326	**(1,331,429)**	(1,132,590)	**84,731**	(111,396)
Attributable to:								
Owners of the parent	**529,695**	267,942	**903,163**	722,066	**(1,331,429)**	(1,132,590)	**101,429**	(142,582)
Non-controlling interest	**(25,667)**	18,926	**8,969**	12,260	**-**	-	**(16,698)**	31,186

Reconciling items comprise the following:

	Year ended May 31	
	2012	2011
	$	$
Corporate admin costs	**873,650**	850,256
Stock-based compensation	**123,105**	62,631
Professional fees	**324,496**	286,935
Depreciation of property, plant and equipment	**45,851**	50,022
Bank charges and interest	**43,304**	38,017
Foreign exchange differences	**56,809**	13,763
Total	**1,467,215**	1,301,624

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

During the year ended May 31, 2011, the Company had one customer in North America and China that accounted for 37% of total revenue for the year.

Further geographical analysis:

	Revenues		Property, Plant and equipment			Goodwill and Intangible Assets			Finance Lease Receivable		
	2012	2011	**2012**	2011	2010	**2012**	2011	2010	**2012**	2011	2010
	$	$	**$**	$	$	**$**	$	$	**$**	$	$
Canada	**6,042,926**	4,122,542	**28,448**	20,115	35,326	**-**	-	-	**512,496**	1,121,330	1,693,341
U.S.A.	**1,130,002**	433,168	**-**	-	-	**-**	-	-	**-**	-	-
U.K.	**4,934,749**	3,372,231	**40,512**	51,824	58,148	**4,145,745**	4,258,567	4,158,804	**-**	-	-
Italy	**541,255**	457,669	**-**	-	-	**-**	-	-	**-**	-	-
Netherlands	**116,665**	96,548	**-**	-	-	**-**	-	-	**-**	-	-
Ireland	**77,857**	108,786	**-**	-	-	**-**	-	-	**-**	-	-
Germany	**31,809**	159,894	**-**	-	-	**-**	-	-	**-**	-	-
Rest of Europe	**31,999**	179,468	**-**	-	-	**-**	-	-	**-**	-	-
Singapore	**63,316**	5,456	**-**	-	-	**-**	-	-	**-**	-	-
China	**62,211**	332,393	**1,364**	2,588	2,210	**-**	-	-	**-**	-	-
Pakistan	**19,427**	105,136	**-**	-	-	**-**	-	-	**-**	-	-
Turkey	**6,647**	108,848	**-**	-	-	**-**	-	-	**-**	-	-
Malaysia	**4,484**	159,445	**-**	-	-	**-**	-	-	**-**	-	-
Rest of world	**89,340**	59,012	**-**	-	-	**-**	-	-	**-**	-	-
Total	**13,152,687**	9,700,596	**70,324**	74,527	95,684	**4,145,745**	4,258,567	4,158,804	**512,496**	1,121,330	1,693,341

5. CASH AND CASH EQUIVALENTS

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

	May 31, 2012 $	May 31, 2011 $	June 1, 2010 $
Cash	**1,370,830**	971,052	412,587
Cash equivalents	**1,121**	1,111	20,906
Cash and cash equivalents	**1,371,951**	972,163	433,493

6. TRADE AND OTHER RECEIVABLES

	May 31, 2012 $	May 31, 2011 $	June 1, 2010 $
Trade receivables, gross	**2,992,211**	1,645,428	1,869,200
Allowance for doubtful accounts	**(56,753)**	(232,155)	(248,517)
Trade receivables, net	**2,935,458**	1,413,273	1,620,683
Related party	**-**	34,029	46,741
Contracts for heat recovery solutions (see Note 6.1)	**103,756**	107,104	-
Unbilled product revenue (see Note 6.2)	**-**	65,296	-
Prepayments	**282,908**	118,908	239,416
Other miscellaneous receivables	**112,024**	112,767	12,600
	3,434,146	1,851,377	1,919,440

The net carrying value of trade receivables is considered a reasonable approximation of fair value. Other miscellaneous receivables include $96,431 ($96,431 in 2011) due from a Chinese distributor receiving payments on the Company's behalf from a Chinese customer.

At May 31, 2012, $197,685 (6.7%) of the Company's trade receivables balance is over 90 days past due, but not impaired ($393,547 (27.8%) at May 31, 2011 and $346,715 (21.4%) at June 1, 2010).

Related party receivables include amounts due to the Company by directors and key management personnel, as well as close family members and enterprises that are controlled by these individuals and shareholders.

The change in allowance for doubtful accounts was as follows:

	2012 $	2011 $
Balance, beginning of year	**232,155**	248,517
Amounts written off (uncollectable)	**(232,155)**	-
Provisions	**56,753**	-
Foreign exchange adjustments	**-**	(16,362)
Balance, end of year	**56,753**	232,515

All of the Company's trade and other receivables have been reviewed for indicators of impairment. Certain trade receivables were found to be impaired and an allowance for credit losses of $56,753 has been recorded accordingly within administrative expenses. The impaired trade receivables relate to customers with whom the Company has to date had no success in recovering amounts billed. Although the Company is continuing with attempts to recover the amounts billed, a provision has been made based upon the age of the debts and the status of current negotiations with the customers involved.

