

# Condensed Interim Consolidated Financial Statements

**June 30, 2011 and 2010**  
(expressed in Canadian Dollars)



Smartcool Systems Inc.  
1280 – 333 Seymour Street  
Vancouver, BC  
V6B 5A6 Canada

|           |                            |
|-----------|----------------------------|
| TEL       | +1 604 669 1388            |
| TOLL-FREE | +1 888 669 1388            |
| FAX       | +1 604 602 0674            |
| EMAIL     | officeCanada@smartcool.net |

**Notice of No Auditor Review of Interim Financial Statements**

Under National Instrument 51-102, Part 4, subsection 4.3(3)(a), if an auditor has not performed a review of the interim financial statements, they must be accompanied by a notice indicating that the financial statements have not been reviewed by an auditor.

The accompanying unaudited interim financial statements of the Company have been prepared by and are the responsibility of the Company's management.

The Company's independent auditor has not performed a review of these financial statements in accordance with standards established by the Canadian Institute of Chartered Accountants for a review of interim financial statements by an entity's auditor.

# Smartcool Systems Inc.

## Condensed consolidated statements of financial position

(Expressed in Canadian dollars, unless otherwise stated)

(Unaudited)

|  | June 30<br>2011     | December 31<br>2010 | January 1<br>2010   |
|--|---------------------|---------------------|---------------------|
|  | \$                  | \$                  | \$                  |
| <b>ASSETS</b>  |                     |                     |                     |
| <b>Current assets</b>  |                     | (note 21)           | (note 21)           |
| Cash and cash equivalents  | 873,797             | 610,261             | 147,051             |
| Short-term investments   | -                   | -                   | 101,646             |
| Trade and other receivables  | 1,294,993           | 1,019,861           | 657,840             |
| Inventory (note 6)   | 604,537             | 509,585             | 717,844             |
| Prepaid expenses and deposits  | 182,479             | 75,487              | 242,302             |
|  | <u>2,955,806</u>    | <u>2,215,194</u>    | <u>1,866,683</u>    |
| <b>Capitalized development costs</b>                                 | -                   | -                   | 39,961              |
| <b>Property and equipment</b> (note 7)                               | 195,506             | 111,629             | 203,617             |
|  | -                   | -                   |                     |
| <b>Intangible assets</b> (note 8)                                    | <u>6,396,052</u>    | <u>3,016,449</u>    | <u>3,507,008</u>    |
|  | <u>9,547,364</u>    | <u>5,343,272</u>    | <u>5,617,269</u>    |
| <b>LIABILITIES</b>   |                     |                     |                     |
| <b>Current liabilities</b>   |                     |                     |                     |
| Trade payables and accruals  | 980,378             | 657,969             | 552,034             |
| Current portion of obligations under acquisition contracts (note 10) | 2,057,543           | 371,937             | 263,190             |
| Current portion of finance leases (note 11)                          | 35,055              | -                   | 9,144               |
| Current portion of debentures (note 12)                              | 534,302             | 386,290             | -                   |
| Current portion of deferred tenant inducement                        | 8,083               | 12,379              | 10,820              |
|  | <u>3,615,361</u>    | <u>1,428,575</u>    | <u>835,188</u>      |
| <b>Obligations under acquisition contracts</b> (note 10)             | 108,838             | 250,734             | 582,602             |
| <b>Finance leases</b> (note 11)                                      | 31,142              | -                   | -                   |
| <b>Debentures</b> (note 12)  | -                   | 228,978             | -                   |
| <b>Deferred tenant inducement</b>                                    | <u>50,118</u>       | <u>51,455</u>       | <u>63,834</u>       |
|  | <u>3,805,459</u>    | <u>1,959,742</u>    | <u>1,481,624</u>    |
| <b>SHAREHOLDERS' EQUITY</b>  |                     |                     |                     |
| Share capital (note 13(b))   | 29,321,339          | 26,036,145          | 25,639,345          |
| Reserve for equity settled share based transactions (note 13(d))     | 5,466,054           | 4,477,547           | 4,036,345           |
| Foreign currency translation adjustment                              | (53,559)            | 29,654              | -                   |
| Deficit  | <u>(28,991,929)</u> | <u>(27,159,816)</u> | <u>(25,540,045)</u> |
|  | <u>5,741,905</u>    | <u>3,383,530</u>    | <u>4,135,645</u>    |
|  | <u>9,547,364</u>    | <u>5,343,272</u>    | <u>5,617,269</u>    |

### Nature of operations and liquidity risk (note 1) Commitments (note 15)

Approved and authorized for issue by the Board of Directors on June 29, 2011

"George Burnes"  
George Burnes

"Jeffrey Lowe"  
Jeffrey Lowe

# Smartcool Systems Inc.

## Condensed consolidated statements of operations

(Expressed in Canadian dollars, unless otherwise stated)

(Unaudited)

|  | Three months ended June 30 |                   | Six months ended June 30 |                         |
|--|----------------------------|-------------------|--------------------------|-------------------------|
|  | 2011<br>\$                 | 2010<br>\$        | 2011<br>\$               | 2010<br>\$<br>(note 21) |
| <b>Revenue</b>   | 276,398                    | 1,137,863         | 1,220,356                | 1,772,790               |
| <b>Cost of sales</b>   | 120,167                    | 303,779           | 377,444                  | 599,346                 |
| <b>Gross profit</b>  | 156,231                    | 834,084           | 842,912                  | 1,173,444               |
| <b>Operating Expenses</b>  |                            |                   |                          |                         |
| General and administrative expenses                                      | 1,017,941                  | 802,461           | 1,911,190                | 1,512,766               |
| Stock-based compensation   | 106,395                    | 71,146            | 164,007                  | 215,339                 |
| Research and development   | 3,428                      | 14,666            | 5,360                    | 29,029                  |
| Amortization   | 192,608                    | 141,864           | 338,406                  | 290,031                 |
|  | 1,320,372                  | 1,030,137         | 2,418,963                | 2,047,165               |
| <b>Operating loss</b>  | (1,164,141)                | (196,053)         | (1,576,051)              | (873,721)               |
| <b>Other items</b>   |                            |                   |                          |                         |
| Finance cost   | 88,824                     | 64,468            | 160,559                  | 99,139                  |
| Finance income   | (550)                      | (647)             | (772)                    | (4,280)                 |
| Foreign exchange loss  | 876                        | (13,801)          | 27,470                   | 29,251                  |
| Acquisition transaction costs  | -                          | -                 | 68,805                   | -                       |
|  | 89,150                     | 50,020            | 256,062                  | 124,110                 |
| Income taxes   | -                          | -                 | -                        | -                       |
| <b>Net loss for the period</b>   | <b>(1,253,291)</b>         | <b>(246,073)</b>  | <b>(1,832,113)</b>       | <b>(997,831)</b>        |
| Net loss per share   |                            |                   |                          |                         |
| Basic  | (0.02)                     | (0.01)            | (0.03)                   | (0.02)                  |
| Diluted  | (0.02)                     | (0.01)            | (0.03)                   | (0.02)                  |
| Weighted average number of common shares outstanding (basic and diluted) | <b>60,545,341</b>          | <b>45,145,572</b> | <b>56,520,543</b>        | <b>44,321,396</b>       |

## Smartcool Systems Inc.

### Condensed consolidated statements of comprehensive loss

(Expressed in Canadian dollars, unless otherwise stated)

(Unaudited)

---

|   | Three months ended June 30 |                  | Six months ended June 30 |                  |
|---|----------------------------|------------------|--------------------------|------------------|
|   | 2011                       | 2010             | 2011                     | 2010             |
|   | \$                         | \$               | \$                       | \$               |
|   |                            | (note 21)        |                          | (note 21)        |
| <b>Net loss for the period</b>          | <b>(1,253,291)</b>         | <b>(246,073)</b> | <b>(1,832,113)</b>       | <b>(997,831)</b> |
| Foreign currency translation adjustment | (10,992)                   | (62,993)         | (53,559)                 | 44,303           |
| Total comprehensive loss                | <b>(1,264,283)</b>         | <b>(309,066)</b> | <b>(1,885,672)</b>       | <b>(953,528)</b> |

---

# Smartcool Systems Inc.

## Condensed consolidated statement of cash flows

(Expressed in Canadian dollars, unless otherwise specified)  
(Unaudited)

|  | Three months ended June 30 |                  | Six months ended June 30 |                  |
|--|----------------------------|------------------|--------------------------|------------------|
|  | 2011                       | 2010             | 2011                     | 2010             |
|  | \$                         | \$               | \$                       | \$               |
|  |                            | (note 21)        |                          | (note 21)        |
| <b>Cash flows from operating activities</b>                    |                            |                  |                          |                  |
| Loss for the period  | (1,253,291)                | (246,074)        | (1,832,113)              | (997,831)        |
| Items not affecting cash:                                      |                            |                  |                          |                  |
| Amortization of property and equipment                         | 24,121                     | 27,372           | 41,993                   | 62,113           |
| Amortization of intangible assets                              | 168,487                    | 114,493          | 296,413                  | 227,918          |
| Amortization of capitalized development costs                  | -                          | 13,320           | -                        | 26,640           |
| Stock-based compensation                                       | 106,395                    | 71,146           | 164,007                  | 215,339          |
| Deferred tenant inducement                                     | (2,928)                    | (2,705)          | (5,633)                  | (5,410)          |
| Unrealized foreign exchange loss                               | 15,870                     | 1,558            | 29,276                   | 84,898           |
| Accrued interest on debentures                                 | 14,341                     | 28,706           | 34,303                   | 39,039           |
| Accrued interest of obligation under acquisition contract      | 5,024                      | 2,580            | 9,062                    | 7,256            |
| Accretion of obligation under acquisition contract             | 49,869                     | 16,744           | 78,564                   | 33,034           |
| Foreign exchange loss on obligation under acquisition contract | (13,902)                   | 19,207           | (31,959)                 | (48,473)         |
|  | <u>(886,014)</u>           | <u>46,347</u>    | <u>(1,216,087)</u>       | <u>(355,477)</u> |
| Changes in non-cash working capital items:                     |                            |                  |                          |                  |
| Trade and other receivables                                    | 404,233                    | (688,485)        | (272,716)                | (576,481)        |
| Inventory  | 74,860                     | 64,102           | (94,800)                 | 47,010           |
| Prepaid expenses and deposits                                  | (93,105)                   | 48,052           | (107,185)                | 171,346          |
| Trade payables and accruals                                    | (181,792)                  | (32,403)         | 308,716                  | 59,510           |
| Net cash flows used in operating activities                    | <u>(681,818)</u>           | <u>(562,387)</u> | <u>(1,382,072)</u>       | <u>(654,092)</u> |
| <b>Cash flows from investing activities</b>                    |                            |                  |                          |                  |
| Proceeds from sale of short-term investments                   | -                          | 55,007           | -                        | 101,646          |
| Purchase of property and equipment                             | (9,099)                    | -                | (126,108)                | -                |
| Business acquisitions, net of cash acquired                    | -                          | -                | (2,052,208)              | -                |
| Net cash (used in) provided by investing activities            | <u>(9,099)</u>             | <u>55,007</u>    | <u>(2,178,316)</u>       | <u>101,646</u>   |
| <b>Cash flows from financing activities</b>                    |                            |                  |                          |                  |
| Shares and warrants issued for cash, net of issue costs        | 99,560                     | 460,941          | 3,882,018                | 460,941          |
| Debenture issued for cash                                      | -                          | 247,500          | -                        | 552,750          |
| Decrease in debentures   | (37,273)                   | -                | (115,272)                | -                |
| Decrease in acquisition contract obligation                    | -                          | -                | -                        | (79,383)         |
| Increase in finance leases                                     | -                          | -                | 67,610                   | -                |
| Decrease of finance lease obligation                           | (8,883)                    | (4,317)          | -                        | (9,144)          |
| Net cash provided by financing activities                      | <u>53,404</u>              | <u>704,124</u>   | <u>3,834,356</u>         | <u>925,164</u>   |
| Net increase in cash and cash equivalents                      | (637,513)                  | 196,744          | 273,968                  | 372,718          |
| Effects of exchange rates changes on cash                      | (4,038)                    | (5,266)          | (10,432)                 | (5,050)          |
| Cash and cash equivalents, beginning of period                 | 1,515,348                  | 323,241          | 610,261                  | 147,051          |
| <b>Cash and cash equivalents, end of period</b>                | <u>873,797</u>             | <u>514,719</u>   | <u>873,797</u>           | <u>514,719</u>   |
| Cash and cash equivalents consist of:                          |                            |                  |                          |                  |
| Deposits with banks  | 873,797                    | 514,719          | 873,797                  | 514,719          |
| Guaranteed investment certificates                             | -                          | -                | -                        | -                |
|  | <u>873,797</u>             | <u>514,719</u>   | <u>873,797</u>           | <u>514,719</u>   |

### Supplementary cash flow information (note 20)

See accompanying notes to the consolidated financial statements

## Smartcool Systems Inc.

### Condensed consolidated statement of shareholders' equity

(Expressed in Canadian dollars, unless otherwise stated)

(Unaudited)

|  | Share<br>capital<br>\$ | Reserve for<br>equity settled<br>share based<br>transactions | Foreign<br>currency<br>translation<br>adjustment<br>\$ | Deficit<br>\$       | Total<br>Shareholders'<br>Equity<br>\$ |
|--|------------------------|--|--|---------------------|--|
| <b>Balance at January 1, 2010 (Note •)</b> | 25,639,345             | 4,036,345  |  | (25,540,045)        | 4,135,645                              |
| Comprehensive loss for the period          |                        |  | 44,303   | (997,831)           | (953,528)                              |
| Share issued for:                          |                        |  |  |                     | -                                      |
| Private placement                          | 464,675                |  |  |                     | 464,675                                |
| Finder's fee                               | (37,500)               |  |  |                     | (37,500)                               |
| Unexercised warrants                       |                        | 122,878  |  |                     | 122,878                                |
| Share issue costs                          | (3,068)                | (3,053)  |  |                     | (6,121)                                |
| Stock based compensation                   |                        | 215,339  |  |                     | 215,339                                |
| <b>Balance at June 30, 2010</b>            | <b>26,063,452</b>      | <b>4,371,509</b>   | <b>44,303</b>  | <b>(26,537,876)</b> | <b>3,941,388</b>                       |
| Comprehensive loss for the period          |                        |  | (14,649)   | (621,940)           | (636,589)                              |
| Adjustments:                               |                        |  |  |                     | -                                      |
| Shares                                     | (24,389)               |  |  |                     | (24,389)                               |
| Unexercised warrants                       |                        | (46,925)   |  |                     | (46,925)                               |
| Share issue costs                          | (2,918)                | (658)  |  |                     | (3,576)                                |
| Stock based compensation                   |                        | 153,621  |  |                     | 153,621                                |
| <b>Balance at December 31, 2010</b>        | <b>26,036,145</b>      | <b>4,477,547</b>   | <b>29,654</b>  | <b>(27,159,816)</b> | <b>3,383,530</b>                       |
| Net loss                                   |                        |  |  | (1,832,113)         | (1,832,113)                            |
| Foreign currency translation adjustment    |                        |  | (83,213)   |                     | (83,213)                               |
| Total comprehensive loss for the period    |                        |  | (53,559)   | (28,991,929)        | (1,915,326)                            |
| Share issued for:                          |                        |  |  |                     | -                                      |
| Private placement                          | 3,292,666              |  |  |                     | 3,292,666                              |
| Exercised options                          | 210,298                |  |  |                     | 210,298                                |
| Finder's fees                              | (154,761)              | (33,238)   |  |                     | (187,999)                              |
| Unexercised warrants                       |                        | 871,270  |  |                     | 871,270                                |
| Share issue costs                          | (63,009)               | (13,532)   |  |                     | (76,541)                               |
| Stock based compensation                   |                        | 164,007  |  |                     | 164,007                                |
| <b>Balance at June 30, 2011</b>            | <b>29,321,339</b>      | <b>5,466,054</b>   | <b>(53,559)</b>  | <b>(28,991,929)</b> | <b>5,741,905</b>                       |

# Notes to Condensed Consolidated Financial Statements

## For the six months ended June 30, 2011

(Expressed in Canadian dollars, unless otherwise specified)

(Unaudited)

### 1. Nature of operations and liquidity risk

Smartcool Systems Inc. ("Smartcool" or the "Company"), which was incorporated on August 31, 2000 under the Canada Business Corporations Act as 378211 Canada Inc., changed its name to Citotech Systems Inc. on October 16, 2000, and changed its name again to Smartcool Systems Inc. on July 20, 2004.

