



## **Management Discussion and Analysis**

For the three months ended March 31, 2009

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The following Management Discussion and Analysis (“MD&A”), dated May 29<sup>th</sup>, 2009, provides information that management believes is relevant to an assessment and understanding of the company’s consolidated results of operations and financial condition. This discussion should be read in conjunction with the unaudited interim consolidated financial statements for the three months ended March 31, 2009 and the audited financial statements and accompanying notes for the year ended December 31, 2008.

### **Forward Looking Statements**

This MD&A contains forward-looking information, including statements regarding the future results of operations and marketing activities. Forward looking statements generally can be identified by the use of forward looking terminology such as “may”, “will”, “expect”, “intend”, “anticipate”, “plan”, “foresee”, “believe” or similar terminology. Although these forward-looking statements are based on what management believes to be current and reasonable assumptions, they involve known and unknown risks, uncertainties and other factors that may cause the actual results and performance to differ materially from those stated, anticipated, or implied in these forward-looking statements. Readers are cautioned not to place undue reliance on forward-looking information as no assurances can be given to future results, performance, or achievements.

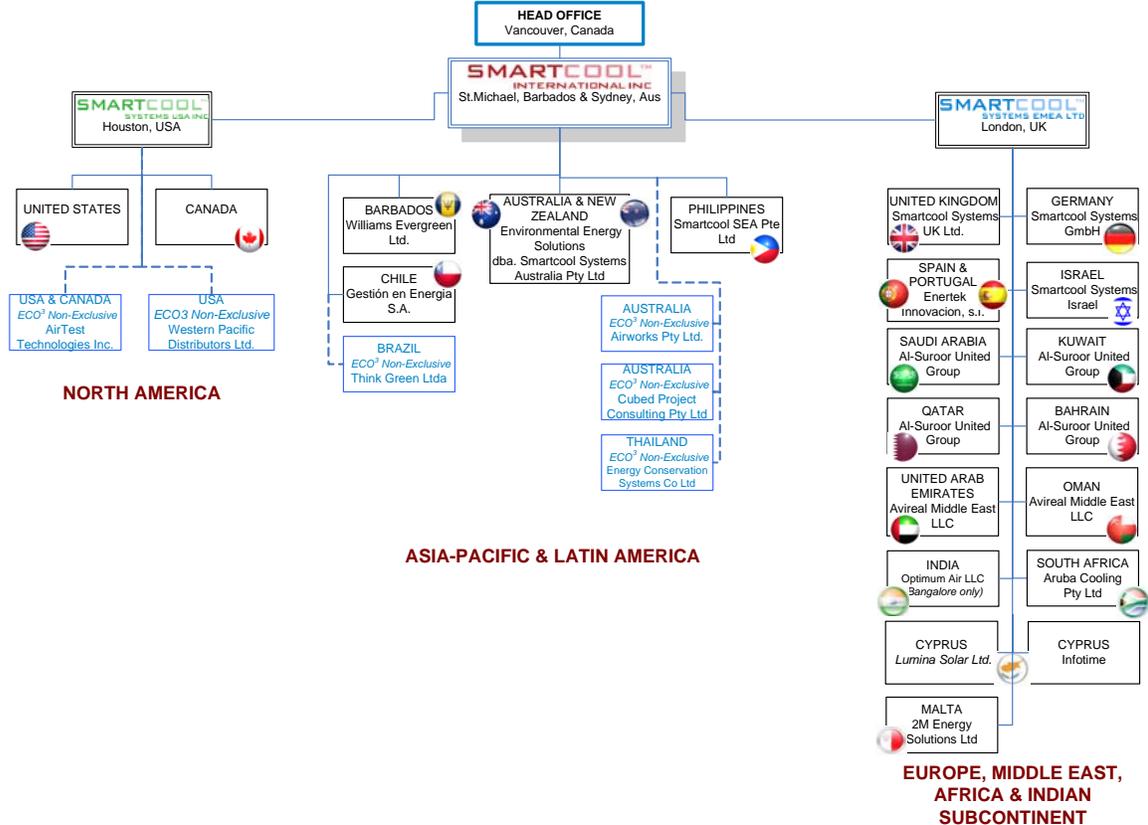
### **Business Overview**

Smartcool Systems Inc. is a cleantech company that specializes in energy and cost reduction technologies for air conditioning and refrigeration systems. Smartcool’s first product, the Energy Saving Module™ (ESM)™, has met with a great deal of success targeting industrial and commercial businesses around the world. The expansion of the product line with introduction of the new ECO<sup>3</sup>™ in early 2009 has launched Smartcool into a new era of development and growth.