6.1. Contracts for heat recovery solutions

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

	May 31, 2012 **$**	May 31, 2011 $	June 1, 2010 $
Aggregate amount of costs incurred and recognized profits and losses for all contracts in progress	**11,089,255**	4,281,849	490,363
Less progress billings	**(11,501,958)**	(4,312,054)	(1,242,922)
	(412,703)	(30,205)	(752,559)
Recognized as:			
Due from customers for contract work, recognized in trade and other receivables	**103,756**	107,104	-
Customer deposits paid on order before commencement of project, recognized in deferred revenue (Note 15)	**(441,328)**	(137,309)	(230,441)
Due to customers for contract work, recognized in deferred revenue (Note 15)	**(75,131)**	-	(522,118)
	(412,703)	(30,205)	(752,559)

6.2. Unbilled product revenue

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

	May 31, 2012 **$**	May 31, 2011 $
Aggregate amount of costs incurred and recognized profits and losses for all contracts in progress	**1,136,298**	878,085
Less progress billings	**(1,318,006)**	(996,937)
	(181,708)	(118,852)
Recognized as:		
Due from customer for product sent, recognized in trade and other receivables	**-**	65,296
Due to customer for product not yet sent, recognized in deferred revenue (Note 15)	**(181,708)**	(184,148)
	(181,708)	(118,852)

There were no amounts for unbilled product revenue at June 1, 2010.

7. INVENTORY

	May 31, 2012 **$**	May 31, 2011 $	June 1, 2010 $
Inventory	**439,493**	420,999	394,507

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

For the year ended May 31, 2012, a total of $455,143 of inventories was expensed to cost of sales (2011 - $548,308). A total of $11,068 of inventories (2011 - $8,872) were written off as slow-moving. No reversal of previous write-downs have been recorded during the year (2011 - $nil).

8. FINANCE LEASE RECEIVABLE

The Company's finance lease receivable includes the following:

	May 31, 2012	May 31, 2011	June 1, 2010
	$	$	$
Total estimated minimum lease payments receivable	**530,779**	1,215,814	1,979,833
Less: unearned income	**(18,283)**	(94,484)	(286,492)
	512,496	1,121,330	1,693,341
Less: current portion	**(512,496)**	(653,807)	(534,281)
	-	467,523	1,159,060

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. The lease expires on December 31, 2012, at which time the customer has the option to purchase the asset for $1,000,000 or extend the lease term for a further 24 months with a 15% reduction in the purchase price of the asset to $850,000 at the end of the extended term.

During the year ended May 31, 2012, the customer took advantage of a clause within the agreement allowing for a shutdown of a maximum of 45 days without penalty. The effect of this shutdown during the year was to decrease the value of the finance lease receivable by approximately $92,539. This write-off was partially offset by an increase of $37,781 due to the lease commencing one month earlier than originally anticipated. The net result of these two issues was a write-down in the finance lease receivable at the end of May 31, 2012 of $54,758 (2011 and 2010 - $nil). There are no further allowances available within the lease agreement for shutdowns without penalty.

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

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

	$
Less than one year	391,249
Residual value	139,530
	530,779

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

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

For the years ended May 31, 2012 and 2011

(Expressed in Canadian Dollars)

9. PROPERTY, PLANT AND EQUIPMENT

	Plant and Equipment	Furniture and Fixtures	Laboratory Equipment	Computers	Leasehold Improve-ments	Motor Vehicles	Total
	$	$	$	$	$	$	$
Cost, June 1, 2010	77,562	112,889	52,857	305,862	13,789	19,576	582,535
Additions	13,762	-	-	10,475	1,145	-	25,382
Disposals	-	-	-	(1,946)	-	-	(1,946)
Translation adjustments	3,915	1,228	-	6,880	-	978	13,001
Cost, May 31, 2011	95,239	114,117	52,857	321,271	14,934	20,554	618,972
Additions	5,680	5,212	-	30,707	-	-	41,599
Translation adjustments	(286)	(87)	-	(269)	-	(56)	(698)
Cost, May 31, 2012	**100,633**	**119,242**	**52,857**	**351,709**	**14,934**	**20,498**	**659,873**
Accumulated depreciation, June 1, 2010	56,829	104,779	42,256	280,181	766	2,040	486,851
Depreciation for the year	10,962	2,163	8,531	18,648	4,596	5,122	50,022
Disposals	-	-	-	(973)	-	-	(973)
Translation adjustments	2,873	1,141	-	4,413	-	118	8,545
Accumulated depreciation, May 31, 2011	70,664	108,083	50,787	302,269	5,362	7,280	544,445
Depreciation for the year	8,582	1,973	1,761	23,816	4,597	5,122	45,851
Translation adjustments	(219)	(83)	-	(429)	-	(16)	(747)
Accumulated depreciation, May 31, 2012	**79,027**	**109,973**	**52,548**	**325,656**	**9,959**	**12,386**	**589,549**
Net book value, May 31, 2012	**21,606**	**9,269**	**309**	**26,053**	**4,975**	**8,112**	**70,324**
Net book value, May 31, 2011	24,575	6,034	2,070	19,002	9,572	13,274	74,527
Net book value, June 1, 2010	20,733	8,110	10,601	25,681	13,023	17,536	95,684

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

Capital commitments relating to motor vehicles held under finance leases, as at May 31, 2012 were as follows:

