

THERMAL ENERGY INTERNATIONAL INC.

Unaudited Condensed Consolidated Interim Statements of Financial Position

(Expressed in Canadian dollars)

| | February 29, 2016 | May 31, 2015 |
|---|---------------------|---------------------|
| | \$ | \$ |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents (note 5) | 1,295,645 | 715,343 |
| Trade and other receivables (note 6) | 2,056,157 | 2,329,514 |
| Current tax receivable | 86,735 | 85,669 |
| Inventory (note 7) | 455,698 | 408,555 |
| Finance lease receivable (note 8) | 124,072 | 111,524 |
| | 4,018,307 | 3,650,605 |
| Non-current assets: | | |
| Finance lease receivable (note 8) | 23,578 | 116,560 |
| Property, plant and equipment (note 9) | 62,374 | 62,363 |
| Intangible assets (note 10) | 700,168 | 706,748 |
| Goodwill (note 11) | 1,330,367 | 1,342,869 |
| Deferred tax asset | 16,351 | 17,720 |
| | 2,132,838 | 2,246,260 |
| Total assets | 6,151,145 | 5,896,865 |
| Liabilities | | |
| Current liabilities: | | |
| Trade payables (note 13) | 927,312 | 692,393 |
| Current tax liabilities | 11,449 | 3,051 |
| Pensions and other employer obligations | 85,071 | 79,527 |
| Other liabilities (note 14) | 994,063 | 873,712 |
| Deferred revenue (note 15) | 1,084,940 | 1,298,533 |
| Provisions (note 16) | 215,000 | 215,000 |
| | 3,317,835 | 3,162,216 |
| Non-current liabilities: | | |
| Deferred tax liabilities | 25,156 | 610 |
| Total liabilities | 3,342,991 | 3,162,826 |
| Equity | | |
| Capital stock (note 17) | 32,308,827 | 32,308,827 |
| Contributed surplus | 3,625,513 | 3,497,359 |
| Accumulated other comprehensive income | 516,784 | 559,149 |
| Deficit | (33,659,646) | (33,643,663) |
| Equity attributable to owners of the parent | 2,791,478 | 2,721,672 |
| Non-controlling interest | 16,676 | 12,367 |
| Total equity | 2,808,154 | 2,734,039 |
| Total liabilities and equity | 6,151,145 | 5,896,865 |

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

On behalf of the Board



President and C.E.O.



Director

THERMAL ENERGY INTERNATIONAL INC.**Unaudited Condensed Consolidated Interim Statements of Comprehensive Income**

(Expressed in Canadian dollars)

| | Three months ended | | Nine months ended | |
|--|--------------------|-------------|-------------------|-------------|
| | February 29 | February 28 | February 29 | February 28 |
| | 2016 | 2015 | 2016 | 2015 |
| | \$ | \$ | \$ | \$ |
| Revenue | 3,220,621 | 1,440,985 | 8,278,830 | 4,275,131 |
| Cost of sales | 1,191,381 | 729,079 | 3,532,538 | 1,840,847 |
| Gross profit | 2,029,240 | 711,906 | 4,746,292 | 2,434,284 |
| Expenses: | | | | |
| Administration | 616,969 | 631,168 | 1,979,119 | 1,954,712 |
| Selling, marketing and business development | 921,392 | 761,383 | 2,601,598 | 2,415,450 |
| Research and development | 33,083 | 38,182 | 154,116 | 119,381 |
| | 1,571,444 | 1,430,733 | 4,734,833 | 4,489,543 |
| Operating income (loss) | 457,796 | (718,827) | 11,459 | (2,055,259) |
| Finance revenue | 5,997 | 12,134 | 20,619 | 53,489 |
| Income (loss) before income taxes | 463,793 | (706,693) | 32,078 | (2,001,770) |
| Income taxes (expense) recovery | (46,071) | 49,101 | (41,323) | 184,595 |
| Net income (loss) for the period | 417,722 | (657,592) | (9,245) | (1,817,175) |
| Other comprehensive income (loss) for the period | | | | |
| Items that may be reclassified subsequently to profit or loss: | | | | |
| Exchange differences arising on translation of overseas operations | (176,603) | 130,314 | (44,794) | 66,837 |
| Total comprehensive income (loss) for the period | 241,119 | (527,278) | (54,039) | (1,750,338) |
| Net income (loss) for the period attributable to: | | | | |
| Owners of the parent | 421,040 | (656,470) | (15,983) | (1,816,049) |
| Non-controlling interest | (3,318) | (1,122) | 6,738 | (1,126) |
| Net income (loss) for the period | 417,722 | (657,592) | (9,245) | (1,817,175) |
| Total comprehensive income (loss) for the period attributable to: | | | | |
| Owners of the parent | 248,464 | (527,607) | (58,348) | (1,747,759) |
| Non-controlling interest | (7,345) | 329 | 4,309 | (2,579) |
| Total comprehensive income (loss) for the period | 241,119 | (527,278) | (54,039) | (1,750,338) |
| Net income (loss) per share - basic and diluted (note 21) | 0.003 | (0.004) | 0.000 | (0.011) |

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

THERMAL ENERGY INTERNATIONAL INC.

Unaudited Condensed Consolidated Interim Statements of Changes in Equity

Nine months ended February 29, 2016 and February 28, 2015

(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, 2014 | 32,717,630 | 3,054,624 | (31,492,278) | 508,149 | 4,788,125 | 18,426 | 4,806,551 |
| Stock-based compensation (note 19) | | 179,903 | | | 179,903 | | 179,903 |
| Repurchase of Class A common shares (note 17) | (354,553) | 179,099 | | | (175,454) | | (175,454) |
| Transactions with owners | (354,553) | 359,002 | - | - | 4,449 | - | 4,449 |
| Net loss for the period | | | (1,816,049) | | (1,816,049) | (1,126) | (1,817,175) |
| Other comprehensive income (loss): exchange differences arising on translation of overseas operations | | | | 68,290 | 68,290 | (1,453) | 66,837 |
| Total comprehensive income (loss) for the period | - | - | (1,816,049) | 68,290 | (1,747,759) | (2,579) | (1,750,338) |
| Balance at February 28, 2015 | 32,363,077 | 3,413,626 | (33,308,327) | 576,439 | 3,044,815 | 15,847 | 3,060,662 |
| Balance at June 1, 2015 | 32,308,827 | 3,497,359 | (33,643,663) | 559,149 | 2,721,672 | 12,367 | 2,734,039 |
| Stock-based compensation (note 19) | | 128,154 | | | 128,154 | | 128,154 |
| Transactions with owners | 0 | 128,154 | - | - | 128,154 | - | 128,154 |
| Net income (loss) for the period | | | (15,983) | | (15,983) | 6,738 | (9,245) |
| Other comprehensive income (loss): exchange differences arising on translation of overseas operations | | | | (42,365) | (42,365) | (2,429) | (44,794) |
| Total comprehensive income (loss) for the period | - | - | (15,983) | (42,365) | (58,348) | 4,309 | (54,039) |
| Balance at February 29, 2016 | 32,308,827 | 3,625,513 | (33,659,646) | 516,784 | 2,791,478 | 16,676 | 2,808,154 |