In 2004, the Company incorporated a wholly owned subsidiary, Smartcool Systems (USA) Inc. ("Smartcool USA"), under the laws of Nevada. Smartcool International Inc. ("Smartcool International"), another wholly owned subsidiary, was incorporated in Barbados in June 2006. In April 2008, the Company completed the incorporation of its subsidiary, Smartcool Systems (EMEA) Ltd. ("Smartcool EMEA"), headquartered in Alton, England. In February 2011, Smartcool EMEA acquired all the outstanding shares of Smartcool Systems UK ("Smartcool UK"), also headquartered in Alton, England.

The Company's shares are listed on the TSX Venture Exchange and the head office, principal address, and registered office is located at 1280-333 Seymour Street, Vancouver, BC, V6B 5A6.

Smartcool and its subsidiaries are focused on acquiring, commercializing, and marketing energy saving technologies for commercial and retail businesses. Currently the Company has two principal revenue streams: the sale and installation of Energy Savings Modules (ESM™ & ECO3™) to end customers and the sale of the ESM™ & ECO3™ to distributors worldwide.

The ESM™ is manufactured by a third party in Australia and is designed specifically to reduce the electricity consumption and maximum demand of refrigeration and air conditioning compressors by improving their performance and maintaining temperature control. The ESM™ uses microprocessor technology and software algorithms.

Introduced in early 2009, the ECO3™ is manufactured in China and is a simple retro-fit product that can be installed on any air conditioning or refrigeration unit with one or two compressors.



Smartcool Systems Inc.  
1280 – 333 Seymour Street  
Vancouver, BC  
V6B 5A6 Canada

|           |                            |
|-----------|----------------------------|
| TEL       | +1 604 669 1388            |
| TOLL-FREE | +1 888 669 1388            |
| FAX       | +1 604 602 0674            |
| EMAIL     | officeCanada@smartcool.net |



These condensed consolidated financial statements are prepared on a going concern basis, except for certain financial assets and liabilities which are measured at fair value through profit or loss.

During the six months ended June 30, 2011, the Company incurred a loss of \$1,832,113 (June 30, 2010 - \$997,831) and the Company had deficit of \$28,991,929 as at June 30, 2011 (December 31, 2010 - \$27,159,816).

To date the Company has been able to raise capital to finance its operations whenever necessary. The Company's ultimate success and the recoverability of its assets will depend on the Company's ability to successfully execute its business plan which includes the existence of a market for its products, achieving profitable operations, meeting its business acquisition obligations, and the continued support of the Company's shareholders and employees.

On February 22, 2011, the Company completed a private placement raising gross proceeds of \$4,000,000 from the issuance of 13,333,330 units comprising of one common share and one half of one common share purchase warrant.

## 2. Significant Accounting Policies

### Basis of Presentation and Statement of Compliance

The Company has adopted International Financial Reporting Standards ("IFRS") at January 1, 2011, with a transition date of January 1, 2010. IFRS require entities that adopt IFRS to make an explicit and unreserved statement in their first annual IFRS financial statements of compliance with IFRS. The Company will make this statement when it issues its annual financial statements for the year ended December 31, 2011.

These condensed consolidated financial statements represent the first interim financial statements of the Company and its subsidiaries prepared in accordance with International Accounting Standards ("IAS") 34, *Interim Financial Reporting*, as issued by the International Accounting Standards Board ("IASB") and IFRS 1, *First-time Adoption of International Financial Reporting Standards* ("IFRS 1"). In accordance with IFRS 1, the Company has:

- Provided comparative financial information
- Applied the same accounting policies throughout all periods presented;
- Retrospectively applied all effective IFRS standards as of January 1, 2010, as required; and
- Applied certain optional exemptions and certain mandatory exceptions as applicable for first-time IFRS adopters (Note 21).

The Company's consolidated financial statements were previously prepared in accordance with Canadian Generally Accepted Accounting Principles ("Canadian GAAP"). Canadian GAAP differs in some areas from IFRS. In preparing these financial

statements, management has amended certain accounting, measurement, and consolidation methods previously applied under Canadian GAAP financial statements to comply with IFRS.

### **Use of estimates and judgments**

The preparation of financial statements in accordance with IFRS requires the use of certain critical accounting estimates and assumptions. It also requires management to exercise judgment in applying the Company's accounting policies. The areas involving a higher degree of judgment or complexity, or areas where assumptions and estimates are significant to the financial statements are outlined below. Actual results may differ from those estimates.

Significant estimates are used for, but not limited to, assessment of impairment of intangible assets and recoverability of long-lived assets, determination of present value of obligations under acquisition contract, determination of fair value of debentures, allocation of purchase price of business acquisitions, valuation of stock options and warrants, recoverability of trade and other receivables, determination of valuation allowance for income tax assets, and amortization rates and methods.

Judgments made by management in the application of IFRS that have a significant effect on the financial statements and estimates with a significant risk of material adjustment in the current and following fiscal years are discussed below:

- Useful lives – the useful lives of equipment and leasehold improvements and intangible assets and the related depreciation;
- Inventory valuation – the provision for obsolescence of inventory and net realizable value;
- Receivable valuation – the recoverability of account receivables;
- Share-based payments – the inputs used in accounting for share-based payment;
- Debentures – discount rate used in fair value calculation of the debenture
- Contingencies – any future contingencies and commitments

### **Basis of Consolidation**

The Company consolidates subsidiaries controlled by the Company. Control exists when the Company has the power, directly or indirectly, to govern the financial and operating policies of an entity so as to obtain benefits from its activities. The financial statements of subsidiaries are included in the condensed consolidated interim financial statements from the date that control commences until the date that control ceases.

The condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, Smartcool USA, Smartcool International, Smartcool EMEA and Smartcool UK from February 28, 2011, the date of acquisition. All inter-company transactions, balances, revenues and expenses, have been eliminated.

### **Business combinations**

Acquisitions of businesses are accounted for using the acquisition method. The consideration transferred in a business combination is measured at fair value, which is calculated as the sum of the acquisition-date fair values of the assets transferred by the Company, liabilities incurred by the Company to the former owners of the acquiree and the equity interests issued by the Company in exchange for control of the acquiree. Acquisition-related costs are generally recognized in profit or loss as incurred.

If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, the Company reports provisional amounts for the items for which the accounting is incomplete. Those provisional amounts are adjusted during the measurement period, or additional assets or liabilities are recognized, to reflect new information obtained about facts and circumstances that existed at the acquisition date that, if known, would have affected the amounts recognized at that date.

Where the fair value of the identifiable net assets acquired exceeds the cost of the acquisition, the surplus, which represents the discount on the acquisition, is recognized directly in the statement of operations loss in the period of acquisition.

### **Foreign currency**

#### **a. Functional and presentation currency**

These condensed consolidated financial statements are presented in Canadian dollars, which is the functional currency of Smartcool Systems Inc. and Smartcool International. The functional currency of Smartcool USA is the United States dollar. The functional currency of Smartcool EMEA and Smartcool UK is the British Pounds. These condensed consolidated financial statements have been translated to the Canadian dollar in accordance with IAS 21, *The Effects of Changes in Foreign Exchange Rates*.

Assets and liabilities in the subsidiaries functional currencies are translated to the Canadian dollar (presentation currency of the consolidated entity) using the exchange rate at period end. Revenue and expenses are translated using the exchange rates at the date of the transactions.

Subsequent to the adoption of IFRS, all resulting exchange differences are reported as a separate component of shareholders' equity titled "Foreign currency translation adjustment".

**b. Foreign Currency Transactions**

Foreign currency monetary assets and liabilities are translated into the entity's functional currency using the closing rate at the end of each reporting period. Non-monetary assets and liabilities are translated at the rates on the date the fair value was determined or at historical cost using the rate at the date of the transaction. Translation gains and losses are included in the statement of operations.

### Revenue Recognition

Revenue from the sale and installation of the ESM™ and ECO<sup>3</sup>™ is recognized when the ESM™ & ECO<sup>3</sup>™ have been installed, significant risks and rewards of ownership of the equipment have been transferred to the customer, the Company does not retain continuing managerial involvement or effective control over the equipment, the sales price can be determined and probably collectible, and the cost of the transaction can be measured reliably.

Revenue from the international distribution of the ESM™ & ECO<sup>3</sup>™ is recognized when the equipment has been shipped, title has been transferred, the sales price has been determined and the cost of the equipment can be measured reliably. Revenue is also recognized when equipment has been ordered and laid away as instructed by the customer, the sales price has been determined and a significant portion of it has been paid. Provisions are established for estimated warranty costs at the time revenue is recognized. The Company records deferred revenue when cash is received in advance of the above revenue recognition criteria being met.

### Warranty

The Company provides for future warrant costs based on management's best estimates of such costs, taking into account past experience and warranty provisions of distribution and sale agreements.

### Share-based Payments

The fair value of all stock options granted to employees is determined using the Black-Scholes option pricing model, and the resulting value is charged to operations over the vesting period.

The fair value of options granted to non-employees is determined using fair value of the goods or services received. The resulting value is charged to operations when a performance commitment is made or the options are fully vested and non-forfeitable, whichever is earliest, and the expense is recognized over the period in which the goods or services from the non-employees are received. A corresponding increase in equity reserve is recorded when stock options are expensed. When stock options are exercised, share capital is credited by the sum of the consideration paid and the related portion previously recorded in equity reserve. At the time of grant, the expense is determined based on estimated forfeiture rate. The expense will be adjusted to recognize the effect of actual forfeitures as they occur. The fair value of warrants issued to agents for their finder's fee is based on the fair value of the services provided and charged to share issuance costs.

### Inventory

Inventory is recorded at the lower of cost and net realizable value. Costs of inventories are determined using the weighted average cost method. Cost of inventory includes invoiced cost from the manufacturer and other costs in bring the inventory to their present location and condition and net realizable value represents the estimated selling price for inventories less all estimated costs of completion and costs necessary to make the sale.

### Property and equipment

Property and equipment are stated at cost less accumulated amortization and accumulated impairment losses. Amortization is computed using the straight line method over the assets' estimated useful lives, less their estimated residual value, at the following rates:

|                                     |  |
|-------------------------------------|--|
| Computer hardware                   | 33%  |
| Computer software                   | 20%  |
| Testing and demonstration equipment | 40%  |
| Office equipment and furniture      | 20%  |
| Motor vehicles                      | 25%  |
| Leasehold improvements              | Shorter of Term of the lease and useful life |

Residual value and estimated useful lives are reviewed at least annually.

### Intangible assets

#### a. Research and development

Research costs are expensed as incurred. Development costs are expensed as incurred unless they can be measured reliable, the product or process is technically and commercially feasible, future economic benefits are probable, and the Company intends to and has sufficient resources to complete development and to use the asset. The Company has determined that as at September 30, 2008, development costs of \$106,561 have met these criteria. The costs were fully amortized on September 30, 2010.

**b. Other intangible assets**

Intangible assets are recorded at cost and include the ESM™ brand, ESM™ intellectual property, distribution agreements and supplier agreements. The ESM™ brand has been determined to have an indefinite life and is not amortized. The remaining intangible assets with finite lives are amortized on a straight-line basis over their estimated useful lives as follows:

|                                    |               |
|------------------------------------|---------------|
| ESM™ Intellectual property         | 10 years      |
| North American distribution rights | 10 years      |
| United Kingdom distribution rights | 9 years       |
| Distribution agreements            | 10 - 15 years |
| Supplier agreements                | 10 years      |

Total amortization for the three months ended March 31, 2011 of \$132,293 is included under Net loss for the period on the statement of operations.

**Impairment**

**a. Property and Equipment and intangible assets with a finite useful life**

Property and equipment and intangible assets with a finite life are assessed for indications of impairment at the end of each reporting period. If such indications exist, then the recoverable amount of the asset or cash-generating unit (“CGU”) is estimated.

An impairment loss is recognized when the carrying amount of the asset or CGU exceeds its recoverable amount. A CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of cash inflows from other assets or groups of assets. The recoverable amount of an asset or CGU is the greater of its value in use and its fair value less costs to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and risks specific to the asset or CGU.

Impairment losses are recognized in respects to CGU’s are first allocated to reduce the carrying amount of any goodwill allocated to the CGUs, and then to reduce the carrying amount of the other assets in the unit on a pro-rata basis. Impairment losses are recognized in profit and loss for the period it is identified.

**b. Intangible assets with an indefinite useful life**

Intangible assets with an indefinite life are reviewed for impairment annually, or more frequently, if events or changes in circumstances indicate that the asset might be impaired. The asset is written down when the carrying amount exceeds its recoverable amount.

**c. Financial Assets**

Financial assets, other than those at fair value through profit and loss (“FVTPL”), are assessed for indicators of impairment at each period end. Financial assets are impaired when there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial asset, the estimated future cash flows of the investment have been impacted.

Impairment of financial assets carried at amortized cost, is the difference between the asset’s carrying amount and the present value of the estimated future cash flows, discounted at the financial asset’s original effective interest rate.

The carrying amount of all financial assets, excluding trade and other receivables, is directly reduced by the impairment loss. Uncollectible amounts in trade and other receivables are written off against the allowance account.

Available-for-sale financial assets are impaired if the cost (net of any principal payment and amortizations) is greater than the current fair value, less any impairment previously recognized in profit and loss. The impairment amount is transferred from equity to the statement of operations. Reversals of available-for-sale financial assets are not recognized in profit.

For all other financial assets carried at amortized cost in which impairment was previously recognized, if subsequent measurement indicates that the recorded impairment has decreased, and the decrease can be related objectively to an event occurring after the impairment was recognized, then the reversal of the impairment is recognized in the statement of operations. On the date of the impairment reversal, the carrying value of the financial asset cannot exceed its amortized cost had impairment not been recognized.