	$
Year 1	5,124
Year 2	2,988
Total	8,112

10. OTHER INTANGIBLE ASSETS

	Trade Names & Trademarks	Non-compete Agreement	Industrial Know-how	Designs & Drawings	Customer Relationships	Total
	$	$	$	$	$	$
Cost, June 1, 2010	699,200	91,200	106,400	117,040	250,800	1,264,640
Translation adjustments	33,718	4,398	5,131	5,644	12,095	60,986
Cost, May 31, 2011	732,918	95,598	111,531	122,684	262,895	1,325,626
Translation adjustments	(1,978)	(258)	(301)	(331)	(710)	(3,578)
Cost, May 31, 2012	**730,940**	**95,340**	**111,230**	**122,353**	**262,185**	**1,322,048**
Accumulated amortization, June 1, 2010	-	87,400	40,787	44,865	96,140	269,192
Amortization for the year	-	4,000	22,266	24,494	52,486	103,246
Translation adjustments	-	4,198	2,007	2,207	4,729	13,141
Accumulated amortization, May 31, 2011	-	95,598	65,060	71,566	153,355	385,579
Amortization for the year	-	-	22,240	24,464	52,422	99,126
Translation adjustments	-	(258)	(170)	(186)	(399)	(1,013)
Accumulated amortization, May 31, 2012	**-**	**95,340**	**87,130**	**95,844**	**205,378**	**483,692**
Net book value, May 31, 2012	**730,940**	**-**	**24,100**	**26,509**	**56,807**	**838,356**
Net Book Value, May 31, 2011	732,918	-	46,471	51,118	109,540	940,047
Net Book Value, June 1, 2010	699,200	3,800	65,613	72,175	154,660	995,448

Trade Names and Trademarks are intangible assets with indefinite lives and are not subject to amortization. They were tested for impairment as at May 31, 2012. The discount factor used was the same as detailed in Goodwill (Note 11). Trade Names and Trademarks relate specifically to the GEM® product. The growth rates attributed by Management to the GEM® product line are 71%, 39%, 47%, 10% and 10% respectively for the next five years. As mentioned in Note 11, this seemingly aggressive growth in 2013 reflects GEM® sales returning to the levels experienced in 2010 and 2011, plus subsequent continued growth resulting from increased presence in North America, Europe and the rest of the world.

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:

	May 31, 2012	May 31, 2011	June 1, 2010
	$	$	$
Balance, beginning of year	**3,318,520**	3,163,356	3,529,503
Additions	**-**	-	181,025
Translation adjustments	**(11,131)**	155,164	(547,172)
Balance, end of year	**3,307,389**	3,318,520	3,163,356

Goodwill was tested for impairment as at May 31, 2012. For the purpose of annual impairment testing, goodwill is allocated to the following cash-generating units, which are the units expected to benefit from the synergies of the business combinations in which the goodwill arises: Gardner Energy Management Limited and GEMchem Limited, a 67% owned subsidiary of Gardner Energy Management Limited.

The recoverable amounts of the cash-generating units were determined based on value-in-use calculations, covering a one year budget, followed by an extrapolation over five years of expected cash flows to be derived from the cash-generating units assuming growth rates as set out below, and applying a pre-tax discount rate of 20%. The pre-tax discount rate used represents the weighted average cost of capital ("WACC") of the Company, which includes the cost of equity and the cost of debt. The cost of equity was computed as 23%, incorporating the following factors: market risk premium adjusted for the target levered beta, based upon comparable companies, the risk-free rate of return and a size and company specific risk premium. The cost of debt was assumed as the risk free rate plus a premium of 3%. In computing the WACC, a capital structure comprising 20% debt and 80% equity was assumed, after considering the capital structure of comparable companies. The resulting pre-tax discount rate was lower than the previous year rate as a result of a reduced risk-free rate of return plus lower income tax rates in the U.K.

Gardner Energy Management Limited's growth in the first year was assumed to be 55%, as per the detailed budget prepared with 31% in year 2, 34% in year 3 and 10% per annum thereafter. The seemingly aggressive growth in 2013 reflects GEM® sales returning to the levels experienced in 2010 and 2011, plus continuing growth in sales of heat recovery solutions in the U.K. The following two years include increased sales as a result of the additional sales staff, agents and distributors who have already joined the team or who are being targeted to join in 2013. Sensitivity analysis revealed that a reduction of 20% in projected overall revenue across all future years would result in the same conclusion as shown below.

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

Summary of rates used:

		Average Revenue Growth rates			Discount rates		
Cash Generating Unit		**2012**	2011	2010	**2012**	2011	2010
Gardner Energy Management	Year 1	**55%**	32.1%	118.5%	**20%**	24%	28.5%
	Year 2	**31%**	20%	25%	**20%**	24%	28.5%
	Year 3	**34%**	15%	25%	**20%**	24%	28.5%
	Year 4	**10%**	15%	25%	**20%**	24%	28.5%
	Year 5	**10%**	15%	25%	**20%**	24%	28.5%
GEMChem	Year 1	**8%**	13%	16%	**20%**	24%	23.5%
	Year 2	**37%**	15%	15%	**20%**	24%	23.5%
	Year 3	**3%**	10%	15%	**20%**	24%	23.5%
	Year 4	**20%**	10%	15%	**20%**	24%	23.5%
	Year 5	**18%**	10%	15%	**20%**	24%	23.5%

Apart from the considerations described above in determining value-in-use of the cash-generating units, management is not currently aware of any other factors that would necessitate changes in its key estimates. Management believes that any reasonably possible change in the key assumptions on which the recoverable amount is based would not cause the aggregate carrying amount to exceed the aggregate recoverable amount of the cash generating unit.

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

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

At the date of transition to IFRS, June 1, 2010, and at May 31, 2011, the amount of goodwill was tested for impairment based on conditions at that date. The forecast at the transition date showed that no impairment was necessary.

12. SHORT-TERM BORROWINGS

As at May 31, 2012 and May 31, 2011, the Company had an authorized credit facility in the amount of $241,000, of which $nil was utilized at year end (2011 - $nil). At June 1, 2010, a subsidiary had a bank loan amounting to $11,093, secured by certain trade receivables carrying a total value of $243,207 of the subsidiary which carries a service charge of 0.805% of the gross loan subject to a minimum annual charge of approximately $24,000 and an interest rate of 1.95% over the LIBOR rate. The Company has continued access to this short term financing facility.