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

THERMAL ENERGY INTERNATIONAL INC.
Unaudited Condensed Consolidated Interim Statement of Cash Flows

(Expressed in Canadian dollars)

| | Three months ended | | Nine months ended | |
|---|---------------------------|---------------------------|---------------------------|---------------------------|
| | February 29 2016 \$ | February 28 2015 \$ | February 29 2016 \$ | February 28 2015 \$ |
| Operating activities: | | | | |
| Net income (loss) for the period | 417,722 | (657,592) | (9,245) | (1,817,175) |
| Add (deduct) items not involving cash: | | | | |
| Depreciation of property, plant and equipment | 8,305 | 9,029 | 24,077 | 26,724 |
| Gain on disposal of property, plant and equipment | - | - | (8,076) | - |
| Finance revenue | (5,997) | (12,134) | (20,619) | (53,489) |
| Stock-based compensation (note 19) | 31,314 | 49,395 | 128,154 | 179,903 |
| Income tax expense (recovery) | 46,071 | (49,101) | 41,323 | (184,595) |
| Unrealized foreign exchange and translation adjustments | (32,411) | (24,810) | (5,169) | (54,126) |
| Changes in working capital : | | | | |
| Trade and other receivables | (221,335) | (55,648) | 273,357 | 295,211 |
| Inventory | 6,658 | (32,475) | (47,143) | (90,929) |
| Trade payables | 167,794 | (11,407) | 234,919 | (423,608) |
| Deferred revenue | (347,069) | 582,354 | (213,593) | 792,098 |
| Other liabilities | (27,755) | 93,861 | 128,859 | 5,312 |
| Income taxes refund (payment) | (3,400) | (40,339) | (3,547) | 6,700 |
| Interests received on finance lease | 5,997 | 12,134 | 20,619 | 53,489 |
| Other interests received | 57 | 36 | 696 | 104 |
| Interest paid | (1,264) | (1,060) | (3,660) | (3,336) |
| Net cash provided (used) in operating activities | 44,687 | (137,757) | 540,952 | (1,267,717) |
| Investing activities: | | | | |
| Finance lease principal payments received | 30,003 | 247,749 | 80,434 | 568,284 |
| Proceeds from disposal of property, plant and equipment | - | - | 8,076 | - |
| Additions to property, plant and equipment | (14,336) | (3,554) | (24,316) | (32,462) |
| Net cash provided by investing activities | 15,667 | 244,195 | 64,194 | 535,822 |
| Financing activities: | | | | |
| Repurchase of Class A common shares | - | (9,920) | - | (175,454) |
| Net cash used by investing activities | - | (9,920) | - | (175,454) |
| Increase (decrease) in cash and cash equivalents for the period | 60,354 | 96,518 | 605,146 | (907,349) |
| Cash and cash equivalents, beginning of period | 1,239,677 | 1,038,425 | 715,343 | 2,046,417 |
| Exchange differences on cash and cash equivalents | (4,386) | 10,948 | (24,844) | 6,823 |
| Cash and cash equivalents, end of period | 1,295,645 | 1,145,891 | 1,295,645 | 1,145,891 |

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

1. Nature of operations:

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

These unaudited condensed consolidated interim financial statements were approved and authorized for issue by the Board of Directors on April 14, 2016. The condensed consolidated interim financial statements comprise the financial results of the parent and its subsidiaries (collectively known as "the Company") for the three months and nine months ended February 29, 2016 and February 28, 2015.

2. Basis of presentation:

(a) Going concern:

These financial statements have been prepared assuming the Company will continue as a going concern. The going concern basis of presentation assumes the Company will continue in operation for the foreseeable future and be able to realize its assets and discharge its liabilities and commitments in the normal course of business. However, the Company experienced net losses in the nine months ended February 29, 2016 and February 28, 2015. In addition, the Company has a deficit of \$33,659,646.

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

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

2. Basis of presentation (continued):

(b) Statement of compliance:

These condensed consolidated interim financial statements have been prepared in accordance with International Accounting Standard 34 "Interim Financial Reporting" ("IAS 34") as issued by the International Accounting Standards Board ("IASB"), utilizing the accounting policies the Company adopted in its May 31, 2015 audited annual consolidated financial statements. The accounting policies are based on the International Financial Reporting Standards ("IFRS"). These unaudited condensed consolidated interim financial statements do not include all of the information required for full annual financial statements and should be read in conjunction with the audited consolidated financial statements of the Company for the year ended May 31, 2015.

The significant accounting policies are summarized in note 3.

(c) Measurement basis:

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

(d) Significant accounting judgements and estimates:

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

The critical estimates include:

- Impairment:

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

2. Basis of presentation (continued):

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

- Impairment (continued):

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

No impairment was recognized for the year ended May 31, 2015.

- Future production outputs related to the finance lease:

When a new finance lease or amendment is signed, in determining minimum lease payments receivable, management makes estimates regarding monthly energy outputs of the leased asset based on assumptions regarding the efficiency of the asset, the operations of the plant in which it is located, penalty payments resulting from temporary plant shut-downs and residual value of the equipment. These assumptions relate to future events and circumstances. Actual results may vary from estimate. Further information on the future production outputs related to the finance lease is provided in note 8.

- Assumptions used in the Black-Scholes fair value calculations:

The estimation of share-based payment expense requires the selection of an appropriate valuation model and consideration as to the inputs necessary for the valuation model chosen. In calculating the share-based payment expense, key estimates such as the rate of forfeiture of options granted, the expected life of the option, the volatility of the Company's stock price and the risk free interest rate are used. Further details of inputs used in the measurement of fair values at grant date are provided in note 19.

- Allowance for doubtful accounts:

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

2. Basis of presentation (continued):

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

- Heat recovery solutions contract revenue:

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

- Deferred tax assets:

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

The critical judgements include:

- Lease classification:

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

- Multi-element arrangements:

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

2. Basis of presentation (continued):

(e) Functional currency and foreign currency translation:

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

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

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

3. Significant accounting policies:

(a) Basis of consolidation:

The condensed consolidated interim financial statements incorporate the financial statements of the parent, which is the ultimate parent, and its subsidiaries. Subsidiaries are consolidated from the date on which the parent company obtains control, and continue to be consolidated until control ceases. Control is established when the parent company is exposed to, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the entity. The financial statements of the subsidiaries are prepared using consistent accounting policies and all material inter-company transactions are eliminated in full upon consolidation.