**Reversal of Impairment**

An impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only to the extent that the asset’s carrying amount does not exceed the carrying amount that would have been determined, net of depreciation or amortization, if no impairment loss has been recognized. An impairment loss with respect to goodwill is never reversed.

**Financial Instruments****a. Financial Assets**

The Company classifies its financial assets in the following categories: fair value through profit or loss (FVTPL), held to maturity investments, available-for-sale financial assets, and loans and receivables. The classification depends on the nature and purpose for which the financial assets were acquired. Management determines the classification of financial assets at initial recognition.

**i. Financial assets at fair value through profit or loss (“FVTPL”)**

Financial assets are classified as FVTPL when the financial asset is held for trading or is designated as FVTPL on initial recognition.

A financial asset is classified as held for trading when it is purchased and incurred with the intention of generating profits in the near term, part of an identified portfolio of financial instruments that the Company manages and has actual pattern of short-term profit-taking; or is a derivative that is not designated and effective as a hedging instrument.

Financial assets classified as FVTPL are stated at fair value with any resulting gain or loss recognized in profit or loss. Transaction costs are expensed in the period in which the costs are incurred.

The Company’s only financial asset classified as fair value through profit or loss is cash and cash equivalents and restricted cash.

Cash and cash equivalents consist of cash on deposit and highly liquid investments that are readily convertible into cash with maturities of three months or less when purchased.

**ii. Held to Maturity Investments**

Held to maturity investments are measured at amortized cost using the effective interest rate method. Transaction costs are added and amortized to the statement of operations over the life of the financial instrument on an effective yield basis.

The Company classified short-term investments of interest bearing term deposits with maturity dates of more than three months as held to maturity investment. Interest on these term deposits is recognized in the condensed consolidated statement of operations using the effective interest method.

The Company does not hold any held-to-maturity investments as at June 30, 2011 (December 31, 2010 - \$0, January 1, 2010 - \$101,646).

**iii. Available-for-sale Financial Assets**

Financial assets classified as available-for-sale are carried at fair value (where determinable based on market prices of actively traded securities) with changes in fair value recorded in other comprehensive income. Available-for-sale securities are written down to fair value through earnings whenever it is necessary to reflect other-than temporary impairment.



The Company does not hold any available-for-sale financial assets as of June 30, 2011 or December 31, 2010.

**iv. Loans and Receivable**

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Loans and receivables are measured at amortized cost using the effective interest method, less any impairment.

The Company classifies trade and other receivables as loans and receivables.

**v. Derecognition of financial assets**

A financial asset is derecognized when the contractual right to the asset's cash flows expires or if the Company transfers the financial asset and substantially all risks and rewards of ownership to another entity.

**b. Financial Liabilities**

Financial liabilities are classified as either financial liabilities at FVTPL or other financial liabilities.

**i. Other Financial Liabilities**

Other financial liabilities are initially measured at fair value, net of transaction costs, and subsequently measured at amortized cost, with any resulting premium or discount from the face value being amortized to income or expense using the effective interest method.

The Company classifies trade payables and accruals, obligations under acquisition contracts, finance leases, and debentures as other financial liabilities.

**ii. Derecognition of Financial Liabilities**

The Company derecognizes financial liabilities when, and only when, the Company's obligations are discharged, cancelled, or expired.

**Share purchase warrants**

The Company issued common shares and share purchase warrants as a unit. The unit price is allocated to common shares and warrants based on their relative fair values. The fair value of common shares is the market price on the date of issue and the fair value of warrants is determined using the Black-Scholes option pricing model. Because the Black-Scholes option pricing model requires the input of highly subjective assumptions, including the volatility of share price, changes in subjective input assumptions can materially affect the fair value estimate.

The Company also issued warrants to agents as compensation for services. Warrants were also issued as non-cash consideration for business acquisitions.

### **Loss per share**

Basic loss per share is computed using the weighted average number of common shares outstanding during the year. Diluted loss per share amounts are calculated giving effect to the potential dilution that would occur if securities or other contracts to issue common shares were exercised or converted to common shares using the treasury stock method. The treasury stock method assumes that proceeds received from the exercise of stock options and warrants are used to repurchase common shares at the prevailing market rate. The outstanding warrants and options to purchase common shares were excluded from the calculation of diluted loss per share, because their impact would have been anti-dilutive.

### **Income taxes**

Income tax expense in the statement of operations for the periods presented comprises current and deferred tax. Income tax is recognized in profit or loss except to the extent that it relates to items recognized directly in equity, in which case it is recognized in equity.

Current tax expense is the expected tax payable on the taxable income for the year, using tax rates substantively enacted at period end, adjusted for amendments to tax payable with regards to previous years.

Deferred tax is calculated using the liability method, providing for temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The following temporary differences are not provided for: the initial recognition of assets or liabilities that affect neither accounting nor taxable profit; the initial recognition of goodwill or a transaction, other than a business combination, that affects neither accounting profit nor taxable profit; and differences relating to investments in subsidiaries to the extent that they will probably not reverse in the foreseeable future. The amount of deferred tax provided is based on the expected manner of realization or settlement of the carrying amount of assets and liabilities, using tax rates enacted or substantively enacted at the reporting date.

A deferred tax asset is recognized only to the extent that it is probable that future taxable profits will be available against which the asset can be utilized. To the extent that the Company does not consider it probable that a future tax asset will be recovered, it provides a valuation allowance against that excess.

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.

As at June 30, 2011, tax assets from net operating losses carried forward and temporary differences amounted to \$4,125,000. Valuation allowance of the same amount has been recognized.

### **Accounting standards issued but not yet effective**

Standards issued but not yet effective up to the date of issuance of the Company's condensed consolidated financial statements are listed below.

**Financial Instruments – Disclosures:** The International Accounting Standard Board (the "IASB") has issued an amendment to IFRS 7, "Financial Instruments : Disclosures" (the "IFRS 7 amendment") requiring incremental disclosures regarding transfers of financial assets. The IFRS 7 amendment is effective for annual periods beginning on or after July 1, 2011. The Company will apply the amendment at the beginning of the 2012 financial year and does not expect the implementation to have a significant impact on disclosures.

**Deferred Taxes – Recovery of Underlying Assets:** The IASB has issued an amendment to IAS 12, "Income Taxes" (the "IAS 12 amendment") that introduces an exception to the general measurement requirements of IAS 12 in respect of investment properties measured at fair value. This amendment is effective for annual periods beginning or after January 1, 2012. The Company will apply the amendment at the beginning of the 2012 financial year and does not expect the implementation to have a material impact on the Company's financial statements.

**Financial Instruments:** The IASB has issued a new standard, IFRS 9, "Financial Instruments" ("IFRS 9") which will ultimately replace IAS 39, "Financial Instruments: Recognition and Measurement ("IAS 39") . The replacement of IAS 39 is a multi-phase project with the objective of improving and simplifying the reporting of financial instruments and the issuance of IFRS 9 is part of the first phase of this project. This standard becomes effective on January 1, 2013. The Company has not assessed the impact of this new standard.

**Consolidated Financial Statements:** The IASB has issued a new standard, IFRS 10, which establishes principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. IFRS 10 supersedes IAS 27 "Consolidated and Separate Financial Statements" and SIC-12 "Consolidation—Special Purpose Entities" and is effective for annual periods beginning on or after January 1, 2013. Earlier application is permitted. The company is currently evaluating the impact of this standard on its consolidated financial statements.

**Fair value measurements:** The IASB has issued IFRS 13, which defines fair value and sets out in a single IFRS framework for measuring fair value and requires disclosures about fair value measurements. The IFRS 13 applies to IFRSs that require or permit fair value measurements or disclosures about fair value measurements (and measurements, such as fair value less costs to sell, based on fair value or disclosures about those

measurements), except in specified circumstances. IFRS 13 is to be applied for annual periods beginning on or after January 1, 2013. Earlier application is permitted. The company is currently evaluating the impact of this standard on its consolidated financial statements.

The IASB has issued an amendment to IAS 1 “Presentation of financial statements” (“IAS 1 amendment”), which requires the presentation of items of other comprehensive income (“OCI”), classified by nature, to be grouped into items that will not be reclassified subsequently to profit or loss; and items that will be reclassified subsequently to profit or loss when specific conditions are met. The IAS 1 amendment is effective for annual periods beginning on or after July 1, 2012. IAS 1 amendment is not applicable to the Company.

### 3. Business combination

On February 28, 2011, Smartcool EMEA, a subsidiary of Smartcool International, acquired all the outstanding shares of the third party distributor Smartcool Systems UK Ltd., which held the exclusive rights for sale of ESM products to customers in UK and Ireland.

The main reason for the acquisition was to access existing customer relationships. Prior to the acquisition Smartcool EMEA sold equipment to Smartcool Systems UK Ltd. at wholesale prices, who then in turn charged customers retail prices. After the acquisition Smartcool EMEA, doing business as Smartcool Systems UK Ltd., will directly manage these customer accounts improving gross revenue and profitability. Another significant factor in the acquisition is accessing enhanced technical abilities and knowledge transfer from UK team’s large database of installations. This allows the merged entity to leverage this knowledge to grow the business through expanding direct selling opportunities and third party distributor support. The main area for growth in the upcoming years is in this geographic region and the acquisition allows for a stronger platform to build from.

#### Consideration transferred and purchase price allocation

In consideration, the Company agreed to pay a total of £2,840,438 over a twelve-month period plus 1,000,000 share purchase warrants. £1,840,438 was paid in cash upon closing. The remaining balance of £1,000,000 will be paid in four equal payments quarterly with the last one on March 1, 2012.

With the exception of the first quarterly payment, Smartcool has at its discretion the option to defer the three remaining quarterly payments. The deferment will incur an interest charge equal to Royal Bank of Canada prime rate for the first three months and prime rate plus 5% after that period. At the acquisition date, the fair value of these scheduled payments was determined to be £940,494GBP based on discounting the future payments at a rate of 10%.

The warrants have an exercise price of \$0.30 and vesting period of 12 months. They will expire two years from the vesting date. The fair value of these warrants has been determined to be \$227,675 (note 13(d)).

The allocation of the purchase price is based on management's preliminary estimates and certain assumptions with respect to the fair value increment associated with the assets acquired and the liabilities assumed. The actual fair value of the assets and liabilities are to be determined as of the date of the acquisition when further analysis is completed. Consequently, the actual allocation of the purchase price may result in adjustments different than those shown below.

The preliminary purchase price allocation is subject to change and is summarized as follows:

|  | GBP       | CAD       |
|--|-----------|-----------|
| Purchase of all outstanding shares of Smartcool UK | 2,840,438 | 4,410,745 |
| Fair value of warrants issued                      |           | 227,675   |
|  | 2,840,438 | 4,638,420 |
| <b>Allocation of the purchase price:</b>           |           |           |
| Net working capital                                |           | 846,486   |
| Property and equipment                             |           | 103,230   |
| Distribution rights and other intangible assets    |           | 3,768,164 |
| Finance leases                                     |           | (79,460)  |
| Net identifiable assets                            |           | 4,638,420 |

From the acquisition date, February 28, 2011, to June 30, 2011, revenue of \$53,889 and net loss of \$611,762 from Smartcool UK were included in the consolidated statement of comprehensive loss of the Company.

The consolidated revenue of the Company would have increased by \$3,287 and net loss increased by \$137,505 if the revenue and net loss of Smartcool UK had been included in the consolidated statement of comprehensive loss for the six-month period ended June 30, 2011.

#### 4. Restricted cash

In 2010, the Company issued units of participation subordinated secured debentures and warrants through a private placement. Under the terms of the debenture, the holders are entitled to receive quarterly payments towards the principal amount. The total of quarterly payments is equal to 5% of the gross cash revenue received by the Company in each quarter. The payment of quarterly principal payments owing during the first twelve-month period commencing from the closing date, however, may be delayed and paid on a date that is 13 months from the closing date. When such payments are delayed, the Company is required to deposit into a separate trust account, on a quarterly basis, an amount equal to any first year quarterly principal payment that would otherwise have been payable.

As of June 30, 2011, total cash of \$97,737, has been designated as restricted cash in accordance with the debenture terms (December 31, 2010 - \$166,289, June 30, 2010 - \$42,351).

## 5. Trade Receivables

|   | June 30,<br>2011 | December 31,<br>2010 |
|---|------------------|----------------------|
| <sup>1</sup> Trade receivables, net of allowances for doubtful accounts | \$1,218,521      | \$971,316            |
| Other receivables   | 76,472           | 48,545               |
|   | <b>1,294,993</b> | <b>1,019,861</b>     |

<sup>1</sup> Allowance for doubtful accounts June 30, 2011: \$103,610 (December 31, 2010: \$24,209)

At June 30, 2011, the analysis of trade receivables that were past due but not impaired is as follows:

|                               | June 30, 2011    | December 31, 2010 |
|-------------------------------|------------------|-------------------|
| Neither past due nor impaired | \$187,837        | \$411,193         |
| < 30 days                     | 11,126           | 7,832             |
| 30-60 days                    | 140,396          | 134,337           |
| 60-90 days                    | 174,835          | 297,969           |
| 90-120 days                   | 2,980            | 13,156            |
| > 120 days                    | 701,347          | 106,829           |
|                               | <b>1,218,521</b> | <b>971,316</b>    |

All trade and other receivables are classified as current assets. In determining the recoverability of a trade or other receivable, the Company performs a risk analysis considering the type and age of the outstanding receivable, as well as the Company's exposure to credit and currency risks as disclosed in Note 15.

## 6. Inventory

|                             | June 30, 2011  | December 31, 2010 |
|-----------------------------|----------------|-------------------|
| ESM™, ECO3™ and Peripherals | \$590,861      | \$497,216         |
| Other products              | 13,676         | 12,369            |
| Total inventory             | <u>604,537</u> | <u>509,585</u>    |

During the three months ended June 30, 2011, total inventories of \$79,962 were recognized as costs of sales (2010 - \$203,893). During the six months ended June 30, 2011, total inventories of \$265,298 have been recognized as cost of sales (June 30, 2010 - \$312,311).