13. TRADE PAYABLES

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

	May 31, 2012	May 31, 2011	June 1, 2010
	$	$	$
Trade payables	**1,017,557**	618,121	507,022

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:

	May 31, 2012	May 31, 2011	June 1, 2010
	$	$	$
Finance leases payable	**8,113**	13,274	12,642
Accruals	**942,175**	520,241	400,652
Other	**124,490**	69,784	20,737
	1,074,778	603,299	434,031

Included in accruals is $12,134 due to directors ($25,000 in 2011, $22,167 in 2010)

15. DEFERRED REVENUE

	May 31, 2012	May 31, 2011	June 1, 2010
	$	$	$
Customer deposits relating to heat recovery solutions (Note 6.1)	**441,328**	137,309	230,441
Deferred revenue relating to heat recovery solutions (Note 6.1)	**75,131**	-	522,118
Deferred revenue relating to GEM product (Note 6.2)	**181,708**	184,148	-
Deferred revenue relating to services	**4,889**	22,242	17,242
	703,056	343,699	769,801

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

16. PROVISIONS

	May 31, 2012	May 31, 2011	June 1, 2010
	$	$	$
Balance, beginning of year	**265,000**	265,000	265,000
Amounts utilized	**(50,000)**	-	-
Balance, end of year	**215,000**	265,000	265,000

On October 25, 2005, the Company was served with a statement of claim from its past President. Among other things, the lawsuit alleges that the former president was wrongfully dismissed from his employment. Damages are claimed in the approximate amount of $4 million, plus an as yet undetermined value of share options, interest and legal costs. The Company has filed a statement of defence in response and has counterclaimed for approximately $5 million in damages plus interest and costs.

Two attempts have been made at a mediated settlement. Neither attempt has been successful. Although the lawsuit was commenced in October, 2005, the plaintiff has yet to take the proceeding to the point of oral examinations for discovery.

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

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

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

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

During the year ended May 31, 2012, a provision of $50,000 was released relating to termination payments to former employees.

17. EQUITY

17.1. 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.

	2012		2011	
	# Shares	**$**	# Shares	$
Class A Common shares issued				
Balance, beginning of year	**163,770,922**	**33,148,184**	163,777,922	33,148,184
Cancelled shares (i)	**(684,306)**	**(12,000)**	-	-
Balance, end of year	**163,086,616**	**33,136,184**	163,770,922	33,148,184

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

Loans to acquire shares:	**2012**	2011	2010
	$	$	$
Shareholders	**-**	100,246	110,246
Market value of shares held as security	**-**	19,833	31,733

Loans were extended to shareholders to acquire shares of the Company through the exercise of options. These loans bore interest at a rate of 5% and matured at dates which ranged from 2 to 5 years from the date of issue. In certain instances, the borrowers' liabilities in respect of these loans were at all times limited to the value of the underlying shares for which the loan was granted. They could be repaid in part or in full at any time before maturity, at which time the shares with an equivalent value to the repayment would be released to the borrower by the Company.

Repayments of $nil and cancellations of $100,246 were made on these loans for the year ended May 31, 2012. For the year ended May 31, 2011, loans of $10,000 were cancelled.

The loans outstanding as at May 31, 2011 and June 1, 2010 were not all secured by share certificates.

17.2. Warrants

In fiscal 2009, the Company completed a private placement and as a result, the agent was issued 5,236,363 transferable warrants, valued at $636,200. These warrants expired during the year ended May 31, 2011. Activity in share purchase warrants was as follows:

	2012		2011	
	# Warrants	**Weighted Average Exercise Price $**	# Warrants	Weighted Average Exercise Price $
Balance, beginning of year	**-**	**-**	5,236,363	0.22
Expired	**-**	**-**	(5,236,363)	0.22
Balance, end of year	**-**	**-**	-	-

18. CAPITAL MANAGEMENT

The Company's objectives when managing capital is to safeguard the Company's ability to continue as a going concern and to maintain flexible capital structure for its projects for the benefit of its stakeholders. In the management of capital, the Company includes the components of equity attributable to the owners of the parent, excluding accumulated other comprehensive income, which at May 31, 2012 totalled $6,319,822 (May 31, 2011 - $6,129,315 and June 1, 2010 - $6,207,511). 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 20% of the outstanding shares and the total number of shares to be optioned to any optionee may not exceed 5% of the number of issued and outstanding shares as at the option granting date. The options are granted with an exercise price equal to the market value of the common shares of the Company at the date of grant, less any permissible discounts, and may be exercised at any time after the vesting date, not to exceed five years from the date of granting. Vesting period for options granted is at the discretion of the Board of Directors. 5,870,000 new options were granted in the year ended May 31, 2012 and 180,000 new options granted in 2012 were forfeited in the same year.

Activity in stock options was as follows:

	2012		2011	
	# Options	**Weighted Average Exercise Price $**	# Options	Weighted Average Exercise Price $
Outstanding, beginning of year	**5,881,250**	**0.12**	4,075,000	0.16
Granted	**5,870,000**	**0.10**	2,656,250	0.10
Forfeited	**(273,750)**	**0.10**	-	-
Expired	**(475,000)**	**0.29**	(850,000)	0.30
Outstanding, end of year	**11,002,500**	**0.10**	5,881,250	0.12
Exercisable, end of year	**3,020,834**	**0.10**	2,058,333	0.14

There were no options exercised for the years ended May 31, 2012 and 2011.