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

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

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

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(a) Basis of consolidation (continued):

All subsidiaries have a reporting date of November 30.

(b) Business combinations:

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

(c) Cash and cash equivalents:

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

(d) Inventories:

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(e) Leases:

(i) The Company as a lessor - finance leases:

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

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

(ii) The Company as a lessee:

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(f) Property, plant and equipment:

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

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

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

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

(g) Intangible assets:

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(g) Intangible assets (continued):

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

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

Amortization is included within administrative expenses.

(h) Goodwill:

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

(i) Impairment:

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

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(i) Impairment (continued):

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

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

(j) Provisions, contingent liabilities and contingent assets:

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

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

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

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

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

Warranties:

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

(k) Equity:

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

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

Deficit includes all current and prior year retained losses.

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

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

(l) Equity-settled stock-based compensation:

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

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

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

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

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

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

(m) Revenue recognition:

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

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

Sale of goods

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(m) Revenue recognition (continued):

Rendering of services

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

Contracts for heat recovery solutions

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

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(m) Revenue recognition (continued):

Multi-element arrangements

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

Interest revenue and expenses

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

(n) Post employee benefits and short-term employee benefits:

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

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

(o) Research costs and government assistance:

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(p) Investment tax credits:

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

(q) Income taxes:

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

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

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(q) Income taxes (continued):

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

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

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

(r) Earnings (loss) per share:

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

(s) Financial instruments:

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(s) Financial instruments (continued):

Financial assets

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

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

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

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

Loans and receivables

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

Financial liabilities

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

(s) Financial instruments (continued):

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.

(t) Segment reporting:

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

The two main operating units are as follows:

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

3. Significant accounting policies (continued):

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

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

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

IFRS 9, "Financial Instruments"

In July 2014, the IASB issued the final version of IFRS 9, bringing together the classification and measurement, impairment and hedge accounting phases of the project to replace IAS 39, "Financial Instruments: Recognition and Measurement. IFRS 9 is applied retrospectively for annual years beginning on or after January 1, 2018. Early application is permitted. The Company does not intend to adopt this standard early and is currently evaluating the impact of adopting this standard on the consolidated financial statements.

IFRS 15, "Revenue from Contracts with Customers"

In May 2014, the IASB issued IFRS 15, Revenue from Contracts with Customers, which provides a single, principles-based five-step model for revenue recognition to be applied to all customer contracts, and requires enhanced disclosures. This standard is effective January 1, 2017 and allows early adoption. On July 22, 2015, the IASB unanimously affirmed its proposal to defer the effective date of IFRS 15 to January 1, 2018. Earlier application of IFRS 15 continues to be permitted. The Company does not intend to adopt this standard early and is currently evaluating the impact of adopting this standard on the consolidated financial statements.

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

4. Segment reporting:

In the quarters and nine month periods ended February 29, 2016 and February 28, 2015, the Company operated in the energy efficiency industry in North America, Europe, China and the 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 by product segment 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 Canada covering North America and China ("Thermal Energy Ottawa"), and the other in Bristol, United Kingdom, covering Europe and the rest of the world ("Thermal Energy Bristol"). These areas are determined by proximity of the region to the reporting unit, plus the location of the contracts in existence with agents and distributors in the respective areas and the historical relationships with those agents and distributors. Corporate costs that cannot easily be attributed to either of the two reporting units are included in reconciling items. The chief operating decision maker focuses on revenues and costs by geographical segments, but manages assets and liabilities on a global basis.

Segment information for the quarter ended February 29, 2016 and the comparative period are detailed in the table below.

| | Thermal Energy Ottawa | | Thermal Energy Bristol | | Reconciling items | | Total | |
|-----------------------------------|-----------------------|-----------|------------------------|-----------|-------------------|-----------|--------------------|-------------|
| | 2016 | 2015 | 2016 | 2015 | 2016 | 2015 | 2016 | 2015 |
| | \$ | \$ | \$ | \$ | \$ | \$ | \$ | \$ |
| Total revenue | 1,333,652 | 665,108 | 1,886,969 | 775,877 | - | - | 3,220,621 | 1,440,985 |
| Cost of sales | (373,305) | (505,551) | (818,076) | (223,528) | - | - | (1,191,381) | (729,079) |
| Gross profit | 960,347 | 159,557 | 1,068,893 | 552,349 | - | - | 2,029,240 | 711,906 |
| Other expenses | (644,360) | (509,284) | (735,444) | (668,933) | (191,640) | (252,516) | (1,571,444) | (1,430,733) |
| Finance revenue | 5,997 | 12,134 | - | - | - | - | 5,997 | 12,134 |
| Income (loss) before income taxes | 321,984 | (337,593) | 333,449 | (116,584) | (191,640) | (252,516) | 463,793 | (706,693) |
| Income taxes (expense) recovery | - | - | (101,416) | 41,441 | 55,345 | 7,660 | (46,071) | 49,101 |
| Net income (loss) | 321,984 | (337,593) | 232,033 | (75,143) | (136,295) | (244,856) | 417,722 | (657,592) |
| Attributable to: | | | | | | | | |
| Owners of the parent | 327,512 | (334,278) | 229,823 | (77,336) | (136,295) | (244,856) | 421,040 | (656,470) |
| Non-controlling interest | (5,528) | (3,315) | 2,210 | 2,193 | - | - | (3,318) | (1,122) |

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

4. Segment reporting (continued):

Segment information for the nine months ended February 29, 2016 and the comparative period are detailed in the table below.

| | Thermal Energy Ottawa | | Thermal Energy Bristol | | Reconciling items | | Total | |
|-----------------------------------|-----------------------|-------------|------------------------|-------------|-------------------|-----------|--------------------|-------------|
| | 2016 | 2015 | 2016 | 2015 | 2016 | 2015 | 2016 | 2015 |
| | \$ | \$ | \$ | \$ | \$ | \$ | \$ | \$ |
| Total revenue | 4,056,385 | 1,967,172 | 4,222,445 | 2,307,959 | - | - | 8,278,830 | 4,275,131 |
| Cost of sales | (1,808,252) | (1,134,528) | (1,724,286) | (706,319) | - | - | (3,532,538) | (1,840,847) |
| Gross profit | 2,248,133 | 832,644 | 2,498,159 | 1,601,640 | - | - | 4,746,292 | 2,434,284 |
| Other expenses | (1,875,003) | (1,602,477) | (2,043,335) | (2,048,926) | (816,495) | (838,140) | (4,734,833) | (4,489,543) |
| Finance revenue | 20,619 | 53,489 | - | - | - | - | 20,619 | 53,489 |
| Income (loss) before income taxes | 393,749 | (716,344) | 454,824 | (447,286) | (816,495) | (838,140) | 32,078 | (2,001,770) |
| Income taxes (expense) recovery | 493 | (134) | (120,825) | 149,828 | 79,009 | 34,901 | (41,323) | 184,595 |
| Net income (loss) | 394,242 | (716,478) | 333,999 | (297,458) | (737,486) | (803,239) | (9,245) | (1,817,175) |
| Attributable to: | | | | | | | | |
| Owners of the parent | 403,718 | (711,824) | 317,785 | (300,986) | (737,486) | (803,239) | (15,983) | (1,816,049) |
| Non-controlling interest | (9,476) | (4,654) | 16,214 | 3,528 | - | - | 6,738 | (1,126) |