## 7. Property and equipment

| <b>Cost</b>                                     | Computers      | Testing and demonstration equipment | Office equipment and furniture | Motor Vehicles | Leasehold improvement | Total          |
|---|----------------|-------------------------------------|--------------------------------|----------------|-----------------------|----------------|
| Balance at January 1, 2010                      | \$158,160      | \$216,579                           | \$44,883                       | -              | \$116,318             | \$535,940      |
| Additions                                       | 1,358          | 17,663                              | 1,501                          | -              | -                     | 20,522         |
| Disposals                                       | -              | -                                   | (3,307)                        | -              | -                     | (3,307)        |
| Effect of foreign currency exchange differences | (3,037)        | (12,903)                            | (3,163)                        | -              | -                     | (19,103)       |
| <b>Balance at December 31, 2010</b>             | <b>156,481</b> | <b>221,339</b>                      | <b>39,914</b>                  | <b>-</b>       | <b>116,318</b>        | <b>534,052</b> |
| Additions (note 4)                              | 19,997         | 8,460                               | 6,432                          | 93,033         | -                     | 127,922        |
| Disposals                                       | (1,381)        | -                                   | (5,222)                        | -              | -                     | (6,603)        |
| Effect of foreign currency exchange differences | (2,216)        | (5,153)                             | 420                            | (2,285)        | -                     | (9,234)        |
| <b>Balance at June 30, 2011</b>                 | <b>172,881</b> | <b>224,646</b>                      | <b>41,544</b>                  | <b>90,748</b>  | <b>116,318</b>        | <b>646,137</b> |

| <b>Accumulated depreciation and impairment</b>  | Computers      | Testing and demonstration equipment | Office equipment and furniture | Motor Vehicles | Leasehold improvement | Total          |
|---|----------------|-------------------------------------|--------------------------------|----------------|-----------------------|----------------|
| Balance at January 1, 2010                      | \$101,113      | \$155,878                           | \$22,017                       | -              | \$53,314              | 332,322        |
| Provisions                                      | 29,979         | 55,303                              | 7,232                          | -              | 11,632                | 104,146        |
| Disposals                                       | -              | -                                   | -                              | -              | -                     | -              |
| Effect of foreign currency exchange differences | (1,424)        | (11,483)                            | (1,139)                        | -              | -                     | (14,046)       |
| <b>Balance at December 31, 2010</b>             | <b>129,668</b> | <b>199,698</b>                      | <b>28,110</b>                  | <b>-</b>       | <b>64,946</b>         | <b>422,422</b> |
| Provisions                                      | 11,176         | 12,690                              | 3,162                          | 9,093          | 5,816                 | 41,936         |
| Disposals                                       | (1,318)        | -                                   | (2,652)                        | -              | -                     | (3,970)        |
| Effect of foreign currency exchange differences | (2,150)        | (6,769)                             | (363)                          | (477)          | -                     | (9,758)        |
| <b>Balance at June 30, 2011</b>                 | <b>137,376</b> | <b>205,620</b>                      | <b>28,257</b>                  | <b>8,616</b>   | <b>70,762</b>         | <b>450,630</b> |

| <b>Carrying value</b>        | Computers | Testing and demonstration equipment | Office equipment and furniture | Motor Vehicles | Leasehold improvement | Total   |
|------------------------------|-----------|-------------------------------------|--------------------------------|----------------|-----------------------|---------|
| Balance at January 1, 2010   | \$57,047  | \$60,701                            | \$22,865                       | -              | \$63,004              | 203,617 |
| Balance at December 31, 2010 | 26,813    | 21,641                              | 11,803                         | -              | 51,372                | 111,629 |
| Balance at June 30, 2011     | 35,505    | 19,026                              | 13,286                         | 82,132         | 45,556                | 195,507 |

The Company has assets under capital lease with total cost of \$49,453. These assets were fully amortized in 2010 and had no book value as at June 30, 2011 (December 31, 2010- \$0).

## 8. Intangible assets

### Definite lives

| Costs  | North                                  | ESM™                            | Distribution   | Supplier          | United Kingdom             | Total     |
|--|--|---------------------------------|----------------|-------------------|----------------------------|-----------|
|  | American<br>distribution<br>rights (a) | intellectual<br>property<br>(b) | agreements (b) | agreements<br>(b) | distribution rights<br>(c) |           |
| Balance at January 1,<br>Acquisition                   | 266,288                                | 124,100                         | 1,861,842      | 113,651           | 2,149,749                  | 4,515,630 |
| Effects of foreign<br>currency exchange                | (9,360)                                | -                               | -              | -                 | (66,434)                   | (75,794)  |
| Balance at December<br>31, 2010                        | 256,928                                | 124,100                         | 1,861,842      | 113,651           | 2,083,315                  | 4,439,836 |
| Acquisition (note 4)                                   |  |                                 |                |                   | 3,768,164                  | 3,768,164 |
| Effects of foreign<br>currency exchange<br>differences | (5,454)                                | -                               | -              | -                 | (89,698)                   | (95,152)  |
| Balance at June 30,                                    | 251,474                                | 124,100                         | 1,861,842      | 113,651           | 5,761,781                  | 8,112,848 |

### Indefinite lives

As at January 1, 2010, December 31, 2010 and March 31, 2011, ESM™ brand (b) had a carrying amount of \$56,100 and is not subject to amortization due to having an indefinite useful life.

| Amortization and<br>impairment losses               | North                                  | ESM™                            | Distribution   | Supplier          | United Kingdom          | Total     |
|---|--|---------------------------------|----------------|-------------------|-------------------------|-----------|
|   | American<br>distribution<br>rights (a) | intellectual<br>property<br>(b) | agreements (b) | agreements<br>(b) | distribution rights (c) |           |
| Balance at January 1, 2010                          | 99,776                                 | 43,435                          | 523,458        | 39,779            | 358,274                 | 1,064,722 |
| Amortization for the period                         | 27,985                                 | 12,410                          | 148,315        | 11,366            | 255,458                 | 455,534   |
| Effects of foreign currency<br>exchange differences | (5,721)                                | -                               | -              | -                 | (35,048)                | (40,769)  |
| Balance at December 31,<br>2010                     | 122,040                                | 55,845                          | 671,773        | 51,145            | 578,684                 | 1,479,487 |
| Amortization for the period                         | 12,608                                 | 6,205                           | 74,200         | 5,682             | 197,725                 | 296,420   |
| Effects of foreign currency<br>exchange differences | (2,624)                                | -                               | -              | -                 | (387)                   | (3,011)   |
| Balance at June 30, 2011                            | 132,024                                | 62,050                          | 745,973        | 56,827            | 776,022                 | 1,772,896 |



| Carrying amounts         | North American distribution rights (a) | ESM™ brand (b) | ESM™ intellectual property (b) | Distribution agreements (b) | Supplier agreements (b) | United Kingdom distribution rights (c) | Total     |
|--------------------------|--|----------------|--------------------------------|-----------------------------|-------------------------|--|-----------|
| As at January 1, 2010    | 166,512                                | 56,100         | 80,665                         | 1,338,384                   | 73,872                  | 1,791,475                              | 3,507,008 |
| As at December 31, 2010  | 134,888                                | 56,100         | 68,255                         | 1,190,069                   | 62,506                  | 1,504,631                              | 3,016,449 |
| Balance at June 30, 2011 | 119,450                                | 56,100         | 62,050                         | 1,115,869                   | 56,824                  | 4,985,759                              | 6,396,052 |

**a. North American distribution rights**

On March 27, 2006, the Company acquired the exclusive rights to distribute the ESM™ throughout North America from Abbotly Technologies Inc. (“Abbotly USA”). Pursuant to the acquisition, Abbotly USA agreed to assign all of its rights and obligations, and the Company agreed to assume all of Abbotly USA’s obligations, under a license agreement between Abbotly USA and Abbotly, and the Company became the master distributor of the ESM™ in North America.

Consideration paid for the acquisition was US\$180,000 (\$201,953), 500,000 share purchase warrants with an exercise price of \$0.27 and a 20% royalty on certain products purchased from Abbotly as long as Smartcool Systems USA still holds the distribution rights.

**b. ESM™ Intellectual Property and worldwide distribution rights**

The Company acquired \$2,278,350 of intangible assets in relation to the acquisition of Abbotly.

Management has performed a review of the carrying value of its distribution agreements. As a result of its assessment, in 2008 the Company recognized an impairment of \$116,914 related to distribution agreements. As a result of this impairment recognition, the total cost of distribution rights was reduced by \$148,799 to \$1,835,701. As at June 30, 2011, distribution rights consist of:

|                                  |             |
|----------------------------------|-------------|
| ESM™ Distribution agreements (b) | \$1,835,701 |
| Other distribution rights        | \$26,140    |
| Total                            | \$1,861,841 |

No impairments were recorded in 2011 and 2010 and the impairment loss recognized in 2008 was not reversed upon transition to IFRS.

**c. Distribution Rights from TECC Services**

On July 11, 2008, the Company acquired the exclusive rights to distribute the ESM™ in the United Kingdom, Spain, Portugal, and the Middle East from T.E.C.C. Services Ltd. ("TECC"). Consideration of £1,035,000GBP (CA\$1,738,750) was payable in cash and £265,000GBP (CA\$532,067) was payable in the form of common shares of the Company. Upon closing, payment of £435,000GBP (CA\$873,393) was made and 743,709 shares were issued. The share price was based on the average closing price of the Company's shares on the TSX Exchange for 20 consecutive trading days, with the last of such trading days being the second day preceding the date of closing.

The remaining balance of £600,000GBP is due in scheduled instalments over four years with the last payment due on July 16, 2012. These instalments are non-interest bearing. At the acquisition date, the fair value of consideration was determined to be \$2,270,800 based on discounting the future payments at a rate of 16%. Transaction costs of \$28,300 were also incurred.

The purchase agreement was amended on December 21, 2009 where payments were rescheduled with the first payment due on January 16, 2010 and the last one on July 16, 2012. The parties also agreed that interest would accrue on £75,000 GBP at RBC prime rate plus 4% from January 16, 2009 and additionally on £75,000 GBP from July 16, 2009 until these amounts are fully paid. The amendment had no material impact on the company's financial position and no gain or loss was recognized in 2009. As at June 30, 2011, the balance of £469,965GBP, including accrued interest of £19,965GBP, remained outstanding.

**d. Distribution Rights from Smartcool UK**

On February 28, 2011, the Company acquired \$3,768,164 of intangible assets in relation to the acquisition of Smartcool UK as described in note 3. These intangible assets include the distribution rights of the ESM™ in the United Kingdom.

**9. Capitalized development costs**

During the three and six months ended June 30, 2011, the Company incurred \$3,428 and \$5,360 of research and development costs that were fully expensed (June 30, 2010 - \$1,346 and \$2,389). No research and development costs were deferred in the period (June 30, 2010 - Nil).

Development costs of \$106,561 incurred in 2008 have been capitalized and amortized over a two year period, starting October 1, 2008 when the new products' commercial production was complete and they became available for sale. These deferred costs were fully amortized by September 2010.

## 10. Obligations under acquisition contracts

### a. TECC Services

At June 30, 2011, the Company owed £450,000GBP related to its acquisition of distribution rights from TECC Services. The obligation amount of £600,000GBP was originally non-interest bearing and has been recorded at its present value using a discount rate of 16%. The purchase agreement was then amended on December 21, 2009 to accrue interest on 150,000 GBP at RBC prime rate plus 4% and adjust timing and amount of repayments (note 8(c)).

|                             |                  |
|-----------------------------|------------------|
|                             | \$               |
| Balance – July 11, 2008     | 865,358          |
| Accretion                   | 40,853           |
| Foreign exchange            | (97,102)         |
| Balance - December 31, 2008 | <u>809,109</u>   |
| Accretion                   | 75,227           |
| Accrued interest            | 9,420            |
| Foreign exchange            | (47,964)         |
| Balance – December 31, 2009 | <u>845,792</u>   |
| Payment                     | (246,425)        |
| Accretion                   | 66,546           |
| Accrued interest            | 17,389           |
| Foreign exchange            | (60,631)         |
| Balance – December 31, 2010 | <u>622,671</u>   |
| Accretion                   | 32,837           |
| Accrued interest            | 8,093            |
| Foreign exchange            | (942)            |
| Balance – June 30, 2011     | <u>662,659</u>   |
| Less: Current portion       | <u>(553,821)</u> |
|                             | <u>108,838</u>   |

Required undiscounted repayments are as follows:

|  | GBP              | CDN\$            |
|--|------------------|------------------|
| July 16, 2011                          | 225,000          | 350,888          |
| January 16, 2012                       | 112,500          | 175,444          |
| July 16, 2012                          | 112,500          | 175,444          |
|  | <u>450,000</u>   | <u>701,775</u>   |
| Accrued interest on 2009 late payments | 19,965           | 30,932           |
| Balance – June 30, 2011                | <u>469,965</u>   | <u>727,117</u>   |
| Less: Current portion                  | <u>(357,465)</u> | <u>(553,821)</u> |
|  | <u>112,500</u>   | <u>174,296</u>   |

The obligations under the acquisition contract are being accreted to their face value over their term. The accretion charge for the period is recorded within interest expense in the consolidated statement of operations.

**a. Smartcool UK**

On February 28, 2011, the Company acquired the business of Smartcool UK for total cash consideration of £2,840,438GBP (Cdn\$4,410,745) and some non-cash consideration (note 3). Upon closing, £1,840,438GBP was settled in cash with the remaining balance of £1,000,000GBP due in four equal installments over the next 12 months.

|                             |                    |
|-----------------------------|--------------------|
| Balance – February 28, 2011 | \$1,488,049        |
| Accretion                   | \$45,726           |
| Foreign exchange            | <u>(31,022)</u>    |
| Accrued interest            | <u>968</u>         |
| Balance, June 30, 2011      | <u>\$1,503,721</u> |

Repayments are scheduled as follows:

|                         | GBP              | CDN\$            |
|-------------------------|------------------|------------------|
| June 1, 2011            | 250,000          | 387,325          |
| September 1, 2011       | 250,000          | 387,325          |
| December 1, 2011        | 250,000          | 387,325          |
| March 1, 2012           | <u>250,000</u>   | <u>387,325</u>   |
| Balance – June 30, 2011 | <u>1,000,000</u> | <u>1,549,300</u> |

**11. Finance leases**

Under the agreement of Smartcool UK acquisition, the Company assumed Smartcool UK's liabilities including five vehicle leases. These leases expire in April 2012, December 2012 and January 2013. They have implied annual interest rate ranging from 5% to 10%.

The following is a schedule of future minimum lease payments under these finance leases together with the balance of the obligations.

**Finance lease payments:**

|                            |                 |
|----------------------------|-----------------|
|                            | \$              |
| 2011                       | 19,817          |
| 2012                       | 34,587          |
| 2013                       | <u>11,793</u>   |
| Balance of the obligations | 66,197          |
| Less current portion       | <u>(35,055)</u> |
|                            | <u>31,142</u>   |

## 12. Debentures

In May 2010, the Company completed its offer of 122 units of debenture and share purchase warrants for aggregate proceeds of \$610,000. The debenture is not redeemable by the holder.

Each unit comprises of a debenture in the principal amount of \$5,000 plus 8,600 warrants, issued at a price of \$5,000 per unit. The debentures have no stated interest rate. They are for a term of three years and entitle the holder to receive distribution of \$150 each quarter per \$5,000 of principal amount with an additional distribution of \$150 if the debenture is repaid by December 31, 2011 and two additional distributions (for a total of \$300) if the debenture is repaid after December 31, 2011, but before maturity. The debentures also receive 5% of gross cash revenue to be paid towards the outstanding principal of the debenture each quarter. The debentures are secured by a general security agreement over the assets of the Company.

The payment of quarterly principal payments owing during the first twelve-month period commencing from the closing date, however, may be delayed and paid on a date that is 13 months from the closing date. When such payments are delayed, the Company is required to deposit into a separate trust account, on a quarterly basis, an amount equal to any first year quarterly principal payment that would otherwise have been payable. As at Jun 30, 2011, total principal payments of \$66,833 have been deferred.