The following share-based payment arrangements were in existence at May 31, 2012, May 31, 2011 and June 1, 2010:

At May 31, 2012:

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

At May 31, 2011:

Number outstanding	Grant date	Expiry date	Exercise price ($)	Fair value at grant date ($)	Number exercisable
225,000	15-Aug-2008	15-Aug-2011	0.33	0.11	225,000
250,000	09-Sep-2008	09-Sep-2011	0.25	0.07	250,000
2,750,000	04-May-2010	04-May-2015	0.10	0.03	1,583,333
2,656,250	10-May-2011	10-May-2016	0.10	0.03	-
5,881,250			**0.12**		**2,058,333**

At June 1, 2010:

Number outstanding	Grant date	Expiry date	Exercise price ($)	Fair value at grant date ($)	Number exercisable
250,000	11-Jun-2007	11-Jun-2010	0.37	0.25	250,000
100,000	20-Jul-2007	20-Jul-2010	0.43	0.26	100,000
250,000	25-Jan-2008	25-Jan-2011	0.20	0.10	250,000
250,000	16-May-2008	16-May-2011	0.27	0.13	250,000
225,000	15-Aug-2008	15-Aug-2011	0.33	0.11	225,000
250,000	09-Sep-2008	09-Sep-2011	0.25	0.07	250,000
2,750,000	04-May-2010	04-May-2015	0.10	0.03	-
4,075,000			**0.16**		**1,325,000**

The fair value of services received in return for share options granted is based on the fair value of share options granted, measured using the Black-Scholes model. As at May 31, 2012, there was $157,624 (2011 – $84,929) of total unrecognized share-based compensation costs related to unvested stock option awards granted under the Plan which are expected to be recognized over a weighted-average period of 3 years.

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

	Grant Date				
	09-Sep-08	04-May-10	10-May-11	12-Jul-11	01-Dec-11
Grant date share price ($)(1)	0.25	0.06	0.05	0.06	0.06
Exercise price ($)	0.25	0.10	0.10	0.10	0.10
Expected volatility (%)(2)	78.98	85.67	91.01	93.27	92.12
Expected life (years)	2.40	4.00	4.00	4.00	4.00
Expected dividend yield (%)	0.00	0.00	0.00	0.00	0.00
Risk-free interest rate (%)	2.50	2.56	1.13	1.05	0.94
Forfeiture rate (%)	0.00	0.00	0.00	0.00	0.00

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

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

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

	2012 **$**	2011 $
Administration	**81,908**	50,791
Selling, marketing and business development	**41,197**	11,840
	123,105	62,631

20. SALES

	2012 **$**	2011 $
Sales of goods	**2,711,016**	4,102,270
Rendering of services	**832,658**	1,009,074
Contracts for heat recovery solutions	**9,609,013**	4,589,252
	13,152,687	9,700,596

Finance revenue comprises interest income earned from finance lease. See Note 8 “Finance lease receivable” for more details.

21. EMPLOYEE BENEFITS EXPENSE

	2012 **$**	2011 $
Salaries and benefits	**3,510,296**	3,050,606
Stock-based compensation (Note 19)	**123,105**	62,631
Pension charge	**40,284**	39,381
	3,673,685	3,152,618

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

22. OTHER SIGNIFICANT EXPENSES

Other significant expenses included in administration expense are as follows:

	2012 **$**	2011 $
Depreciation expense of property, plant and equipment (Note 9)	**45,851**	50,022
Amortization expense of other intangible assets (Note 10)	**99,126**	103,246
Foreign exchange loss	**56,809**	13,763

23. INCOME TAXES

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

	2012 $	2011 $
Income (loss) before income taxes	**123,282**	(109,261)
Income taxes calculated using combined federal and provincial income tax rates in Canada of 27.42% (2011 – 27.54%)	**33,804**	(30,091)
Stock-based compensation	**33,757**	17,249
Difference in tax rate of foreign subsidiaries	**(7,157)**	(12,014)
Difference in statutory and deferred tax rate	**160**	9,588
Tax effect of temporary difference for which no deferred tax asset is recorded	**-**	75,200
Use of temporary difference for which no deferred tax asset was recorded previously	**(19,668)**	-
Permanent differences	**(2,345)**	(57,797)
Current and deferred income tax provision	**38,551**	2,135
Current	**93,883**	106,084
Deferred	**(55,332)**	(103,949)
	38,551	2,135

Major components of the current tax expense are as follows:

	2012	2011
Statutory income tax of the year	**93,883**	104,864
Correction of prior years' tax	**-**	1,220
	93,883	106,084

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

	2012	2011
Origination and reversal of timing differences	**(33,104)**	(113,362)
Difference in statutory and deferred tax rate	**160**	9,588
Correction of prior years' tax	**(2,720)**	(75,375)
Use of temporary difference for which no deferred tax asset was recorded previously	**(19,668)**	-
Tax effect of temporary difference for which no deferred tax asset is recorded	**-**	75,200
	(55,332)	(103,949)

Change in deferred tax liabilities in 2012:

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

Change in deferred tax liabilities in 2011:

	June 1, 2010 $	Recognized in income $	May 31, 2011 $
Property, plant and equipment	127,313	(31,666)	95,647
Finance lease receivable	(423,335)	121,697	(301,638)
Non-capital losses	284,152	(88,314)	195,838
Intangible assets	(354,100)	88,254	(265,846)
	(365,970)	89,971	(275,999)
Impact on other comprehensive income		13,978	
Deferred income tax recovery recognized in comprehensive income		103,949	

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

	2012 $	2011 $
Property, plant and equipment	**886,183**	857,491
Share issue costs	**380,640**	761,280
Provisions	**190,000**	-
Non-capital losses	**12,921,801**	12,839,535
	14,378,624	14,458,306

As at May 31, 2012, the Company had available non-capital income tax loss carry forwards in the following amounts which may be used to reduce federal and provincial taxable income:

Year of Expiry	**Amount** $
2014	354,578
2015	532,623
2026	1,276,366
2027	1,692,621
2028	1,441,849
2029	3,486,435
2030	3,083,819
2031	864,328
2032	132,145
Total	12,864,764

As at May 31, 2012, the Company had non-capital losses on foreign subsidiaries, for which no deferred tax asset was recorded in the amount of $57,037. All losses expire in 2017.