Other expenses within reconciling items comprise the following:

| | Three months ended February 29 | | Nine months ended February 29 | |
|---|-----------------------------------|----------|----------------------------------|----------|
| | 2016 | 2015 | 2016 | 2015 |
| | \$ | \$ | \$ | \$ |
| Corporate admin costs | 193,418 | 192,944 | 594,556 | 560,871 |
| Stock-based compensation | 31,314 | 49,395 | 128,154 | 179,903 |
| Professional fees | 14,146 | 10,250 | 121,012 | 130,741 |
| Depreciation of property, plant and equipment | 8,306 | 9,029 | 24,077 | 26,724 |
| Bank charges and interest | 12,483 | 12,028 | 31,436 | 30,636 |
| Foreign exchange differences | (68,027) | (21,130) | (82,740) | (90,735) |
| Total | 191,640 | 252,516 | 816,495 | 838,140 |

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

During the three months ended February 29, 2016, Thermal Energy Bristol had one customer that accounted for 19% of the company's total revenue for the period.

During the three months ended February 28, 2015, Thermal Energy Ottawa had one customer that accounted for 29% of the company's total revenue for the period.

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

4. Segment reporting (continued):

During the nine months ended February 29, 2016, Thermal Energy Ottawa had one customer that accounted for 10% of total revenue.

During the nine months ended February 28, 2015, Thermal Energy Ottawa had one customer that accounted for 19% of total revenue.

Further geographical analysis:

| | Revenues for the nine months ended | | Property, plant and equipment as at | | Goodwill and intangibles assets as at | | Finance lease receivable (non-current) as at | |
|----------------|------------------------------------|------------------|-------------------------------------|---------------|---------------------------------------|------------------|--|----------------|
| | February 29 | | February 29 | May 31 | February 29 | May 31 | February 29 | May 31 |
| | 2016 | 2015 | 2016 | 2015 | 2016 | 2015 | 2016 | 2015 |
| | \$ | \$ | \$ | \$ | \$ | \$ | \$ | \$ |
| Canada | 185,483 | 421,470 | 45,641 | 46,260 | - | - | 23,578 | 116,560 |
| U.S.A. | 3,864,473 | 1,539,153 | - | - | - | - | - | - |
| U.K. | 3,779,999 | 1,555,951 | 16,733 | 16,103 | 2,030,535 | 2,049,617 | - | - |
| Germany | 120,752 | 192,972 | - | - | - | - | - | - |
| Italy | 105,061 | 232,534 | - | - | - | - | - | - |
| Netherlands | 35,556 | 76,399 | - | - | - | - | - | - |
| Ireland | 16,059 | 28,925 | - | - | - | - | - | - |
| Rest of Europe | 8,571 | 36,636 | - | - | - | - | - | - |
| Kenya | 96,942 | 46,539 | - | - | - | - | - | - |
| India | 23,277 | 68,412 | - | - | - | - | - | - |
| China | 6,429 | 6,549 | - | - | - | - | - | - |
| Rest of world | 36,228 | 69,591 | - | - | - | - | - | - |
| Total | 8,278,830 | 4,275,131 | 62,374 | 62,363 | 2,030,535 | 2,049,617 | 23,578 | 116,560 |

5. Cash and cash equivalents:

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

| | February 29, 2016 | May 31, 2015 |
|----------------------------------|---------------------|-------------------|
| Cash | \$ 1,295,145 | \$ 714,843 |
| Cash equivalents | 500 | 500 |
| Cash and cash equivalents | \$ 1,295,645 | \$ 715,343 |

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

6. Trade and other receivables:

| | February 29, 2016 | May 31, 2015 |
|---|---------------------|---------------------|
| Trade receivables, gross | \$ 1,524,289 | \$ 1,985,463 |
| Allowance for doubtful accounts | - | - |
| Trade receivables, net | 1,524,289 | 1,985,463 |
| Contracts for heat recovery solutions (see note 6(a)) | 145,190 | 115,077 |
| Unbilled product and service revenue (see note 6(b)) | 50,934 | 18,828 |
| Prepayments | 192,459 | 69,604 |
| Sales tax and other miscellaneous receivables | 143,285 | 140,542 |
| | \$ 2,056,157 | \$ 2,329,514 |

The net carrying value of trade receivables is considered a reasonable approximation of fair value. Other miscellaneous receivables include \$108,810 (\$106,066 at May 31, 2015) due from a Chinese distributor receiving payments on the Company's behalf from a Chinese customer.

At February 29, 2016, \$4,341 (0.28%) of the Company's trade receivables balance was over 90 days past due, but not impaired (\$164,375 (8.3%) at May 31, 2015).

The change in allowance for doubtful accounts was as follows:

| | February 29, 2016 | May 31, 2015 |
|---------------------------------------|-------------------|--------------|
| Balance, beginning of year | \$ - | \$ 26,765 |
| Amounts written off (uncollectable) | - | (15,384) |
| Provisions | - | - |
| Reversal of previous year's provision | - | (4,788) |
| Foreign exchange adjustments | - | (6,593) |
| Balance, end of year | \$ - | \$ - |

All of the Company's trade and other receivables have been reviewed for indicators of impairment. No provision was made during the three and nine months ended February 29, 2016 and February 28, 2015. No trade receivables were found to be impaired.

(a) Contracts for heat recovery solutions:

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

6. Trade and other receivables (continued):

(a) Contracts for heat recovery solutions (continued):

| | February 29, 2016 | May 31, 2015 |
|--|---------------------|----------------------|
| Aggregate amount of costs incurred and recognized profits and losses for all contracts in progress | \$ 1,660,737 | \$ 6,325,813 |
| Less progress billings | (2,540,325) | (7,481,047) |
| | \$ (879,588) | \$(1,155,234) |
| Recognized as: | | |
| Due from customers for contract work, recognized in trade and other receivables | \$ 145,190 | \$ 115,077 |
| Customer deposits paid on order before commencement of project, recognized in deferred revenue (note 15) | (448,556) | (226,381) |
| Due to customers for contract work, recognized in deferred revenue (note 15) | (576,222) | (1,043,930) |
| | \$ (879,588) | \$(1,155,234) |

(b) Unbilled product and service revenue:

The amounts included within unbilled product and services revenue are calculated as the net amounts of costs incurred plus recognized profits, less recognized losses and progress billings. The carrying amounts of assets and liabilities are analyzed as follows:

| | February 29, 2016 | May 31, 2015 |
|---|-------------------|-------------------|
| Aggregate amount of costs incurred and recognized profits and losses for all contracts in progress | \$ 217,990 | \$ 31,328 |
| Less progress billings | (227,218) | (40,722) |
| | \$ (9,228) | \$ (9,394) |
| Recognized as: | | |
| Due from customer for service performed, recognized in trade and other receivables | \$ 50,934 | \$ 18,828 |
| Due to customer for products and services not delivered yet, recognized in deferred revenue (note 15) | (60,162) | (28,222) |
| | \$ (9,228) | \$ (9,394) |

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

7. Inventory:

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

For the three months ended February 29, 2016, a total of \$180,521 of inventories was expensed to cost of sales (2015 - \$170,140). For the nine months ended February 29, 2016, a total of \$495,988 of inventories was expensed to cost of sales (2015 - \$444,714). A total of \$nil of inventories (2015 - \$nil) were written off as slow-moving. No reversal of previous write-downs has been recorded during the nine months ended February 29, 2016 or February 28, 2015.

8. Finance lease receivable:

The Company's finance lease receivable includes the following:

| | February 29, 2016 | May 31, 2015 |
|---|-------------------|--------------|
| Total estimated minimum lease payments receivable | \$ 161,054 | \$ 262,108 |
| Less: unearned income | (13,404) | (34,024) |
| | 147,650 | 228,084 |
| Less: current portion | (124,072) | (111,524) |
| | \$ 23,578 | \$ 116,560 |

Finance lease receivable relates to one arrangement. The estimated minimum lease payments receivable in this lease represent the estimated monthly energy outputs of the leased asset and are based on assumptions regarding the efficiency of the asset, the operations of the plant in which it is located and penalty payments resulting from temporary plant shut-downs. On December 31, 2012, the lease with Fortress Specialty Cellulose, as signed on June 29, 2010, expired. On November 27, 2012, an agreement was signed whereby the customer agreed to purchase the recovered energy for a further two years, after which the customer had the option to renew for an additional 24 months on substantially the same terms or purchase the asset from the Company.

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

8. Finance lease receivable (continued):

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

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

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

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

| | |
|----------------------------|------------|
| Less than one year | \$ 137,054 |
| Between two and five years | 24,000 |
| | \$ 161,054 |

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

9. Property, plant and equipment:

| | Plant and Equipment | Furniture and Fixtures | Laboratory Equipment | Computers | Leasehold Improve- ments | Motor Vehicles | Total |
|--|------------------------|------------------------------|-------------------------|----------------|--------------------------------|-------------------|----------------|
| | \$ | \$ | \$ | \$ | \$ | \$ | \$ |
| Cost, May 31, 2015 | 110,449 | 103,083 | 52,857 | 338,544 | 22,877 | 24,524 | 652,334 |
| Additions | 12,914 | – | – | 2,770 | – | 8,632 | 24,316 |
| Disposals | – | – | – | – | – | (26,046) | (26,046) |
| Translation adjustments | (742) | (31) | – | (696) | – | 942 | (527) |
| Cost, February 29, 2016 | 122,621 | 103,052 | 52,857 | 340,618 | 22,877 | 8,052 | 650,077 |
| Accumulated depreciation, May 31, 2015 | 77,206 | 97,562 | 52,857 | 315,386 | 22,436 | 24,524 | 589,971 |
| Depreciation for the period | 7,807 | 1,714 | – | 12,495 | 441 | 1,620 | 24,077 |
| Disposals | – | – | – | – | – | (26,046) | (26,046) |
| Translation adjustments | (824) | (31) | – | (856) | – | 1,412 | (299) |
| Accumulated depreciation, February 29, 2016 | 84,189 | 99,245 | 52,857 | 327,025 | 22,877 | 1,510 | 587,703 |
| Net book value, May 31, 2015 | 33,243 | 5,521 | – | 23,158 | 441 | – | 62,363 |
| Net book value, February 29, 2016 | 38,432 | 3,807 | – | 13,593 | – | 6,542 | 62,374 |

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

9. Property, plant and equipment (continued):

There are no property, plant and equipment held under finance leases and no items of property, plant or equipment are subject to restrictions of title or pledged as security.

10. Intangible assets:

| | Trade Names & Trademarks \$ | Non- compete Agreement \$ | Industrial Know- how \$ | Designs & Drawings \$ | Customer Relationships \$ | Total \$ |
|--|--------------------------------------|------------------------------------|----------------------------------|--------------------------------|---------------------------------|------------------|
| Cost, May 31, 2015 | 874,506 | 114,066 | 133,079 | 146,385 | 313,683 | 1,581,719 |
| Translation adjustments | (8,141) | (1,062) | (1,239) | (1,363) | (2,921) | (14,726) |
| Cost, February 29, 2016 | 866,365 | 113,004 | 131,840 | 145,022 | 310,762 | 1,566,993 |
| Accumulated amortization, May 31, 2015 | 167,758 | 114,066 | 133,079 | 146,385 | 313,683 | 874,971 |
| Translation adjustments | (1,561) | (1,062) | (1,239) | (1,363) | (2,921) | (8,146) |
| Accumulated amortization, February 29, 2016 | 166,197 | 113,004 | 131,840 | 145,022 | 310,762 | 866,825 |
| Net Book Value, May 31, 2015 | 706,748 | – | – | – | – | 706,748 |
| Net Book Value, February 29, 2016 | 700,168 | – | – | – | – | 700,168 |

Trade Names and Trademarks are intangible assets with indefinite lives and are not subject to amortization. Trade Names and Trademarks relate specifically to the GEM™ product. They are tested for impairment at each year-end. No impairment was recognized for the nine months ended February 29, 2016 or February 28, 2015. The growth rates attributed by Management to the GEM™ product line are 49% in 2016, followed by positive 10% in each of the subsequent four years. The aggressive first year growth is the direct result of increased sales staff within the UK and North America. The royalty rate applied to the revenues for the purposes of impairment testing is 2.5%. All other assumptions relating to the calculation of the pre-tax discount rate are as detailed in Goodwill (note 11).

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

11. Goodwill:

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

| | February 29, 2016 | May 31, 2015 |
|----------------------------|-------------------|--------------|
| Balance, beginning of year | \$ 1,342,869 | \$ 1,283,676 |
| Translation adjustments | (12,502) | 59,193 |
| Balance, end of year | \$ 1,330,367 | \$ 1,342,869 |

Goodwill was tested for impairment as at each year end, resulting in no impairment charge as at May 31, 2015. For the purpose of annual impairment testing, goodwill is allocated to the following cash-generating units, which are the units expected to benefit from the synergies of the business combinations in which the goodwill arises: Thermal Energy International (UK) Limited and GEMchem Limited, a 67% owned subsidiary of Thermal Energy International (UK) Limited.