One whole warrant entitles the holder to purchase one common share at the price of \$0.50 per share for a period of three years from the date of issuance. If the Company's share trade at an average price of \$0.80 per share for a period of 60 days, the Company, at its election, may force exercise or cancellation of the warrants. If the Company repays any portion of the principal amount of the debentures prior to January 1, 2011, the number of common shares purchasable pursuant to the warrants shall be decreased proportionately to the amount of principal so repaid.

Finder's fees equal to 10% of the aggregate proceeds from the offerings of the units were payable to the brokers.

On February 9, 2010, the Company closed the first tranche of its debenture offering for gross proceeds of \$250,000. On March 19, 2010, the Company closed the second tranche for gross proceeds of \$85,000. On April 29, 2010, the Company closed the third tranche for gross proceeds of \$200,000 and on May 4, 2010, closed the last tranche of its debenture offering for gross proceeds of \$75,000.

The net proceeds received from the issue of debentures have been split between the financial liability component and an equity component, representing the fair value of the share purchase warrants, as follows:

|                                      |         |
|--------------------------------------|---------|
|                                      | \$      |
| Net proceeds of issue                | 552,751 |
| Equity component                     | 8,101   |
| Liability component at date of issue | 544,650 |

The equity component of \$8,101 has been credited to equity, Share Purchase Warrants (note 13(d)).

The liability component is measured at amortized cost. Interest expenses for the three and six months ended June 30, 2011 were \$32,640 and \$70,903 (June 30, 2010 - \$30,483 and \$39,077), calculated by applying weighted average effective interest rate of 26% to the liability component. Interest payment total of \$36,600 and principal payment total of \$115,269 were paid during the six months ended June 30, 2011. As at June 30, 2011, the carrying amount of these debentures was \$534,302.

| Maturity date            | <b>Feb. 9,<br/>2013</b> | <b>March<br/>19, 2013</b> | <b>April 29,<br/>2013</b> | <b>May 4,<br/>2013</b> | <b>Total</b> |
|--------------------------|-------------------------|---------------------------|---------------------------|------------------------|--------------|
| Debenture principal      | \$250,000               | \$85,000                  | \$200,000                 | \$75,000               | \$610,000    |
| Balance on issuance date | 223,165                 | 75,550                    | 178,830                   | 67,105                 | 544,650      |
| Accrued interest         | 54,555                  | 16,193                    | 32,588                    | 11,970                 | 115,306      |
| Interest payment         | (21,750)                | (6,290)                   | (12,198)                  | (4,450)                | (44,688)     |
| Balance Dec. 31, 2010    | 255,970                 | 85,453                    | 199,220                   | 74,625                 | 615,268      |
| Accrued interest         | 26,941                  | 9,848                     | 24,751                    | 9,363                  | 70,903       |
| Principal payment        | (84,479)                | (23,661)                  | (5,185)                   | (1,944)                | (115,269)    |
| Interest payment         | (15,000)                | (5,100)                   | (12,000)                  | (4,500)                | (36,600)     |
| Balance June 30, 2011    | \$183,432               | \$66,540                  | \$206,786                 | \$77,544               | \$534,302    |
| Less: current portion    | (183,432)               | (66,540)                  | (206,786)                 | (77,544)               | (534,302)    |
| Balance                  | -                       | -                         | -                         | -                      | -            |

### 13. Issued Capital and Equity reserve

#### a. Authorized:

Unlimited common shares without par value  
 100,000,000 Class A preferred shares  
 100,000,000 Class B preferred shares

#### b. Issued common shares

|   | <u>Shares</u>     | <u>Amount</u>     |
|---|-------------------|-------------------|
| Balance, January 1, 2010                    | 44,321,396        | \$25,639,345      |
| Private placement (i)                       | 2,500,000         | 440,286           |
| Share issuance costs                        | -                 | (43,486)          |
| Balance, December 31, 2010                  | 46,821,396        | 26,036,145        |
| Issued for cash via private placement (iii) | 13,333,330        | 3,292,666         |
| Options exercised (c)                       | 654,000           | 210,298           |
| Share issuance costs (iv)                   | -                 | (217,770)         |
| Balance, June 30, 2011                      | <u>60,808,726</u> | <u>29,321,339</u> |

- i. On June 1, 2010, the Company issued 2,500,000 Units at \$0.20 per unit pursuant to a non-brokered private placement, for gross proceeds of \$500,000. Each Unit consists of one common share and one-half warrant. Cash issuance costs of \$40,568 and non-cash issuance costs of \$2,918 were allocated to common shares.
- ii. On February 22, 2011, the Company issued 13,333,330 Units at \$0.30 per unit pursuant to a non-brokered private placement, for gross proceeds of \$3,999,999. Each Unit consists of one common share and one-half warrant. Pursuant to the private placement agreement, the Company also issued 626,667 share purchase warrants as non-cash compensation to agents. Cash issuance costs of \$179,080 and non-cash issuance costs of \$38,690 were allocated to common shares.

#### c. Stock options

Under the Company's stock option plan, the Company may grant stock options to employees, directors, officers and consultants. The maximum number of shares to be awarded under the plan is 9,364,279.

In October 2010, the stock option plan was amended to extend the option term to a maximum period of ten years. This amendment has been approved by shareholders at 2010 annual general meeting and accepted for filing by the TSX Venture Exchange.

As at June 30, 2011, all outstanding options have vesting periods of up to a summary of the Company's stock option activity for employees, directors, officers and consultants is as follows:

|                                   | Number of share<br>options | Weighted<br>average<br>exercise price |
|-----------------------------------|----------------------------|---------------------------------------|
| <b>Balance, January 1, 2010</b>   | 5,719,000                  | \$0.33                                |
| Granted                           | 1,640,000                  | 0.27                                  |
| Cancelled                         | (25,625)                   | 0.28                                  |
| Forfeited                         | (126,875)                  | 0.40                                  |
| Expired or exercised              | (680,000)                  | 0.33                                  |
| <b>Balance, December 31, 2010</b> | 6,526,500                  | 0.31                                  |
| Granted                           | 1,082,500                  | 0.33                                  |
| Cancelled                         | (2,500)                    | 0.33                                  |
| Forfeited                         | (7,500)                    | 0.33                                  |
| Expired or exercised              | (1,189,000)                | 0.24                                  |
| <b>Balance, June 30, 2011</b>     | 6,410,000                  | \$0.33                                |

During the six months ended June 30, 2011, the Company granted 577,500 options (June 30, 2010 –650,000) to officers and employees and 505,000 options (2010 – Nil) to consultants. None of these options had an exercise price lower than the stock price at the date of grant (2010 – Nil).

Stock-based compensation expense for the three months ended June 30, 2011, was \$106,395 (June 30, 2010 - \$71,146), of which \$92,781 was related to employees (2010 – \$130,387) and \$13,614 (June 30, 2010, Expense reduction - \$59,243) was related to consultants. Stock-based compensation expense for the six months ended June 30, 2011, was \$164,007 (June 30, 2010 - \$215,339), of which \$143,780 was related to employees (June 30, 2010 – \$187,459) and \$20,227 (June 30, 2010 - \$27,880) was related to consultants.

Additional information regarding share options outstanding at June 30, 2011, is as follows:



| Range of Exercise prices \$ | Options Outstanding |   |                                    | Options Exercisable |                                    |
|-----------------------------|---------------------|---|------------------------------------|---------------------|------------------------------------|
|                             | Number of Options   | Weighted average remaining contractual life (years) | Weighted average exercise price \$ | Number              | Weighted average exercise price \$ |
| 0.10 - 0.20                 | 222,500             | 2.90  | 0.16                               | 222,500             | 0.16                               |
| 0.23 - 0.29                 | 1,532,500           | 4.57  | 0.26                               | 645,625             | 0.26                               |
| 0.30 - 0.33                 | 3,320,000           | 2.25  | 0.31                               | 3,167,500           | 0.31                               |
| 0.40 - 0.48                 | 780,000             | 3.07  | 0.42                               | 340,000             | 0.43                               |
| 0.54 - 0.60                 | 400,000             | 1.19  | 0.57                               | 400,000             | 0.57                               |
| 0.72 - 0.96                 | 100,000             | 0.64  | 0.84                               | 100,000             | 0.84                               |
|                             | 6,410,000           | 2.84  | 0.33                               | 4,875,625           | 0.34                               |

The Company used the Black-Scholes option pricing model to determine the fair value of the options at the date of grant with the following assumptions:

|                         | 2011            | 2010           |
|-------------------------|-----------------|----------------|
| Risk-free interest rate | 2.14% - 2.64%   | 1.71%-2.45%    |
| Dividend yield          | 0%              | 0%             |
| Volatility              | 92.34% - 93.96% | 93.57%- 98.60% |
| Expected life           | 4.58-4.60 years | 3.8 – 5 years  |

**d. Share purchase warrants**

- i. On June 1, 2010, the Company issued 2,500,000 units of common shares and warrants pursuant to a non-brokered private placement, for gross proceeds of \$500,000. Each Unit consists of one common share and one-half warrant. Each full share purchase warrant entitles the holder to purchase one common share at a price of \$0.35 until June 1, 2011. These warrants are not transferable. A total value of \$67,852 was attributed to the warrants. Issuance costs of \$3,710 were allocated to these warrants.
- ii. On June 1, 2010, the Company issued 125,000 warrants as part of the private placement commission to agents. Each full share purchase warrant entitles the holder to purchase one common share at a price of \$0.35 until June 1, 2011. The fair value of \$8,137 of these warrants has been reflected within share issuance costs.
- iii. On February 22, 2011, the Company issued 13,333,330 Units of commons shares and warrants pursuant to a non-brokered private placement. Each Unit consists of one common share and one-half warrant. Each full share purchase warrant entitles the holder to

purchase one common share at a price of \$0.45 until February 22, 2013. These warrants are not transferable. A total value of \$707,333 was attributed to the warrants.

- iv. Pursuant to the February 28, 2011 private placement agreement, the Company also issued 626,667 share purchase warrants as non-cash compensation to agents. Each warrant entitles the holder to purchase one common share at a price of \$0.30 until February 22, 2012. A total value of \$47,000 was attributed to these warrants. Issuance costs of \$46,771 were allocated to warrants.
- v. On February 28, 2011, the Company issued 1,000,000 share purchase warrants as non-cash consideration for Smartcool UK acquisition. Each warrant entitles the holder to purchase one common share at a price of \$0.30. These warrants will vest 25% on the issuance date and 25% every six months thereafter. They will expire two years from the vesting date. A total value of \$227,675 was attributed to the warrants.

A summary of the Company’s warrant activity is as follows:

|                             | <b>Number<br/>outstanding</b> | <b>Amount \$</b> |
|-----------------------------|-------------------------------|------------------|
| Balance, January 1, 2010    | 1,732,375                     | 52,514           |
| Expired warrants            | (1,732,375)                   | (52,514)         |
| Issued in private placement | 2,424,200                     | 75,953           |
| Warrant issue costs         | -                             | (3,711)          |
| Balance, December 31, 2010  | 2,424,200                     | 72,242           |
| Expired warrants            | (1,375,000)                   | (64,140)         |
| Issued in private placement | 7,293,332                     | 754,333          |
| Issued in UK acquisition    | 1,000,000                     | 227,675          |
| Warrant issue costs         | -                             | (46,771)         |
| Balance, June 31, 2011      | <u>9,342,532</u>              | <u>943,339</u>   |

For the six months ended June 30, 2011, \$754,333 (2010 - \$75,953) of the monies raised and commission for agents has been allocated to these share purchase warrants with the corresponding amounts charged to share capital.

Share purchase warrants outstanding as at June 30, 2011, were as follows:

|                                   | Number of<br>warrants | Weighted<br>average<br>Share Price |
|-----------------------------------|-----------------------|------------------------------------|
| <b>Balance, January 1, 2010</b>   | 1,732,375             | 0.30                               |
| Expired, exercised or cancelled   | (1,732,375)           | 0.30                               |
| Issued                            | 2,424,200             | 0.41                               |
| <b>Balance, December 31, 2010</b> | 2,424,200             | 0.41                               |
| Expired, exercised or cancelled   | (1,375,000)           | 0.35                               |
| Issued                            | 8,293,332             | 0.42                               |
| <b>Balance, June 30, 2011</b>     | 9,342,532             | 0.43                               |

| Issued  | Expiry date       | Number of<br>shares | Exercise<br>price<br>\$ | Weighted<br>average<br>contractual life<br><br>Years |
|---|-------------------|---------------------|-------------------------|--|
|   | February 9, 2013  | 430,000             | 0.50                    | 1.61   |
|   | March 19, 2013    | 146,200             | 0.50                    | 1.72   |
|   | April 29, 2013    | 344,000             | 0.50                    | 1.83   |
|   | May 4, 2013       | 64,500              | 0.50                    | 1.84   |
|   | February 22, 2013 | 6,666,665           | 0.45                    | 1.64   |
|   | February 22, 2012 | 626,667             | 0.30                    | 0.64   |
|   | February 28, 2013 | 250,000             | 0.30                    | 1.66   |
|   | August 28, 2013   | 250,000             | 0.30                    | 2.16   |
|   | February 28, 2014 | 250,000             | 0.30                    | 2.66   |
|   | August 28, 2014   | 250,000             | 0.30                    | 3.16   |
| <b>Total issued and outstanding,<br/>end of quarter</b> |                   | 9,342,532           | 0.43                    | 1.67   |

**14. Income taxes**

At June 30, 2011, the Company has unused non-capital losses of approximately \$14,234,000 available to offset taxable income of future years. The non-capital losses will expire as follows:

|      | \$                |
|------|-------------------|
| 2014 | 507,000           |
| 2015 | 979,000           |
| 2026 | 1,495,000         |
| 2027 | 2,807,000         |
| 2028 | 3,012,000         |
| 2029 | 3,524,000         |
| 2030 | 2,053,000         |
|      | <u>14,377,000</u> |

The Company's operations are conducted in a number of countries with complex tax legislation and regulations pertaining to the Company's activities. Any reassessment of the Company's tax filings by the tax authorities may result in material adjustments to net income or loss, tax assets and operating loss carry-forwards.

In assessing the realizability of deferred tax assets, management considers whether it is probable that taxable profit will be available against which the deductible temporary difference can be utilized. As management believes there is uncertainty regarding the realization of deferred tax assets as at June 30, 2011, a full valuation allowance has been provided.

No income tax has been recorded for the period.

**15. Commitments**

**a. Premise lease**

The Company has entered into three lease agreements to lease office facilities in Vancouver and Alton, Hampshire. These leases will expire in five years. The future minimum lease payments commitments for the Company's office premises are:

|      | \$             |
|------|----------------|
| 2011 | 68,256         |
| 2012 | 105,526        |
| 2013 | 107,101        |
| 2014 | 108,226        |
| 2015 | 76,726         |
| 2016 | 9,035          |
|      | <u>474,870</u> |

For the three and six months ended June 30, 2011, the Company's rent expense including certain operating expenses and property taxes was \$35,921 and \$84,077 (2010 - \$39,360 and \$81,915) and its sublease revenue was \$3,000 and \$6,000 (2010 - \$4,117 and \$10,467).