Smartcool Systems Inc. was established in 2004, and was initially the North American distributor for the ESM™ on behalf of Abbotly Technologies Pty Ltd of Australia. In 2006, Smartcool International Inc., a 100% wholly owned subsidiary of Smartcool Systems Inc., purchased the assets of Abbotly, including intellectual property of the ESM™, and became the sole distributor and manufacturer. With research and development moving to the Vancouver head office, Smartcool Systems was well positioned for further corporate and product development.

Smartcool International Inc. is the master distributor of Smartcool’s product line and is located in Barbados. Following the acquisition, Smartcool International developed an international network of distributors using strategically located offices based in London, England, Sydney, Australia and Houston, Texas to build support and sales channels. . Smartcool Systems USA Inc. is the head distributor for the U.S., Canada (excluding B.C.) and the Caribbean. Smartcool Systems EMEA was formed in 2008 and is the master distributor for Europe, the Middle East, Africa and the Indian Sub-Continent. The Sydney office supports distributors through the Americas and the Asia–Pacific region. Across the four branches of the company, Smartcool employs 21 people, with the management team and a full office of 11 people in Vancouver. The following graphic illustrates the current structure of the Smartcool organization including third party distributors:

# SMARTCOOL™ SYSTEMS INC



## Market Opportunity

Achieving greater energy efficiency is a crucial step towards building more sustainable communities. The generation of electricity for use in buildings is the single largest producer of greenhouse gases in the world. There are two ways to reduce the emissions caused by electricity. The first would be to use more renewable energy sources like wind and solar power. The second is to reduce the amount of electricity currently being used around the world. Taking advantage of this 'fifth fuel' is achieving greater momentum every year and provides the most cost effective option for reducing emissions.

According to the International Energy Outlook 2006, world energy consumption is expected to increase by 71% from 2003 to 2030, most rapidly in the industrial sector. In the U.S. alone, space cooling and refrigeration accounts for 15% of total electricity consumption. At a rate of US\$0.07/kWh in the commercial sector, air-conditioning and refrigeration accounts for US\$26 billion in spending annually. Energy consistently ranks as the second or third largest operating expense for businesses with air-conditioning and refrigeration typically representing the largest electrical expense in the market verticals that Smartcool is targeting.

In countries with higher ambient temperatures, the usage in air conditioning will be significantly higher, coming much closer to 30%. There has been a great deal of development in the lighting field to reduce energy, however, in the area of air conditioning and refrigeration, most of the development has resulted in expensive and complex systems requiring highly skilled installers and programmers. The cost of these systems has prohibited the installation by most small to medium consumers and even larger businesses have been challenged to meet the expense.

With ever increasing energy demands and the rising cost of power, both Government and Industry are searching for ways to simultaneously reduce operating costs and decrease their environmental impact. Governments are implementing rebate programs for companies that institute energy saving measures.

Companies are realizing the economic and social benefits of implementing aggressive environmentally conscious programs that reduce their energy costs. The new administration in the U.S has highlighted the energy crisis as a significant challenge they are fully prepared to address. The investment of over US\$150 billion over the next 10 years to address the dependence on foreign oil, address the global climate crisis and create millions of new jobs is a clear indication of that commitment.

Smartcool is helping clients achieve greater energy efficiency, increase profits and promote environmental sustainability through the installation of the Energy Saving Module™ and ECO<sup>3</sup>™.

## **Technology Overview**

The Energy Saving Module™ and ECO<sup>3</sup>™ are green technologies that reduce the electricity usage (kWh) and demand (KW) of air conditioning and refrigeration compressors through enhanced system performance. This provides substantial economic and environmental benefits for Smartcool's growing customer base. Smartcool's products are compatible with all types of control systems including the latest building automation systems and computer controlled refrigeration plants. Energy savings achieved by the ESM™ and ECO<sup>3</sup>™ are quantifiable and the products can qualify for government and utility rebates. The technology has been validated by rigorous third party testing, government organizations and private business installations.

### **The Energy Saving Module™ (ESM™)**

The Energy Saving Module™ is designed specifically to reduce the electricity consumption (kWh) and maximum demand (KW/KVA) of refrigeration and air conditioning compressors by improving their performance and maintaining temperature control. The ESM™ is designed to interface with all types and makes of air conditioning and refrigeration controllers from the simple thermostat single condensing systems to the most sophisticated computer based multiple compressor parallel systems.