24. NET INCOME (LOSS) PER SHARE

The calculation of basic and diluted income per share for the year ended May 31, 2012 was based on the net income attributable to owners of the parent of $101,429 and a weighted average number of shares outstanding of 163,086,616. The calculation of basic and diluted loss per share for the year ended May 31, 2011 was based on the loss attributable to owners of the parent of $142,582 and the weighted average number of shares outstanding of 163,126,612 (calculated as shares outstanding at May 31, 2011 of 163,770,922 less shares that were subject to shareholder loans of 644,310). All remaining shares that were subject to shareholder loans have been cancelled in the year ended May 31, 2012. In calculating the diluted income (loss) per share, dilutive potential ordinary shares such as share options and warrants have not been included as they would have the effect of decreasing the income (loss) per share in 2011.

25. OPERATING LEASE COMMITMENTS

Thermal Energy International Inc. and its UK subsidiary have entered into lease agreements for the use of land and building, motor vehicles, telecommunication system and other office equipment. These leases range from one to five years with no renewal option included in the contracts. There are no restrictions placed upon the Company by entering into these leases. See Note 9 'Property, Plant and Equipment' for the details of finance lease commitments on certain motor vehicles.

At May 31, 2012, the Company has operating lease commitments as follows:

	Total $	Less than 1 year $	1-5 years	More than 5 years $
Operating Leases	153,500	126,300	27,200	nil

Lease payments recognized as an expense for the year ended May 31, 2012 totalled $133,766 (2011 - $135,027).

26. FINANCIAL INSTRUMENTS

Categories of Financial Instruments

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

Financial Risk Management

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

Market risk

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

Foreign currency exchange risk sensitivity

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

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

	Net financial assets/(liabilities) in CAD$			
	US$	£	Euro	Total CAD $
Functional currency of Company entity				
2012				
Canadian Dollar	**305,207**	**-**	**-**	**305,207**
British Pound	**(63,917)**	**n/a**	**391,799**	**327,882**
	241,290	**-**	**391,799**	**633,089**
2011				
Canadian Dollar	156,975	(16,106)	-	140,869
British Pound	(32,226)	n/a	258,765	226,539
	124,749	(16,106)	258,765	367,408

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

	2012				2011			
	US$	**£**	**Euros**	**Total**	US$	£	Euros	Total
Net income (loss)	**24,129**	**-**	**39,180**	**63,309**	12,475	(1,611)	25,877	36,741
Equity	**30,521**	**509,455**	**-**	**539,976**	15,698	491,892	-	517,590

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

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

Credit risk

Credit risk is the risk of financial loss to the Company if a customer or counterparty to a financial instrument fails to meet its obligations. The financial instruments that potentially expose the Company to credit risk are trade receivables, cash and cash equivalents, related party receivables and other miscellaneous receivables.

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

Accounts receivable

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

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

The amounts reported for trade receivables in the statement of financial position are net of allowances for doubtful accounts. The Company's maximum exposure to credit risk at the reporting date is the carrying value of its cash and cash equivalents (see Note 5), trade receivables, related party receivables and other miscellaneous receivables (see Note 6).

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

Liquidity risk

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

As at May 31, 2012, the Company's financial liabilities, which consist of short-term borrowings, trade payables, accruals and finance leases payable, have a carrying value of $1,967,845 and are all due within one year.

Interest rate risk

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

The Company currently does not use interest rate hedges or fixed interest rate contracts to manage the Company's exposure to interest rate fluctuations. There were no significant investments or borrowings to expose the Company to interest rate sensitivity either at May 31, 2012 or May 31, 2011.

27. 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:

	2012 **$**	2011 $
Salaries and other short term employee benefits	**897,695**	866,492
Incentives	**87,148**	34,418
Directors' fees	**146,419**	103,000
Share-based payments	**76,086**	56,540
	1,207,348	1,060,450

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

28. EXPLANATION OF TRANSITION TO IFRS

The accounting policies set out in Note 2 to these consolidated financial statements have been applied in preparing the consolidated financial statements for the year ended May 31, 2012, the comparative information and the opening statement of financial position at June 1, 2010 (the Company's date of transition).

28.1. IFRS 1 exceptions and exemptions

IFRS 1 allows for certain mandatory exceptions and optional exemptions for first time adopters to alleviate the retrospective application of all standards under IFRS. The Company has applied the mandatory exceptions and certain optional exemptions, as set out below.

Mandatory exceptions adopted

I. De-recognition of financial assets and liabilities

Financial assets and liabilities that were de-recognized before June 1, 2010 under pre-change accounting standards were not recognized under IFRS. The Company has early applied the change in IFRS1 in this respect regarding the application date of the exception, i.e. June 1, 2010.

II. Estimates

The estimates previously made by the Company under previous Canadian GAAP were not revised for the application of IFRS except where necessary to reflect any difference in accounting policy.

Optional exemptions applied

I. Cumulative translation differences

IFRS 1 allows a first time adopter to elect to eliminate all previously recorded cumulative translation differences related to foreign operations at the transition date. The Company has chosen to apply this election.