**b. Abbotly USA**

Under the terms of the North American distribution rights acquisition, the Company is required to pay a 20% royalty on products identified in the Assignment and Assumption agreement dated March 27, 2006 and purchased from Abbotly Pty for North American sales. The initial term of the agreement was to expire on March 3, 2008. Smartcool, under its rights in the Assignment and Assumption agreement, has renewed the licensing agreement for another five year term. The Company has purchased all the remaining inventory from Abbotly USA, as required under this agreement, and is now required to purchase a minimum of \$200,000 of products identified in the Assignment and Assumption agreement from Abbotly Pty per year for purposes of the royalty calculation. The Company did not record any expense for the three and six months ended June 30, 2011. As at June 30, 2011, no royalties were payable to Abbotly USA (June 30, 2010 – US\$3,496).

**16. Segmented information**

The Company installs, distributes, markets and sells the ESM™ products and peripherals. The Company operates in one segment.

Revenue was derived from customers located in the following geographical regions:

|                             | Three months ended<br>June 30, 2011 |              | Six months ended<br>June 30, 2010 |              |
|-----------------------------|-------------------------------------|--------------|-----------------------------------|--------------|
|                             | Amount<br>\$                        | Revenue<br>% | Amount<br>\$                      | Revenue<br>% |
| Europe, Middle East, Africa | 80,437                              | 29           | 419,139                           | 34           |
| Australia                   | 97,782                              | 35           | 198,803                           | 16           |
| South East Asia             | -                                   | -            | 316,057                           | 26           |
| Americas                    | 98,179                              | 36           | 286,357                           | 24           |
| Total revenue               | 276,398                             | 100          | 1,220,356                         | 100          |

During the three months ended June 30, 2011, revenue from three customers exceeded 10% of the Company's total revenue. These customers contributed 35%, 15%, and 12% respectively. During the first three months of the previous year, revenue

from four customers exceeded 10% of the company's total revenue. These customers contributed 18%, 15%, 11% and 10% respectively.

During the six months ended June 30, 2011, revenue from two customers exceeded 10% of the Company's total revenue. These customers contributed 26% and 16% respectively. During the six months of the previous year, revenue from three customers exceeded 10% of the company's total revenue. These customers contributed 15%, 11% and 10% respectively.

Property and equipment are located in:

|        | <b>2011</b> | <b>2010</b> |
|--------|-------------|-------------|
| Canada | 35%         | 68%         |
| UK     | 63%         | 20%         |
| Other  | 2%          | 12%         |
| Total  | 100%        | 100%        |

## 17. Related party transactions

### a. Trading transactions

The Company's related parties consist of companies owned by executive officers and directors and key management as follows:

|                           | <b>Nature of Transaction</b> |
|---------------------------|------------------------------|
| 384518 BC Ltd.            | Consulting                   |
| Windstone Financial Corp. | Consulting                   |
| Key Management            | Consulting/General and       |
| Richards Buell Sutton LLP | Legal Services               |
| TECC. Services Ltd.       | Premises rent                |
| Magnum Energy Inc.        | Rental income                |

The Company incurred the following expenses in connection with the companies owned by key management and directors. These transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties.

|              | Note  | Three months ended |               | Six months ended |               |
|--------------|-------|--------------------|---------------|------------------|---------------|
|              |       | June 30, 2011      | June 30, 2010 | June 30, 2011    | June 30, 2010 |
|              |       | \$                 | \$            | \$               | \$            |
| Consulting   | (i)   | 58,089             | 61,986        | 121,183          | 125,219       |
| Legal fees   | (ii)  | 3,726              | 8,173         | 17,254           | 28,578        |
| Rent expense | (iii) | -                  | 8,472         | 12,777           | 17,777        |
| Lease Income | (iv)  | (3,000)            | (4,117)       | (6,000)          | (10,467)      |

- i. During the three months ended June 30, 2011, consulting fees of \$25,089 were charged by directors of the Company (June 2010 - \$28,986). Consulting fees of \$33,000 were charged by two companies with common directors during the above periods (June 2010 - \$33,000). As at June 30, 2011, \$23,240 was owed to these related parties (June 30, 2010 - \$20,984).

During the six months ended June 30, 2011, consulting fees of \$55,183 were charged by directors of the Company (June 2010 - \$59,719). Consulting fees of \$66,000 were charged by two companies with common directors during the above periods (June 2010 - \$65,500). As at June 30, 2011, \$23,240 was owed to these related parties (June 30, 2010 - \$20,984).

- ii. The Company uses the services of a law firm of which a director is a partner. During the three and six months ended June 30, 2011, fees in the amounts of \$3,726 and \$17,254 charged to the Company for legal services provided. As at June 30, 2011, \$3,812 was owed by this related party (June 30, 2010 - \$62,215).
- iii. The Company rents its office in the United Kingdom from a company with a common director. During the six months ended June 30, 2011, rent expense was \$12,777 (June 2010 - \$17,777). There was no rent expense in the three months ended June 30, 2011 (June 2010 - \$8,472). These transactions have been charged to general and administrative in the statement of operations, comprehensive loss and deficit. At June 30, 2011, no amounts were owed to this related party (June 30, 2010 - £2,416 GBP (CDN\$3,830)).
- iv. The Company subleases its Vancouver office and other facilities to a company with a common director. During the three and six months ended June 30, 2011, sublease income was \$3,000 and \$6,000 (June

2010 - \$4,117 and \$10,467). At June 30, 2011, no amounts were owed from these related parties (June 30, 2010 - \$0.

**b. Compensation of key management personnel**

The Company incurred the following expenses in connection with compensation of key management personnel.

|                      | June 30, 2011 | December 31, 2010 |
|----------------------|---------------|-------------------|
| Short-term benefits  | 52,960        | 74,104            |
| Share-based payments | 106,915       | 205,728           |
| Total                | 159,875       | 279,832           |

**18. Financial instruments**

**a. Financial Instruments**

The Company has classified its financial instruments as follows:

|   | June 30,<br>2011 | December<br>31, 2010 |
|---|------------------|----------------------|
|   | \$               | \$                   |
| <b>Financial assets:</b>  |                  |                      |
| Fair value through profit or loss , measured at fair value:     |                  |                      |
| Cash and cash equivalents                                       | 873,797          | 610,261              |
| Loans and accounts receivable, recorded at amortized            |                  |                      |
| Trade and other receivables                                     | 1,294,993        | 1,019,861            |
| <b>Other Financial liabilities, recorded at amortized cost:</b> |                  |                      |
| Trade payables and accruals                                     | 980,378          | 657,967              |
| Acquisition obligations, finance leases debentures              | 2,766,880        | 1,237,939            |

Interest income from FVTPL and held-to-maturity short-term investments and interest expense from acquisition obligations, debentures and other financial liabilities are recognized in finance cost.

The following summarizes interest income and expense for the three and six months ended June 30, 2011:



|   | Three months ended |               | Six months ended |               |
|---|--------------------|---------------|------------------|---------------|
|   | June 30, 2011      | June 30, 2010 | June 30, 2011    | June 30, 2010 |
|   | \$                 | \$            |                  |               |
| Interest income from FVTPL                        | 550                | 647           | 772              | 918           |
| Interest income from held-to-maturity             | -                  | -             | -                | 3,362         |
| Interest expense from financial obligations       | 37,322             | 47,724        | 80,360           | 66,105        |
| Interest expense from other financial liabilities | 51,502             | 16,744        | 80,199           | 33,034        |

Financial instruments recorded at fair value are measured using a three-level fair value hierarchy:

- Level 1: fair value is determined by reference to quoted prices in active markets for identical assets and liabilities.
- Level 2: fair value is determined based on inputs other than quoted prices for which all significant outputs are observable, either directly or indirectly.
- Level 3: fair value is determined based on inputs that are unobservable and significant to the overall fair value measurement.

The carrying value of cash and cash equivalents, short-term investments, trade and other receivables, the current portion of obligations under acquisition contract, current portion of debentures, tenant inducements, and trade payables and accruals approximates the fair value because of the short-term nature of these instruments.

The carrying value of the long term portion of acquisition obligations of \$108,838 (2010 - \$250,734) and finance leases of \$31,142 (2010 - \$0) having been discounted at 16% (see note 10) and 10% (see note 11), respectively, are considered a close approximation of fair value.

The Company's financial assets that must be recorded at fair value are presented in the following table:

Fair value measurement at June 30, 2011

|                              | Carrying<br>value | June 30, 2011 |         |         |
|------------------------------|-------------------|---------------|---------|---------|
|                              |                   | Level 1       | Level 2 | Level 3 |
|                              |                   | \$            | \$      | \$      |
| Financial assets             |                   |               |         |         |
| Cash and cash<br>equivalents | 873,797           | 873,797       | -       | -       |
| Total                        | 873,797           | 873,797       | -       | -       |

**b. Financial risk management**

The Company is exposed to certain financial risks, including credit risk, liquidity risk, and market risk.

**Credit risk**

Credit risk is the risk of an unexpected loss if a customer or third party to a financial instrument fails to meet its contractual obligations and arises principally from the Company's cash and cash equivalents, short-term investments and trade and other receivable. The Company limits its exposure to credit loss by placing its cash and cash equivalents and short-term investments with high credit quality financial institutions. Credit risk with respect to trade and other receivable is limited due to the Company's customer credit evaluation process.

The Company has \$1,294,993 (2010 - \$1,019,861) in trade receivables which are subject to credit risk.

**Liquidity risk**

The Company's consolidated financial statements have been prepared on a going concern basis, which assumes the realization of assets and the settlement of liabilities in the normal course of business. Liquidity risk results from the Company's inability to meet its financial obligations when they become due. As part of the risk management process, the Board approves the Company's annual operating and capital budgets as well as any material transactions outside the ordinary course of business. To ensure that the Company has sufficient liquidity to meet its current obligations in the next 12 months, additional financing has been obtained through issuance of debentures in the past year.

The timing of future payments related to financial liabilities is outlined in the table below:

|                               | Total            | 1 year           | 2 years        |
|-------------------------------|------------------|------------------|----------------|
|                               | \$               | \$               | \$             |
| Trade payables and accruals   | 925,771          | 925,771          | -              |
| Finance leases                | 66,197           | 35,055           | 31,142         |
| Debentures                    | 534,302          | 534,302          | -              |
| Obligations under acquisition | 2,166,379        | 2,057,541        | 108,838        |
| <b>Total</b>                  | <b>3,692,649</b> | <b>3,552,669</b> | <b>139,980</b> |

### Market risk

Market risk is the risk that changes in market prices, such as foreign exchange rates and interest rates, will affect the Company's income or valuation of its financial instruments.

### Foreign currency risk

The Company is exposed to fluctuations in foreign currency as most of its international distribution transactions are settled in U.S. dollars, Australian dollars and British pounds. The Company's net income and cash flow will therefore be affected by fluctuations in foreign exchange rates. None of these risks has been mitigated through the use of foreign currency forward contracts.

As at June 30, 2011, the Company's monetary assets and liabilities denominated in foreign currencies are as follows:

|                                  | USD            | AUD            | GBP              | Euro           |
|----------------------------------|----------------|----------------|------------------|----------------|
| <u>Assets</u>                    |                |                |                  |                |
| Cash and cash equivalents        | 256,997        | 824            | 7,912            | 7,076          |
| Trade and other receivables      | 537,133        | 136,185        | 406,599          |                |
| <b>Total</b>                     | <b>794,130</b> | <b>137,009</b> | <b>414,511</b>   | <b>7,076</b>   |
| <u>Liabilities</u>               |                |                |                  |                |
| Total payables and accruals      | 38,010         | 24,944         | 359,865          | 107,434        |
| Finance lease obligations        | -              | -              | 35,578           | -              |
| Acquisition obligations, current | -              | -              | 1,357,465        | -              |
| Acquisition obligations, balance | -              | -              | 112,500          | -              |
| <b>Total</b>                     | <b>38,010</b>  | <b>24,944</b>  | <b>1,865,408</b> | <b>107,434</b> |

The following table demonstrates the effect of exchange rate movement on net income due to gains and losses on the revaluation of monetary assets and liabilities denominated in foreign currencies:

| Gain (loss) on \$0.10 increase in<br>CAD | USD      | AUD      | GBP      | Euro   |
|--|----------|----------|----------|--------|
| Monetary Assets                          | (79,413) | (13,701) | (41,451) | (708)  |
| Monetary Liabilities                     | 3,801    | 2,494    | 186,541  | 10,742 |
| Net gain (loss)                          | (75,612) | (11,207) | 145,090  | 10,036 |

### Interest rate risk

The Company is exposed to this risk as late payments under TECC acquisition obligations are subject to interest based on Royal Bank of Canada prime rate plus 4%. As at June 31, 2011, the total of such payments was £150,000GBP (CDN\$233,925).

The Company is exposed to this risk as late payments under Smartcool UK acquisition obligations are subject to interest based on Royal Bank of Canada prime rate. As at June 31, 2011, the total of such payments was £250,000GBP (CDN\$387,325).

### Sensitivity analysis

Assuming a 100-basis point increase in RBC prime rate, as at June 30, 2011, the impact on income before income taxes would be a negative adjustment of £958GBP (CDN\$1,485).

## 19. Capital management

The Company's capital structure includes debentures and shareholders' equity consisting of share capital, reserve for equity settled share based transactions and deficit. As at June 30, 2011, the principal amount of debenture component was \$494,728 (December 31, 2010 - \$610,000) and shareholders' equity was \$5,732,016 (December 2010 - \$3,383,530). The decrease in debentures was attributable to principal payments made during the first six months of 2011, and the increase in shareholders' equity was attributable to February 2011 private placement, partially offset by net loss.

The Company's objectives when managing capital are:

- a. to effectively finance its operations and growth by meeting its operating and capital expenditure budgets;
- b. to maintain financial flexibility in order to meet financial obligations, including obligations under acquisition contracts;

- c. to ensure its ability to carry out its strategic plans and take advantage of acquisition opportunities;
- d. to provide an appropriate investment return to its shareholders and maintain investor, creditor and market confidence.

The Company will increase its capital through the issuance of new shares or debentures if that is necessary and appropriate.

The Company has not changed its approach to capital management during the current quarter.

The Company is not subject to any external capital restrictions.

## 20. Supplementary cash flow information

|  | Three months ended |               | Six months ended |               |
|--|--------------------|---------------|------------------|---------------|
|  | June 30, 2011      | June 30, 2010 | June 30, 2011    | June 30, 2010 |
| Interest paid in cash                              | 17,959             | 16,770        | 36,994           | 18,922        |
| Interest income received in cash                   | 550                | 647           | 772              | 5,925         |
| <b>Non-cash financing and investing activities</b> |                    |               |                  |               |
| Issuance of warrants for share issue costs         | -                  | 4,562         | 47,000           | 4,562         |

### First-Time Adoption of IFRS

The Company adopted IFRS on January 1, 2011, with a transition date of January 1, 2010. IFRS 1, *First Time Adoption of International Financial Reporting Standards*, provides guidance for the initial adoption of IFRS. IFRS 1 requires retrospective application of the standards in the transition statement of financial position, with all adjustments to assets and liabilities taken to retained earnings unless certain exemptions are applied.

The Company has applied the following exemptions to its opening statement of financial position:

**a. Business Combinations**

IFRS 1 indicates that a first-time adopter may apply IFRS 3 retrospectively.