The recoverable amounts of the cash-generating units were determined based on value-in-use calculations, covering a one year budget, followed by an extrapolation over four further years of expected cash flows to be derived from the cash-generating units assuming growth rates as set out below, and applying a pre-tax discount rate of 19% (2014 – 20%) for both cash-generating units. The pre-tax discount rate used represents the weighted average cost of capital (“WACC”) of each cash-generating unit, which includes the cost of equity and the cost of debt. The cost of equity was computed as 18% (2014 – 22%) for each cash-generating unit, incorporating the following factors: market risk premium adjusted for the target levered beta, based upon comparable companies, the risk-free rate of return and a size and company specific risk premium. The cost of debt was assumed as the risk free rate plus a premium of 3%. In computing the WACC, a capital structure comprising 15% (2014 – 15%) debt and 85% (2014- 85%) equity was assumed, after considering the capital structure of comparable companies.

For purposes of the May 31, 2015 impairment testing, Thermal Energy International (UK) Limited’s growth from 2015 to 2016 was assumed to be 173%, as per the detailed budget prepared with 7% growth per annum thereafter. The seemingly aggressive growth in 2016 is the direct result of poor 2015 revenues. The revenues in 2015 are not, in management’s opinion, representative of what can be achieved. T2015 revenues were not consistent with prior years which was the result of delays relating to expected orders from current repeat customers caused by changes to their internal systems and are not expected to continue. The subsequent growth of 7% per annum over the following four years represents further increases from recent new starters, while allowing for some further improvement in the global economic climate.

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

11. Goodwill (continued):

GEMchem Limited's growth from 2015 to 2016 was assumed to be 2%, as per the detailed budget prepared with subsequent growth of 10%, 8%, 8% and 7% in 2017 through to 2020. This is based on a combination of historical results, which demonstrate steady increases year on year, plus anticipated additional sales from existing sales staff.

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

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

12. Short-term borrowings:

The Company has an authorized credit facility of up to approximately \$471,000 dependent on the level of certain UK accounts receivable balances. The available facility as at February 29, 2016 was in the amount of \$104,000 (May 31, 2015 - \$142,000), of which \$Nil was utilized as at February 29, 2016 (May 31, 2015 - \$Nil). The Company has continued access to this short-term financing facility.

13. Trade payables:

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

| | February 29, 2016 | May 31, 2015 |
|----------------|-------------------|--------------|
| Trade payables | \$ 927,312 | \$ 692,393 |

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

14. Other liabilities:

Other liabilities can be summarized as follows:

| | February 29, 2016 | May 31, 2015 |
|--------------------------------------|-------------------|-------------------|
| Accruals | \$ 598,123 | \$ 644,808 |
| Other government remittances payable | 395,940 | 228,904 |
| | \$ 994,063 | \$ 873,712 |

Included in accruals is \$Nil due to directors (\$18,000 at May 31, 2015).

15. Deferred revenue:

| | February 29, 2016 | May 31, 2015 |
|--|---------------------|---------------------|
| Customer deposits relating to heat recovery solutions (note 6(a)) | \$ 448,556 | \$ 226,381 |
| Deferred revenue relating to heat recovery solutions (note 6(a)) | 576,222 | 1,043,930 |
| Deferred revenue relating to GEM™ product and services (note 6(b)) | 60,162 | 28,222 |
| | \$ 1,084,940 | \$ 1,298,533 |

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

16. Provisions:

| | Legal provision | Warranty provision | Total provisions |
|--------------------------------------|-----------------|--------------------|------------------|
| Balance, beginning and end of period | \$ 190,000 | \$ 25,000 | \$ 215,000 |

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

16. Provisions (continued):

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

17. Capital stock:

Authorized:

Unlimited number of Class A common shares, no par value.

Unlimited number of Series 1 preferred shares, voting only in the case of dissolution of the Company, redeemable at the option of the Company, at \$0.01 per share and convertible to common shares on a 1 to 1 basis at the rate of 20% of the number originally issued per year.

Outstanding:

| | Nine months ended February 29, 2016 | | Year ended May 31, 2015 | |
|---|--|------------|----------------------------|------------|
| | # Shares | \$ | # Shares | \$ |
| Class A Common shares issued | | | | |
| Balance, beginning of period | | | | |
| Unrestricted shares | 159,014,616 | 32,308,827 | 161,026,616 | 32,717,630 |
| Shares held in escrow | 250,000 | – | 250,000 | – |
| | 159,264,616 | 32,308,827 | 161,276,616 | 32,717,630 |
| Shares held in escrow cancelled | (250,000) | – | – | – |
| Shares purchased and cancelled ⁽¹⁾ | – | – | (2,012,000) | (408,803) |
| Balance, end of period | 159,014,616 | 32,308,827 | 159,264,616 | 32,308,827 |
| Unrestricted shares | 159,014,616 | 32,308,827 | 159,014,616 | 32,308,827 |
| Shares held in escrow | – | – | 250,000 | – |
| Balance, end of period | 159,014,616 | 32,308,827 | 159,264,616 | 32,308,827 |

⁽¹⁾ For the nine months ended February 29, 2016, no shares were purchased for cancellation by the Company under the NCIB. For the year ended May 31, 2015, 2,012,000 Class A common shares were purchased for cancellation by the Company for a total purchase price of \$195,366, resulting in a reduction to capital stock of \$408,803 and an increase in contributed surplus of \$213,437.

Normal Course Issuer Bid:

On February 17, 2016, the Company announced its intent to re-launch the Normal Course Issuer Bid (“NCIB”) for a further period of twelve months. The NCIB was approved by the TSX Venture Exchange on February 12, 2016. During the 12-month period commencing February 15, 2016 and ending February 15, 2017, the Company is able to purchase on the TSX up to 12,758,701 common shares, representing approximately 8% of the then issued and outstanding common shares. The actual number of common shares purchased, if any, and the timing of such purchases will be determined by the Company by considering market conditions, share prices, its cash position, and other factors.

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

18. Capital management:

The Company's objectives when managing capital are to safeguard the Company's ability to continue as a going concern and to maintain flexible capital structure for its projects for the benefit of its stakeholders. In the management of capital, the Company includes the components of equity attributable to the owners of the parent, excluding accumulated other comprehensive income, which at February 29, 2016 totalled \$2,274,694 (May 31, 2015 - \$2,162,523). 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.