II. Share-based payments

The Company has elected not to restate its share-based payments for share options granted after November 7, 2002 and vested prior to the date of transition.

III. Business Combinations

The Company has elected to use the exemption to adopt IFRS 3 “Business Combinations” prospectively from the date of transition. See Note 28.3.g for more details.

IV. Leases

The Company has elected to use facts and circumstances existing at the date of transition to determine whether an arrangement contains a lease. No such assessment was done under previous Canadian GAAP.

In preparing its opening IFRS statement of financial position, the Company has adjusted amounts reported previously in financial statements prepared in accordance with previous Canadian GAAP. An explanation of how the transition from previous Canadian GAAP to IFRS has affected the Company’s financial position, total comprehensive income and cash flows is set out in the following tables and the notes that accompany those tables.

28.2. Reconciliation of equity

The June 1, 2010 Canadian GAAP equity has been reconciled to IFRS as follows:

Canadian GAAP description	Per GAAP $	Effect of transition to IFRS $	Per IFRS $	IFRS description	Note
ASSETS				**ASSETS**	
Current assets				**Current assets**	
Cash and cash equivalents	433,493		433,493	Cash and cash equivalents	
Accounts receivable	1,680,024	239,416	1,919,440	Trade and other receivables	a
Inventories	394,507		394,507	Inventory	
Net investment in lease	534,281		534,281	Finance lease receivable	
Prepaids and other assets	239,416	(239,416)	-		a
	3,281,721	-	3,281,721		
				Non-current assets	
Property, plant and equipment	95,684		95,684	Property, plant and equipment	
Net investment in lease	1,159,060		1,159,060	Finance lease receivable	
Intangible assets	995,448		995,448	Other intangible assets	
Goodwill	3,143,979	19,377	3,163,356	Goodwill	b
	5,394,171	19,377	5,413,548		
	8,675,892	**19,377**	**8,695,269**	**Total assets**	
LIABILITIES				**LIABILITIES**	
Current liabilities				**Current liabilities**	
Bank loans	11,093		11,093	Short-term borrowings	
Accounts payable	527,759	(20,737)	507,022	Trade payables	c
		77,983	77,983	Current tax liabilities	c
		36,058	36,058	Pensions and other employee obligations	c
		434,031	434,031	Other liabilities	c
		19,377	19,377	Deferred consideration	b
Deferred revenue	769,801		769,801	Deferred revenue	
		265,000	265,000	Provisions	c
Accrued liabilities	804,205	(804,205)	-		c
	2,112,858	**7,507**	**2,120,365**	**Total current liabilities**	
				Non-current liabilities	
Future taxes	354,100	11,870	365,970	Deferred tax liabilities	c
Non-controlling interest	1,423	(1,423)	-		d
	2,468,381	**17,954**	**2,486,335**	**Total liabilities**	
SHAREHOLDERS' EQUITY				**EQUITY**	
Capital stock	32,623,584	524,600	33,148,184	Capital stock	e
Contributed surplus	2,292,153		2,292,153	Contributed surplus	
Accumulated other comprehensive loss	(1,364,689)	1,364,689	-	Accumulated other comprehensive loss	f
Deficit	(27,343,537)	(1,889,289)	(29,232,826)	Deficit	e/f
	6,207,511	-	6,207,511	Equity attributable to owners of the parent	
		1,423	1,423	Non-controlling interest	d
	6,207,511	**1,423**	**6,208,934**	**Total equity**	
	8,675,892	**19,377**	**8,695,269**	**Total liabilities and equity**	

THERMAL ENERGY INTERNATIONAL INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

For the years ended May 31, 2012 and 2011

(Expressed in Canadian Dollars)

The May 31, 2011 Canadian GAAP equity has been reconciled to IFRS as follows:

Canadian GAAP description	Per GAAP $	Effect of transition to IFRS $	Per IFRS $	IFRS description	Note
ASSETS				**ASSETS**	
Current assets				**Current assets**	
Cash and cash equivalents	972,163		972,163	Cash and cash equivalents	
Accounts receivable	1,558,000	293,377	1,851,377	Trade and other receivables	a
Contracts In progress	174,469	(174,469)	-		a
Inventories	420,999		420,999	Inventory	
Net investment in lease	653,807		653,807	Finance lease receivable	
Prepaid and other assets	118,908	(118,908)	-		a
	3,898,346	-	3,898,346		
				Non-current assets	
Property, plant and equipment	74,527		74,527	Property, plant and equipment	
Net investment in lease	467,523		467,523	Finance lease receivable	
Intangible assets	940,047		940,047	Other intangible assets	
Goodwill	3,317,666	854	3,318,520	Goodwill	b
	4,799,763	854	4,800,617		
	8,698,109	**854**	**8,698,963**	**Total assets**	
LIABILITIES				**LIABILITIES**	
Current liabilities				**Current liabilities**	
Accounts payable	657,096	(38,975)	618,121	Trade payables	c
		124,113	124,113	Current tax liabilities	c
		62,173	62,173	Pensions and other employee obligations	c
		603,299	603,299	Other liabilities	c
		854	854	Deferred consideration	b
Deferred revenue	343,699		343,699	Deferred revenue	
		265,000	265,000	Provisions	c
Accrued liabilities	1,025,763	(1,025,763)	-		c
	2,026,558	**(9,299)**	**2,017,259**	**Total current liabilities**	
				Non-current liabilities	
Future taxes	265,846	10,153	275,999	Deferred tax liabilities	c
Non-controlling interest	48,409	(48,409)	-		d
	2,340,813	**(47,555)**	**2,293,258**	**Total liabilities**	
SHAREHOLDERS' EQUITY				**EQUITY**	
Capital stock	32,623,584	524,600	33,148,184	Capital stock	e
Contributed surplus	2,354,784		2,354,784	Contributed surplus	
Accumulated other comprehensive loss	(1,136,708)	1,364,689	227,981	Accumulated other comprehensive loss	f
Deficit	(27,484,364)	(1,889,289)	(29,373,653)	Deficit	e/f
	6,357,296	-	6,357,296	Equity attributable to owners of the parent	
		48,409	48,409	Non-controlling interest	d
	6,357,296	**48,409**	**6,405,705**	**Total equity**	
	8,698,109	**854**	**8,698,963**	**Total liabilities and equity**	