The Company has taken advantage of this election and has applied IFRS 3 to all business combinations that occurred after the transition date.

**b. Share-Based Payments**

IFRS 1 encourages, but does not require, first-time adopters to apply IFRS 2, *Share-Based Payment*, to equity instruments that were granted subsequent to November 7, 2002 and vested before the date of transition to IFRS. The Company has elected not to apply IFRS 2 to awards that vested prior to January 1, 2010, which has been accounted for in accordance with Canadian GAAP.

IFRS 1 also outlines specific guidelines that a first-time adopter must adhere to under certain circumstances. The Company has applied the following mandatory exception to its opening statement of financial position dated January 1, 2010:

**c. Estimates**

In accordance with IFRS 1, an entity's estimates at the date of transition to IFRS must be consistent with estimates made for the same date under previous GAAP, unless there is objective evidence that those estimates were in error. The Company's IFRS estimates as of January 1, 2010, are consistent with its Canadian GAAP estimates for the same date.

IFRS employs a conceptual framework that is similar to Canadian GAAP; however, significant differences exist in certain areas of recognition, measurement and disclosure. While the adoption of IFRS has not changed the actual cash flows of the Company, the adoption has resulted in changes to the Company's reported condensed consolidated statement of operations and financial position. In order to allow financial statement users to better understand these changes, the Company's Canadian GAAP opening statement of financial position at January 1, 2010, statement of comprehensive (loss) income, statement of changes in equity, and statement of cash flows for the three and six months ended June 30, 2011, and statement of financial position at December 31, 2010 have been reconciled to IFRS, along with explanations of the resulting differences.

**d. Deferred Tax Liability**

IFRS requires all deferred tax assets and liabilities to be classified as non-current whereas Canadian GAAP allowed for classification as a current item if appropriate.

**e. Cumulative Translation Difference**

IFRS 1 allows a first-time adopter to deem cumulative translation differences that existed at the date of transition to IFRS to be zero. The Company has chosen to apply this election and has eliminated the cumulative translation difference and adjusted retained earnings by the same amount at the date of transition to IFRS.

The January 1, 2010, Canadian GAAP statement of financial position has been reconciled to IFRS as follows:

|  | Note                | Canadian<br>GAAP | Effect of<br>transition<br>to IFRS | IFRS         |
|--|---------------------|------------------|------------------------------------|--------------|
|  |                     | ₹                | ₹                                  | \$           |
| <b>Assets</b>                                      |                     |                  |                                    |              |
| <b>Current assets</b>                              |                     |                  |                                    |              |
| Cash and cash equivalents                          |                     | 147,051          |                                    | 147,051      |
| Short-term investments                             |                     | 101,646          |                                    | 101,646      |
| Trade and other receivables                        |                     | 657,840          |                                    | 657,840      |
| Inventories  | IAS 21 <sup>a</sup> | 717,857          | (12)                               | 717,844      |
| Prepaid expenses and deposits                      |                     | 242,302          |                                    | 242,302      |
|  |                     | 1,866,697-       | (12)                               | 1,866,685    |
| <b>Capitalized development costs</b>               |                     |                  |                                    |              |
|  |                     | 39,961           | -                                  | 39,961       |
| <b>Property and equipment</b>                      | IAS 21 <sup>a</sup> | 207,720          | (4,103)                            | 203,617      |
| <b>Intangible assets</b>                           | IAS 21 <sup>a</sup> | 3,639,843        | (132,835)                          | 3,507,008    |
|  |                     | 5,754,220        | (136,950)                          | 5,617,269    |
| <b>Liabilities</b>                                 |                     |                  |                                    |              |
| <b>Current liabilities</b>                         |                     |                  |                                    |              |
| Trade payable and accruals                         |                     | 552,034          |                                    | 552,034      |
| Current portion of obligations under contracts     |                     | 263,190          |                                    | 263,190      |
| Current portion of capital leases                  |                     | 9,144            |                                    | 9,144        |
| Current portion of deferred tenants inducement     |                     | 10,820           |                                    | 10,820       |
|  |                     | 835,188          |                                    | 835,188      |
| <b>Obligations under acquisition contract</b>      |                     |                  |                                    |              |
|  |                     | 582,602          |                                    | 582,602      |
| <b>Deferred tenant inducement</b>                  |                     | 63,834           |                                    | 63,834       |
|  |                     | 1,481,625        |                                    | 1,481,625    |
| <b>Shareholders' Equity</b>                        |                     |                  |                                    |              |
| Share capital                                      |                     | 25,639,345       |                                    | 25,639,345   |
| Reserve for equity settled share based transaction |                     | 4,036,345        |                                    | 4,036,345    |
| Foreign currency translation adjustment            |                     | -                |                                    | -            |
| Deficit  | IAS 21 <sup>a</sup> | (25,403,095)     | (136,950)                          | (25,540,045) |
|  |                     | 4,272,595        | (136,950)                          | 4,135,644    |
|  |                     | 5,754,220        | (136,950)                          | 5,617,269    |

a) IAS 21 - The effects of changes in foreign exchange rates: To adjust the translated balances of non-monetary assets and liabilities that are denominated in currencies other than the reporting currency. Under Canadian GAAP, these non-monetary assets and liabilities were translated using the exchange rates at the date of the transactions.

Under IFRS, these items are translated using the exchange rate at period end and the resulting differences are reported as a separate component of equity, 'Foreign currency translation adjustment'.

As noted above, the Company has taken the foreign currency translation exemption and therefore the foreign currency translation account is set to Nil at January 1, 2010.



The Company's Canadian GAAP statement of operations for the three month period ended June 30, 2010, has been reconciled to IFRS as follows:

|                                     | Note                | Canadian<br>GAAP<br>\$ | Effect of<br>transition<br>to IFRS<br>\$ | IFRS<br>\$ |
|-------------------------------------|---------------------|------------------------|--|------------|
| <b>Sales</b>                        |                     | 1,137,863              |  | 1,137,863  |
| <b>Cost of sales</b>                |                     | 303,779                |  | 303,779    |
| <b>Gross margin</b>                 |                     | 834,083                |  | 834,084    |
| <b>Operating expenses</b>           |                     |                        |  |            |
| General and administrative expenses |                     | 802,461                |  | 802,461    |
| Stock-based compensation            |                     | 71,146                 |  | 71,146     |
| Research and development            |                     | 14,666                 |  | 14,666     |
| Amortization                        |                     | 141,864                |  | 141,864    |
|                                     |                     | 1,030,137              |  | 1,030,137  |
| <b>Operating (loss) income</b>      |                     | (196,053)              |  | (196,053)  |
| <b>Other items</b>                  |                     |                        |  |            |
| Finance cost                        |                     | 64,468                 |  | 64,468     |
| Finance Income                      |                     | (647)                  |  | (647)      |
| Foreign exchange loss (gain)        | IAS 21 <sup>b</sup> | (10,092)               | 3,709                                    | (13,801)   |
|                                     |                     | 53,729                 | 3,709                                    | 50,020     |
| <b>Loss before income taxes</b>     |                     | (249,782)              | 3,709                                    | (246,073)  |
| Income tax                          |                     | -                      | -  | -          |
| <b>Net loss for the period</b>      |                     | (249,782)              | 3,709                                    | (246,073)  |

b) IAS 21 - The effects of changes in foreign exchange rates: To adjust foreign exchange gains and losses reported under Canadian GAAP. Under GAAP, all monetary assets and liabilities denominated in currencies other than the reporting currency were translated using the exchange rate at period end and the resulting translation gains and losses were included in consolidated statement of operations.

Under IFRS, only foreign exchange gains and losses on monetary assets and liabilities denominated in a currency other than the functional currency of each entity of the group should be included in the consolidated statement of operations.

The Company's Canadian GAAP statement of operations for the six month period ended June 30, 2010, has been reconciled to IFRS as follows:

|                                     | Note                | Canadian<br>GAAP<br>\$ | Effect of<br>transition<br>to IFRS<br>\$ | IFRS<br>\$ |
|-------------------------------------|---------------------|------------------------|--|------------|
| <b>Sales</b>                        |                     | 1,772,790              |  | 1,772,790  |
| <b>Cost of sales</b>                |                     | 599,346                |  | 599,346    |
| <b>Gross margin</b>                 |                     | 1,173,444              |  | 1,173,444  |
| <b>Operating expenses</b>           |                     |                        |  |            |
| General and administrative expenses |                     | 1,512,766              |  | 1,512,766  |
| Stock-based compensation            |                     | 215,339                |  | 215,339    |
| Research and development            |                     | 29,029                 |  | 29,029     |
| Amortization                        |                     | 290,031                |  | 290,031    |
|                                     |                     | 2,047,165              |  | 2,047,165  |
| <b>Operating (loss) income</b>      |                     | (873,721)              |  | (873,721)  |
| <b>Other items</b>                  |                     |                        |  |            |
| Finance cost                        |                     | 99,139                 |  | 99,139     |
| Finance Income                      |                     | (4,280)                |  | (4,280)    |
| Foreign exchange loss (gain)        | IAS 21 <sup>b</sup> | (50,597)               | 79,848                                   | 29,251     |
|                                     |                     | 44,262                 | (79,848)                                 | 124,110    |
| <b>Loss before income taxes</b>     |                     | (917,983)              | (79,848)                                 | (997,831)  |
| Income tax                          |                     | -                      | -  | -          |
| <b>Net loss for the period</b>      |                     | (917,983)              | (79,848)                                 | (997,831)  |

b) IAS 21 - The effects of changes in foreign exchange rates: To adjust foreign exchange gains and losses reported under Canadian GAAP. Under GAAP, all monetary assets and liabilities denominated in currencies other than the reporting currency were translated using the exchange rate at period end and the resulting translation gains and losses were included in consolidated statement of operations.

Under IFRS, only foreign exchange gains and losses on monetary assets and liabilities denominated in a currency other than the functional currency of each entity of the group should be included in the consolidated statement of operations.

The Company's Canadian GAAP statement of comprehensive loss for the three month period ended June 30, 2010, has been reconciled to IFRS as follows:

|   | Note                | Canadian<br>GAAP | Effect of<br>transition<br>to IFRS | IFRS             |
|---|---------------------|------------------|------------------------------------|------------------|
| Net loss for the period                 | IAS 21 <sup>b</sup> | \$<br>(249,782)  | \$<br>3,709                        | \$<br>(246,073)  |
| Foreign currency translation adjustment | IAS 21 <sup>a</sup> | -                | (62,993)                           | (62,993)         |
| <b>Comprehensive loss</b>               |                     | <b>(249,782)</b> | <b>(59,284)</b>                    | <b>(309,066)</b> |

The Company's Canadian GAAP statement of comprehensive loss for the six month period ended June 30, 2010, has been reconciled to IFRS as follows:

|   | Note                | Canadian<br>GAAP | Effect of<br>transition<br>to IFRS | IFRS             |
|---|---------------------|------------------|------------------------------------|------------------|
| Net loss for the period                 | IAS 21 <sup>b</sup> | \$<br>(917,983)  | \$<br>(79,848)                     | \$<br>(997,831)  |
| Foreign currency translation adjustment | IAS 21 <sup>a</sup> | -                | 44,303                             | 44,303           |
| <b>Comprehensive loss</b>               |                     | <b>(917,983)</b> | <b>(35,545)</b>                    | <b>(953,528)</b> |

a) IAS 21 - The effects of changes in foreign exchange rates: To adjust the translated balances of non-monetary assets and liabilities that are denominated in currencies other than the reporting currency. Under Canadian GAAP, these non-monetary assets and liabilities were translated using the exchange rates at the date of the transactions.

Under IFRS, these items are translated using the exchange rate at period end and the resulting differences are reported as a separate component of equity, 'Foreign currency translation adjustment'.

b) IAS 21 - The effects of changes in foreign exchange rates: To adjust foreign exchange gains and losses reported under Canadian GAAP. Under GAAP, all monetary assets and liabilities denominated in currencies other than the reporting currency were translated using the exchange rate at period end and the resulting translation gains and losses were included in consolidated statement of operations.

Under IFRS, only foreign exchange gains and losses on monetary assets and liabilities denominated in a currency other than the functional currency of each entity of the group should be included in the consolidated statement of operations.

The Company's Canadian GAAP statement of changes in equity at December 31, 2010, has been reconciled to IFRS as follows:

|  | Note                | Canadian<br>GAAP<br>\$ | Effect of<br>transition<br>to IFRS<br>\$ | IFRS<br>\$ |
|--|---------------------|------------------------|--|------------|
| <b>Balance, January 1, 2010</b>                    | IAS 21 <sup>a</sup> | 4,272,595              | (136,950)                                | 4,135,645  |
| Total comprehensive loss for the period            | IAS 21 <sup>b</sup> | (917,983)              | (35,545)                                 | (953,528)  |
| Shares issued for private placement                |                     | 464,675                |  | 464,675    |
| Share purchase warrants                            |                     | 69,936                 |  | 69,936     |
| Finder's fees                                      |                     | (37,500)               |  | (37,500)   |
| Share issue costs                                  |                     | (5,693)                |  | (5,693)    |
| Reserve for equity settled share based transaction |                     | 267,853                | -  | 267,853    |
| <b>Balance, June 30, 2010</b>                      | IAS 21 <sup>a</sup> | 4,113,883              | (172,495)                                | 3,941,388  |
| Comprehensive loss for the period                  | IAS 21 <sup>b</sup> | (637,197)              | 608                                      | (636,589)  |
| Shares adjustment                                  |                     | (24,389)               |  | (24,389)   |
| Share purchase warrant adjustment                  |                     | (47,582)               |  | (47,582)   |
| Share issue cost adjustment                        |                     | (2,918)                |  | (2,918)    |
| Reserve for equity settled share based transaction |                     | 153,621                |  | 153,621    |
| <b>Balance, December 31, 2010</b>                  | IAS 21 <sup>a</sup> | 3,555,418              | (171,887)                                | 3,383,531  |

a) IAS 21 - The effects of changes in foreign exchange rates: To adjust the translated balances of non-monetary assets and liabilities that are denominated in currencies other than the reporting currency. Under Canadian GAAP, these non-monetary assets and liabilities were translated using the exchange rates at the date of the transactions.

Under IFRS, these items are translated using the exchange rate at period end and the resulting differences are reported as a separate component of equity, 'Foreign currency translation adjustment'.

b) IAS 21 - The effects of changes in foreign exchange rates: To adjust foreign exchange gains and losses reported under Canadian GAAP. Under GAAP, all monetary assets and liabilities denominated in currencies other than the reporting currency were translated using the exchange rate at period end and the resulting translation gains and losses were included in consolidated statement of operations.

Under IFRS, only foreign exchange gains and losses on monetary assets and liabilities denominated in a currency other than the functional currency of each entity of the group should be included in the consolidated statement of operations.