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

19. Share-based payments (continued):

Activity in stock options was as follows:

| | Three months ended February 29, 2016 | | Three months ended February 28, 2015 | |
|----------------------------------|---|---|---|---|
| | # Options | Weighted Average Exercise Price \$ | # Options | Weighted Average Exercise Price \$ |
| Outstanding, beginning of period | 23,048,220 | 0.09 | 21,242,360 | 0.09 |
| Granted | – | n/a | 250,000 | 0.08 |
| Forfeited | (1,692,000) | 0.09 | – | n/a |
| Outstanding, end of period | 21,356,220 | 0.09 | 21,492,360 | 0.09 |

| | Nine months ended February 29, 2016 | | Nine months ended February 28, 2015 | |
|----------------------------------|--|---|--|---|
| | # Options | Weighted Average Exercise Price \$ | # Options | Weighted Average Exercise Price \$ |
| Outstanding, beginning of period | 23,690,720 | 0.09 | 21,502,610 | 0.09 |
| Granted | – | n/a | 250,000 | 0.08 |
| Forfeited | (2,334,500) | 0.09 | (260,250) | 0.08 |
| Outstanding, end of period | 21,356,220 | 0.09 | 21,492,360 | 0.09 |

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

19. Share-based payments (continued):

There were no options exercised for the nine months ended February 29, 2016 or February 28, 2015.

The following share-based payment arrangements were in existence at February 29, 2016, May 31, 2015 and February 28, 2015:

At February 29, 2016:

| Number outstanding | Grant date | Expiry date | Exercise price (\$) | Fair value at grant date (\$) | Number exercisable | Weighted average exercise price for exercisable options |
|--------------------|-------------|-------------|---------------------|-------------------------------|--------------------|---|
| 2,062,500 | 10-May-2011 | 10-May-2016 | 0.10 | 0.03 | 2,062,500 | 0.10 |
| 250,000 | 12-Jul-2011 | 12-Jul-2016 | 0.10 | 0.03 | 250,000 | 0.10 |
| 3,860,000 | 01-Dec-2011 | 01-Dec-2016 | 0.10 | 0.03 | 3,860,000 | 0.10 |
| 4,340,000 | 22-Nov-2012 | 22-Nov-2017 | 0.10 | 0.03 | 4,340,000 | 0.10 |
| 3,072,000 | 18-Nov-2013 | 18-Nov-2018 | 0.05 | 0.03 | 2,048,000 | 0.05 |
| 3,297,360 | 28-May-2014 | 28-May-2019 | 0.10 | 0.06 | 1,099,120 | 0.10 |
| 250,000 | 01-Dec-2014 | 01-Dec-2019 | 0.09 | 0.05 | 83,334 | n/a |
| 4,224,360 | 29-May-2015 | 29-May-2020 | 0.08 | 0.04 | – | n/a |
| 21,356,220 | | | 0.09 | | 13,742,594 | 0.09 |

At May 31, 2015:

| Number outstanding | Grant date | Expiry date | Exercise price (\$) | Fair value at grant date (\$) | Number exercisable | Weighted average exercise price for exercisable options |
|--------------------|-------------|-------------|---------------------|-------------------------------|--------------------|---|
| 2,250,000 | 10-May-2011 | 10-May-2016 | 0.10 | 0.03 | 2,250,000 | 0.10 |
| 250,000 | 12-Jul-2011 | 12-Jul-2016 | 0.10 | 0.03 | 250,000 | 0.10 |
| 4,340,000 | 01-Dec-2011 | 01-Dec-2016 | 0.10 | 0.03 | 4,340,000 | 0.10 |
| 4,820,000 | 22-Nov-2012 | 22-Nov-2017 | 0.10 | 0.03 | 3,213,334 | 0.10 |
| 3,411,000 | 18-Nov-2013 | 18-Nov-2018 | 0.05 | 0.03 | 1,137,000 | 0.05 |
| 3,721,360 | 28-May-2014 | 28-May-2019 | 0.10 | 0.06 | 1,240,453 | 0.10 |
| 250,000 | 01-Dec-2014 | 01-Dec-2019 | 0.09 | 0.05 | – | n/a |
| 4,648,360 | 29-May-2015 | 29-May-2020 | 0.08 | 0.04 | – | n/a |
| 23,690,720 | | | 0.09 | | 12,430,787 | 0.10 |

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

19. Share-based payments (continued):

At February 28, 2015:

| Number outstanding | Grant date | Expiry date | Exercise price (\$) | Fair value at grant date (\$) | Number exercisable | Weighted average exercise price for exercisable options |
|--------------------|-------------|-------------|---------------------|-------------------------------|--------------------|---|
| 2,450,000 | 04-May-2010 | 04-May-2015 | 0.10 | 0.03 | 2,450,000 | 0.10 |
| 2,250,000 | 10-May-2011 | 10-May-2016 | 0.10 | 0.03 | 2,250,000 | 0.10 |
| 250,000 | 12-Jul-2011 | 12-Jul-2016 | 0.10 | 0.03 | 250,000 | 0.10 |
| 4,340,000 | 01-Dec-2011 | 01-Dec-2016 | 0.10 | 0.03 | 4,340,000 | 0.10 |
| 4,820,000 | 22-Nov-2012 | 22-Nov-2017 | 0.10 | 0.03 | 3,213,334 | 0.10 |
| 3,411,000 | 18-Nov-2013 | 18-Nov-2018 | 0.05 | 0.03 | 1,137,000 | 0.05 |
| 3,721,360 | 28-May-2014 | 28-May-2019 | 0.10 | 0.06 | – | n/a |
| 250,000 | 01-Dec-2014 | 01-Dec-2019 | 0.08 | 0.05 | – | n/a |
| 21,492,360 | | | 0.09 | | 13,640,334 | 0.10 |

The fair value of services received in return for share options granted is based on the fair value of share options granted, measured using the Black-Scholes model. As at February 29, 2016 there was \$127,102 (May 31, 2015 - \$277,437) of total unrecognized share-based compensation costs related to unvested stock option awards granted under the Plan which are expected to be recognized over a weighted-average year of three years.

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

| | Grant Date | | | |
|--|------------|-----------|-----------|-----------|
| | 18-Nov-13 | 28-May-14 | 01-Dec-14 | 29-May-15 |
| Grant date share price (\$) ⁽¹⁾ | 0.05 | 0.10 | 0.08 | 0.06 |
| Exercise price (\$) | 0.05 | 0.10 | 0.09 | 0.08 |
| Expected volatility (%) ⁽²⁾ | 91.70 | 90.99 | 89.64 | 87.70 |
| Expected life (years) | 4.00 | 4.00 | 4.00 | 4.00 |
| Expected dividend yield (%) | 0.00 | 0.00 | 0.00 | 0.00 |
| Risk-free interest rate (%) | 1.74 | 1.50 | 1.38 | 0.88 |
| Forfeiture rate (%) | 0.00 | 0.00 | 0.00 | 13.00 |