28.3. Notes to the reconciliations

a) Management has chosen to present prepayments and contracts in progress within Trade and other receivables. This disclosure change has no impact on either total assets or total equity and liabilities.

b) Deferred consideration relating to the purchase of Gardner Energy Management Ltd., estimated as $19,377 as at the opening position, was not provided under Canadian GAAP. However, under IFRS 3 "Business Combinations", contingent consideration should be included in the cost of the acquisition at the date of the acquisition if payment of the amount is probable and it can be measured reliably. This adjustment impacts goodwill and deferred consideration by $19,377 and $854 within the statement of financial position as at June 1, 2010 and May 31, 2011, respectively.

c) Management has chosen to present accrued liabilities as other liabilities. In addition, IFRS requires separate disclosure of provisions, pensions and other employee obligations and current tax liabilities. Due to the transition, commodity taxes in the amount of $20,737 have been reclassified from accounts payable to other liabilities at June 1, 2010 (May 31, 2011 - $38,975). Accrued liabilities in the amount of $11,870 at June 1, 2010 relating to deferred tax liabilities of a foreign subsidiary have been reclassified from accrued liabilities to deferred tax liabilities (May 31, 2011 - $10,153). This disclosure change has no impact on either total assets or total equity and liabilities.

d) Under Canadian GAAP, non-controlling interest was recorded as long-term liabilities. Under IFRS, however, they are included within equity. There is no net impact on total equity and liabilities.

e) Under pre-change accounting standards, the entire proceeds on the issuance of flow-through shares were credited to capital stock.

Under IFRS, issuance of flow-through shares represents an issue of ordinary shares and the sale of tax deductions to the investors. When the flow-through shares are issued, the sale of tax deductions is deferred and presented as other liabilities in the statement of financial position. The proceeds received from flow-through placements are allocated between capital stock and the liability using the residual method. Proceeds are first allocated to shares according to the quoted price of existing shares at the time of issuance and the residual proceeds are allocated to the liability. The liability component recorded initially on the issuance of shares is reversed on renouncement of tax deductions to the investors and when eligible expenses are incurred and recognized in profit or loss in reduction of deferred income tax expense.

Under pre-change accounting standards, when the renouncement, according to tax legislation, of tax deductions related to the resource expenditure, temporary taxable differences were created and a deferred income tax was recorded as well as share issue cost for the same amount.

According to the provisions of tax legislation relating to flow-through shares, the Company has to transfer its right to tax deductions for expenses related to exploration activities to the benefit of the investors. Under IFRS, when the Company has fulfilled its obligation to transfer its right, which happens when the Company has incurred eligible expenditures and the Company has renounced its right to tax deductions, a deferred tax liability is recognized for the taxable temporary difference that arises from the difference between the carrying amount of eligible expenditures capitalized as an asset and its tax basis.

As there is no exemption under IFRS1 for first-time adopters regarding flow-through shares, the treatment under IFRS needs to be adopted retrospectively.

The impact on the Company's transition to IFRS is an increase to capital stock and an increase to deficit by $524,600 as at May 31, 2011 and June 1, 2010.

f) Under IFRS, the Company elected to re-set its cumulated foreign exchange adjustments to zero. The adjustment of $1,364,689 impacts accumulated other comprehensive loss and deficit as at May 31, 2011 and June 1, 2010.

g) The Company has elected to not restate business combinations that occurred before the date of transition to IFRS. The carrying amount of goodwill has not been adjusted for intangible assets subsumed within goodwill or for intangible assets that do not qualify for recognition under IFRS. The amount of goodwill at the date of transition relates to the Gardner Energy Management Ltd. cash-generating unit. At the date of transition, this goodwill was tested for impairment based on cash flow forecasts made at that date. No impairment was identified. The amount of goodwill recognized upon transition to IFRS is therefore the carrying amount under previous Canadian GAAP at June 1, 2010.

h) Under pre-change accounting standards, an entity can consider the entire award as a group, determine the fair value using the average term of the instruments and then recognize the compensation expense on a straight-line basis over the vesting period. Additionally, under pre-change accounting standards, forfeitures were recognized as they occurred.

Pursuant to IFRS2, each portion of an award with graded vesting options must be considered as a separate award of share options with its own vesting date and fair value and must be recognized on that basis. Additionally, under IFRS, entities are required to estimate awards that are expected to vest and to revise that estimate if subsequent information indicates that actual forfeitures are likely to differ from initial estimates.

No adjustments were made to expense for share-based payments to reflect the above accounting method differences as the Company was already considering awards as separate awards and estimated forfeitures were not materially different to actual forfeitures.

28.4. Material adjustments to total comprehensive income and statement of cash flows

There are no material differences between total comprehensive income presented under IFRS and total comprehensive income presented under previous Canadian GAAP, nor are there any material differences between the statement of cash flows presented under IFRS and the statement of cash flows presented under GAAP.

There are a number of amendments to the statements of financial position, however, as there have been no changes to total comprehensive income or cash flows, no reconciliations are presented.