The Company's Canadian GAAP statement of operations for the twelve month period ended December 31, 2010, has been reconciled to IFRS as follows:

|   | Note                | Canadian<br>GAAP<br>\$ | Effect of<br>transition<br>to IFRS<br>\$ | IFRS<br>\$  |
|---|---------------------|------------------------|--|-------------|
| <b>Sales</b>                            |                     | 4,209,645              |  | 4,209,645   |
| <b>Cost of sales</b>                    |                     | 1,264,220              |  | 1,264,220   |
| <b>Gross margin</b>                     |                     | 2,945,425              |  | 2,945,425   |
| <b>Operating expenses</b>               |                     |                        |  |             |
| General and administrative expenses     |                     | 3,272,909              |  | 3,272,909   |
| Stock-based compensation                |                     | 368,960                |  | 368,960     |
| Research and development                |                     | 51,509                 |  | 51,509      |
| Amortization                            |                     | 560,102                |  | 560,102     |
|   |                     | 4,253,480              |  | 4,253,480   |
| <b>Operating loss</b>                   |                     | (1,308,055)            |  | (1,308,055) |
| <b>Other items</b>                      |                     |                        |  |             |
| Finance costs                           |                     | 211,165                |  | 211,165     |
| Finance Income                          |                     | (4,777)                |  | (4,777)     |
| Foreign exchange loss (gain)            | IAS 21 <sup>b</sup> | 12,542                 | 64,591                                   | 77,133      |
|   |                     | 218,930                | 64,591                                   | 283,521     |
| <b>Income loss before income taxes</b>  |                     | (1,526,985)            | 64,594                                   | (1,591,576) |
| Income tax expense                      |                     | (28,195)               | -  | (28,195)    |
| <b>Net (loss) income for the period</b> |                     | (1,555,180)            | 64,591                                   | (1,619,771) |

b) IAS 21 - The effects of changes in foreign exchange rates: To adjust foreign exchange gains and losses reported under Canadian GAAP. Under GAAP, all monetary assets and liabilities denominated in currencies other than the reporting currency were translated using the exchange rate at period end and the resulting translation gains and losses were included in consolidated statement of operations. Under IFRS, only foreign exchange gains and losses on monetary assets and liabilities denominated in a currency other than the functional currency of each entity of the group should be included in the consolidated statement of operations.

The Company's Canadian GAAP statement of comprehensive (loss) income for the twelve month period ended December 31, 2010 has been reconciled to IFRS as follows:

|   | Note                | Canadian<br>GAAP | Effect of<br>transition<br>to IFRS | IFRS        |
|---|---------------------|------------------|------------------------------------|-------------|
|   |                     | \$               | \$                                 | \$          |
| Net loss for the period                 | IAS 21 <sup>b</sup> | (1,555,180)      | \$(64,591)                         | (1,619,771) |
| Foreign currency translation adjustment | IAS 21 <sup>a</sup> | -                | 29,654                             | 29,654      |
| Comprehensive loss                      |                     | (1,555,180)      | (34,937)                           | (1,590,117) |

a) IAS 21 - The effects of changes in foreign exchange rates: To adjust the translated balances of non-monetary assets and liabilities that are denominated in currencies other than the reporting currency. Under Canadian GAAP, these non-monetary assets and liabilities were translated using the exchange rates at the date of the transactions.

Under IFRS, these items are translated using the exchange rate at period end and the resulting differences are reported as a separate component of equity, 'Foreign currency translation adjustment'.

b) IAS 21 - The effects of changes in foreign exchange rates: To adjust foreign exchange gains and losses reported under Canadian GAAP. Under GAAP, all monetary assets and liabilities denominated in currencies other than the reporting currency were translated using the exchange rate at period end and the resulting translation gains and losses were included in consolidated statement of operations.

Under IFRS, only foreign exchange gains and losses on monetary assets and liabilities denominated in a currency other than the functional currency of each entity of the group should be included in the consolidated statement of operations.

The Company's Canadian GAAP statement of financial position at June 30, 2010, has been reconciled to IFRS as follows:

|   | Note                | Canadian<br>GAAP | Effect of<br>transition<br>to IFRS | IFRS         |
|---|---------------------|------------------|------------------------------------|--------------|
|   |                     | \$               | \$                                 | \$           |
| <b>Assets</b>                                       |                     |                  |                                    |              |
| <b>Current assets</b>                               |                     |                  |                                    |              |
| Cash and cash equivalents                           |                     | 472,368          |                                    | 472,368      |
| Short-term investments                              |                     | -                |                                    | -            |
| Restricted cash                                     |                     | 42,351           |                                    | 42,351       |
| Trade and other receivables                         |                     | 1,234,323        |                                    | 1,234,323    |
| Inventories   | IAS 21 <sup>a</sup> | 670,846          | (12)                               | 670,834      |
| Prepaid expenses and deposits                       |                     | 70,956           |                                    | 70,956       |
|   |                     | 2,490,844        | (12)                               | 2,490,832    |
| <b>Capitalized development costs</b>                |                     |                  |                                    |              |
|   |                     | 13,321           |                                    | 13,321       |
| <b>Property and equipment</b>                       | IAS 21 <sup>a</sup> | 145,607          | (3,700)                            | 141,907      |
| <b>Intangible assets</b>                            | IAS 21 <sup>a</sup> | 3,412,790        | (168,783)                          | 3,244,007    |
|   |                     | 6,062,562        | (172,495)                          | 5,890,067    |
| <b>Current liabilities</b>                          |                     |                  |                                    |              |
| Trade payable and accruals                          |                     | 611,544          |                                    | 611,544      |
| Current portion of obligations under contracts      |                     | 358,022          |                                    | 358,022      |
| Current portion of capital leases                   |                     | -                |                                    | -            |
| Current portion of debentures                       |                     | 42,351           |                                    | 42,351       |
| Current portion of deferred tenants inducement      |                     | 10,820           |                                    | 10,820       |
|   |                     | 1,022,737        |                                    | 1,022,737    |
| Obligations under acquisition contract              |                     | 401,069          |                                    | 401,069      |
| Debentures  |                     | 466,449          |                                    | 466,449      |
| Deferred tenant inducement                          |                     | 58,424           |                                    | 58,424       |
|   |                     | 1,948,679        |                                    | 1,948,679    |
| Share capital                                       |                     | 26,063,452       |                                    | 26,063,452   |
| Reserve for equity settled shared based transaction |                     | 4,731,508        |                                    | 4,731,508    |
| Foreign currency translation adjustment             | IAS 21 <sup>a</sup> | -                | 44,303                             | 44,303       |
| Deficit   | IAS 21 <sup>b</sup> | (26,321,077)     | (216,798)                          | (26,537,875) |
|   |                     | 4,113,883        | (172,495)                          | 3,941,388    |
|   |                     | 6,062,562        | (172,495)                          | 5,890,067    |

a) IAS 21 - The effects of changes in foreign exchange rates: To adjust the translated balances of non-monetary assets and liabilities that are denominated in currencies other than the reporting currency. Under Canadian GAAP, these non-monetary assets and liabilities were translated using the exchange rates at the date of the transactions. Under IFRS, these items are translated using the exchange rate at period end and the resulting differences are reported as a separate component of equity, 'Foreign currency translation adjustment'.

b) IAS 21 - The effects of changes in foreign exchange rates: To adjust foreign exchange gains and losses reported under Canadian GAAP. Under GAAP, all monetary assets and liabilities denominated in currencies other than the reporting currency were translated using the exchange rate at period end and the resulting translation gains and losses were included in consolidated statement of operations. Under IFRS, only foreign exchange gains and losses on monetary assets and liabilities denominated in a currency other than the functional currency of each entity of the group should be included in the consolidated statement of operations.

The Company's Canadian GAAP statement of financial position at December 31, 2010, has been reconciled to IFRS as follows:

|   | Note                | Canadian<br>GAAP | Effect of<br>transition<br>to IFRS | IFRS         |
|---|---------------------|------------------|------------------------------------|--------------|
|   |                     | \$               | \$                                 | \$           |
| <b>Assets</b>                                       |                     |                  |                                    |              |
| <b>Current assets</b>                               |                     |                  |                                    |              |
| Cash and cash equivalents                           |                     | 443,972          |                                    | 610,261      |
| Restricted cash                                     |                     | 166,289          |                                    | -            |
| Trade and other receivables                         |                     | 1,019,861        |                                    | 1,019,861    |
| Inventories   | IAS 21 <sup>a</sup> | 509,749          | (164)                              | 509,585      |
| Prepaid expenses and deposits                       |                     | 75,487           | -                                  | 75,487       |
|   |                     | 2,215,358        | (164)                              | 2,215,183    |
| <b>Property and equipment</b>                       | IAS 21 <sup>a</sup> | 115,490          | (3,861)                            | 111,629      |
| <b>Intangible assets</b>                            | IAS 21 <sup>a</sup> | 3,184,309        | (167,862)                          | 3,016,450    |
|   |                     | \$5,515,157      | \$(171,887)                        | \$5,343,272  |
| <b>Liabilities</b>                                  |                     |                  |                                    |              |
| <b>Current liabilities</b>                          |                     |                  |                                    |              |
| Trade payable, accruals and provisions              |                     | \$657,967        |                                    | \$657,967    |
| Current portion of obligations under contracts      |                     | 371,937          |                                    | 371,937      |
| Current portion of debentures                       |                     | 386,290          |                                    | 386,290      |
| Current portion of deferred tenants inducement      |                     | 12,379           |                                    | 12,379       |
|   |                     | 1,428,573        |                                    | 1,428,573    |
| <b>Obligations under acquisition contract</b>       |                     | 250,734          |                                    | 250,734      |
| <b>Debentures</b>                                   |                     | 228,978          |                                    | 228,978      |
| <b>Deferred tenant inducement</b>                   |                     | 51,455           |                                    | 51,455       |
|   |                     | 1,959,740        |                                    | 1,959,740    |
| <b>Shareholders' Equity</b>                         |                     |                  |                                    |              |
| Share capital                                       |                     | 26,036,145       |                                    | 26,036,145   |
| Reserve for equity settled share based transactions |                     | 4,477,547        |                                    | 4,477,547    |
| Foreign currency translation adjustment             | IAS 21 <sup>a</sup> | -                | 29,654                             | 29,654       |
| Deficit   | IAS 21 <sup>b</sup> | (26,958,275)     | (201,541)                          | (27,159,816) |
|   |                     | 3,555,417        | (171,887)                          | 3,383,530    |
|   |                     | \$5,515,157      | \$(171,887)                        | \$5,343,272  |

a) IAS 21 - The effects of changes in foreign exchange rates: To adjust the translated balances of non-monetary assets and liabilities that are denominated in currencies other than the reporting currency. Under Canadian GAAP, these non-monetary assets and liabilities were translated using the exchange rates at the date of the transactions. Under IFRS, these items are translated using the exchange rate at period end and the resulting differences are reported as a separate component of equity, 'Foreign currency translation adjustment'.

b) IAS 21 - The effects of changes in foreign exchange rates: To adjust foreign exchange gains and losses reported under Canadian GAAP. Under GAAP, all monetary assets and liabilities denominated in currencies other than the reporting currency were translated using the exchange rate at period end and the resulting translation gains and losses were included in consolidated statement of operations. Under IFRS, only foreign exchange gains and losses on monetary assets and liabilities denominated in a currency other than the functional currency of each entity of the group should be included in the consolidated statement of operations.



The Company's Canadian GAAP consolidated statement of cash flows for the twelve month period ended December 31, 2010, has been reconciled to IFRS as follows:

|   | Note                | Canadian<br>GAAP | Effect of<br>transition<br>to IFRS | IFRS        |
|---|---------------------|------------------|------------------------------------|-------------|
|   |                     | \$               |                                    | \$          |
| <b>Cash flows from operating activities</b>                     |                     |                  |                                    |             |
| Net loss for the period   | IAS 21 <sup>b</sup> | (1,555,180)      | (64,591)                           | (1,619,771) |
| Items not involving cash  |                     |                  |                                    |             |
| Amortization of property and equipment                          |                     | 104,568          |                                    | 104,568     |
| Amortization of intangible assets                               |                     | 455,534          |                                    | 455,534     |
| Amortization of capitalized development costs                   |                     | 39,961           |                                    | 39,961      |
| Stock-based compensation  |                     | 368,960          |                                    | 368,960     |
| Deferred tenant inducement                                      |                     | (10,821)         |                                    | (10,821)    |
| Accrued interest on debentures                                  |                     | 70,618           |                                    | 70,618      |
| Unrealized foreign exchange loss                                | IAS 21 <sup>b</sup> | -                | 71,730                             | 71,730      |
| Accrued interest on obligation under acquisition contracts      |                     | 17,389           |                                    | 17,389      |
| Accretion of obligations under acquisition contract             |                     | 66,546           |                                    | 66,546      |
| Foreign exchange gain on obligations under acquisition contract |                     | (60,632)         |                                    | (60,632)    |
|   |                     | (503,057)        | 7,139                              | (467,724)   |
| Change in non-cash working capital balances                     |                     |                  |                                    |             |
| Trade and other receivables                                     |                     | (362,020)        |                                    | (362,020)   |
| Inventories   |                     | 208,108          |                                    | 208,108     |
| Prepaid expenses and deposits                                   |                     | 166,815          |                                    | 166,815     |
| Trade payable, accruals and provisions                          |                     | 105,933          |                                    | 105,933     |
| <b>Net cash used in operating activities</b>                    |                     | (384,221)        | -                                  | (377,082)   |
| <b>Cash flows used in investing activities</b>                  |                     |                  |                                    |             |
| Proceeds from sale of short-term investments                    |                     | 101,646          |                                    | 101,646     |
| Purchase of property and equipment                              |                     | (12,338)         |                                    | (12,338)    |
| Restricted cash   |                     | (166,289)        |                                    | (166,289)   |
| <b>Net cash used in investing activities</b>                    |                     | (76,981)         | -                                  | (76,981)    |
| <b>Cash flows from financing activities</b>                     |                     |                  |                                    |             |
| Shares and warrants issued for cash, net of issue costs         |                     | 460,941          |                                    | 460,941     |
| Debentures issued for cash                                      |                     | 552,751          |                                    | 552,751     |
| Decrease in acquisition contract obligations                    |                     | (246,425)        |                                    | (246,425)   |
| Decrease of capital lease obligations                           |                     | (9,144)          |                                    | (9,144)     |
| <b>Net cash flows provided by financing activities</b>          |                     | 758,123          | -                                  | 758,123     |
| Net increase in cash and cash equivalents                       |                     | 296,921          |                                    | 304,060     |
| Effect of exchange rate changes on cash                         | IAS 7 <sup>c</sup>  | -                | (7,139)                            | (7,139)     |
| Cash and cash equivalents, beginning of period                  |                     | 147,051          |                                    | 147,051     |
| <b>Cash and cash equivalents, end of period</b>                 |                     | 443,972          | -                                  | 443,972     |

b) IAS 21 - The effects of changes in foreign exchange rates: To adjust foreign exchange gains and losses reported under Canadian GAAP. Under GAAP, all monetary assets and liabilities denominated in currencies other than the reporting currency were translated using the exchange rate at period end and the resulting translation gains and losses were included in consolidated statement of operations. Under IFRS, only foreign exchange gains and losses on monetary assets and liabilities denominated in a currency other than the functional currency of each entity of the group should be included in the consolidated statement of operations.

c) IAS 7 - Financial Instruments disclosure - to present the effect of exchange rate changes on cash held in a foreign currency separately from operating, investing and financing activities.