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

19. Share-based payments (continued):

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

| | Three months ended February 29, 2016 | Three months ended February 28, 2015 |
|---|---|---|
| Administration | \$ 19,051 | \$ 33,962 |
| Selling, marketing and business development | 12,262 | 15,433 |
| | \$ 31,313 | \$ 49,395 |

| | Nine months ended February 29, 2016 | Nine months ended February 28, 2015 |
|---|--|--|
| Administration | \$ 90,055 | \$ 122,540 |
| Selling, marketing and business development | 38,099 | 57,363 |
| | \$ 128,154 | \$ 179,903 |

20. Pension plan:

The Company contributes to defined contribution pension plans for permanent employees of one of its subsidiaries. The Company matches employee contributions. The plans and their assets are held by independent managers. The pension charge represents contributions paid by the Company and amounted to \$19,679 in the three months ended February 29, 2016 (2015 - \$17,141) and \$58,423 in the nine months ended February 29, 2016 (2015 - \$50,160)

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

21. Earnings (loss) per share:

The calculation of basic and diluted earnings (loss) per share for the three months ended February 29, 2016 was based on the net income attributable to owners of the parent of \$421,040 (2015 - net loss of \$656,470) and a weighted average number of shares outstanding of 159,014,616 (2015 - 159,406,772). The calculation of basic and diluted earnings (loss) per share for the nine months ended February 29, 2016 was based on the net loss attributable to owners of the parent of \$15,983 (2015 - net loss of \$1,816,049) and a weighted average number of shares outstanding of 159,014,616 (2015 - 160,216,382). Diluted income or loss per share for the three and nine months ended February 29, 2016 and February 28, 2015 did not include the effect of outstanding stock options existing at these dates as they would either have the effect of decreasing the net loss per share or be anti-dilutive.

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

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

| | Nine months ended February 29, 2016 | Nine months ended February 28, 2015 |
|---|--|--|
| Issued common shares at beginning of period | 159,014,616 | 161,026,616 |
| Effect of repurchase of shares | | (810,234) |
| Weighted average number of basic common shares at end of period | 159,014,616 | 160,216,382 |
| Effect of stock options on issue | | |
| Weighted average number of diluted common shares at end of period | 159,014,616 | 162,216,382 |

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

22. Operating lease commitments:

Thermal Energy International Inc. and its UK subsidiary have entered into lease agreements for the use of land and buildings, telecommunication systems and other office equipment. These leases range from one to five years with no renewal option included in the contracts. There are no restrictions placed upon the Company by entering into these leases.

At February 29, 2016, the Company has operating lease commitments as follows:

| | Total | Less than 1 year | 1-5 years | More than 5 years |
|------------------|------------|---------------------|------------|----------------------|
| Operating leases | \$ 356,133 | \$ 135,171 | \$ 220,640 | \$ 322 |

Lease payments recognized as an expense for the three months ended February 29, 2016 totalled \$37,709 (2015 - \$36,067). For the nine months ended February 29, 2016, they were \$112,855 (2015 - \$107,300).

23. Financial instruments:

Financial risk management:

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

(a) Market risk:

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

(i) Foreign currency risk:

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

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

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

23. Financial instruments (continued):

Financial risk management (continued):

(a) Market risk (continued):

(i) Foreign currency risk (continued):

| | Net financial assets/(liabilities) in CAD\$ | | Total CAD \$ |
|---------------------------------------|---|----------------|-----------------|
| | US \$ | Euro | |
| Functional currency of Company entity | | | |
| February 29, 2016 | | | |
| Canadian Dollar | 739,130 | – | 739,130 |
| British Pound | (218,028) | 113,396 | (104,632) |
| | 521,102 | 113,396 | 634,498 |
| <u>May 31, 2015</u> | | | |
| Canadian Dollar | 404,338 | – | 404,338 |
| British Pound | – | 152,879 | 152,879 |
| | 404,338 | 152,879 | 557,217 |
| <u>February 28, 2015</u> | | | |
| Canadian Dollar | 523,960 | – | 523,960 |
| British Pound | – | 133,383 | 133,383 |
| | 523,960 | 133,383 | 657,343 |

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

23. Financial instruments (continued):

Financial risk management (continued):

(a) Market risk (continued):

(i) Foreign currency risk (continued):

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

| | Nine months ended February 29, 2016 | | | Nine months ended February 28, 2015 | | |
|-------------------|-------------------------------------|--------|--------|-------------------------------------|--------|--------|
| | US\$ | Euros | Total | US\$ | Euros | Total |
| Net income (loss) | 52,110 | 11,340 | 63,450 | 52,356 | 13,338 | 65,734 |

| | As at February 29, 2016 | | | As at May 31, 2015 | | |
|--------|-------------------------|--------|--------|--------------------|--------|--------|
| | US\$ | Euros | Total | US\$ | Euros | Total |
| Equity | 52,110 | 11,340 | 63,450 | 40,434 | 15,288 | 55,722 |

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

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

(ii) Interest rate risk:

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

The Company currently does not use interest rate hedges or fixed interest rate contracts to manage the Company's exposure to interest rate fluctuations. There were no significant investments or borrowings to expose the Company to interest rate sensitivity either at February 29, 2016 or February 28, 2015.

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

23. Financial instruments (continued):

Financial risk management (continued):

(b) Credit risk:

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

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

Accounts receivable

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

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

The amounts reported for trade receivables in the statement of financial position are net of allowances for doubtful accounts. The Company's maximum exposure to credit risk at the reporting date is the carrying value of its cash and cash equivalents (see note 5), trade receivables, other miscellaneous receivables (see note 6) and finance lease receivable. In determining the fair value of the finance lease, the Company uses the discounted cash future cash flows of the asset, being the minimum lease payments, discounted using a rate of 14.3% - rate implicit in the lease. The fair value of the finance lease receivable at February 29, 2016 was \$161,054.

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

23. Financial instruments (continued):

Financial risk management (continued):

(b) Credit risk (continued):

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

(c) Liquidity risk:

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

As at February 29, 2016, the Company's financial liabilities, which consist of trade payables and accruals, have a carrying value of \$1,525,435 (\$1,337,201 at May 31, 2015) and are all due within one year.

24. Related party transactions:

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

Transactions with key management personnel

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

| | Three months ended February 29, 2016 | Three months ended February 28, 2015 |
|---|---|---|
| Salaries and other short-term employee benefits | \$ 264,151 | \$ 263,769 |
| Share-based payments | 13,531 | 23,738 |
| | \$ 277,682 | \$ 287,507 |

THERMAL ENERGY INTERNATIONAL INC.

Notes to the Unaudited Condensed Consolidated Interim Financial Statements (continued)

February 29, 2016 and February 28, 2015
(Expressed in Canadian dollars)

24. Related party transactions (continued):

| | Nine months ended February 29, 2016 | Nine months ended February 28, 2015 |
|---|--|--|
| Salaries and other short-term employee benefits | \$ 798,761 | \$ 826,142 |
| Share-based payments | 59,741 | 85,510 |
| | \$ 858,502 | \$ 911,652 |

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