The ESM™ is not a controller. It is a supplement to the existing system - designed to work with the existing air conditioning and refrigeration equipment along with current control methodology in order to reduce the energy consumption. When a call for cooling comes from the existing controls, the ESM™ takes over to determine when and for how long each compressor or unloader will run. Because the primary control is not replaced, the ESM™ can be put into bypass at any time and the system returns to operating exactly as it was prior to the installation. This is an important distinction for system repairs and/or troubleshooting.

The ESM™ enables the compressor to maximize the rate of heat removal by optimizing the natural physical properties of the compressor operating cycle. This process, known as "Compressor Optimization" can reduce compressor running time by up to 30% with no affect on the temperature conditions.

### **The ECO<sup>3</sup>™**

In early 2009, Smartcool Systems Inc. launched its newest product: the ECO<sup>3</sup>™. This unique retrofit device can be installed on any air conditioning or refrigeration unit with one or two compressors, and will save an average of 12% of the energy used by that system. The most significant feature of the new ECO<sup>3</sup>™ is its ability to save energy on the cooling and heating cycles of compressor driven heat pumps, significantly increasing the opportunity for energy savings. With its IP64 enclosure rating, and its simple installation process, the ECO<sup>3</sup>™ can be installed quickly (under 2 hours by an experienced technician) in virtually any location without additional and often costly protection from the elements. Once installed, the large display screen of the ECO<sup>3</sup>™ allows for easy monitoring of the amount of energy it is saving for the customer.

## **Third Party Assessment**

Smartcool's technology has undergone significant testing, resulting in a great deal of evidence of its energy saving capabilities. In addition to independent third party tests, over 26,000 units of the ESM™ and ECO<sup>3</sup>™ have been installed worldwide.

The University of Miami, on behalf of Florida Power and Light (FPL), conducted extensive testing of the ESM™ installed over a twelve month period in 2006. The testing showed that the ESM™ reduced kWh usage of the

entire air conditioning system by 8.9% – which provides a savings of 13.38% of the kWh usage by the compressors, an annual reduction of 43,660 kWh and a reduction in greenhouse gas emissions of 58,911 lbs. The ESM™ also reduced the peak demand of the system by 10.8%.

Oak Ridge National Laboratory (ORNL), a division of the U.S. Department of Energy, conducted a two phase test of the ESM™ in 2004-2005. The first phase of the test involved the analysis of data collected from an installation on a refrigeration rack in a grocery store. Phase 1 results were sufficiently promising to merit and a second phase of testing in a controlled laboratory environment. The second phase evaluated the ability of the ESM™ to reduce the electrical consumption of a four compressor roof top unit in a controlled laboratory environment. Test results showed an 11.87% reduction in kWh usage by the compressors in the system and a 2.2% demand (KW) reduction.

Previously, a test on a refrigeration system was conducted by the Los Angeles Department of Water and Power (LADWP). The ESM™ was installed on two compressors of the refrigeration system of Notrica's Market in Bellflower, California. The average daily kWh usage savings recorded during this test was between 20% and 24%. These reductions were achieved while maintaining the temperature performance of the system.

### **Applications for Smartcool's Technology**

The ESM™ and ECO<sup>3</sup>™ have a large number of potential applications in a variety of different industries. Between the two products, Smartcool is able to offer a cost-effective energy efficiency solution for virtually any cooling systems, with the exception of blast chillers. In every Smartcool installation, the ESM™ and ECO<sup>3</sup>™ provide great economic, environmental and energy reducing benefits for the client's facility.

#### *Air Conditioning Units*

The ESM™ is compatible with any air conditioning system, while the ECO<sup>3</sup>™ is compatible with packaged units with one or two stages of control. Air conditioning in facilities such as commercial real estate, supermarkets, hotels, restaurants, schools, hospitals, data centers and telecommunications facilities can all benefit from the energy efficiency products supplied by Smartcool.

#### *Refrigeration Units*

The ECO<sup>3</sup>™ is compatible with any single compressor refrigeration system. The ESM™ is compatible with all refrigeration systems, including large multi-compressor racks. Process cooling, cold storage warehouses, hospitals, supermarkets, mini-marts or convenience stores, restaurants and many other businesses can save money on their refrigeration bills by installing the ESM™ or ECO<sup>3</sup>™.

#### *Chillers*

Most modern chillers are fitted with Micro-Processor Chiller Management Systems that usually allow a third party interface to modify the chiller capacity control. The Intelligent Interface Module allows the ESM™ to modify chiller capacity control using remote set point control, temperature reset, dual set point control or pulse width modulation.

The ability of the ESM™ to provide savings on a chiller is achieved by the ability of the IIM to interface with the primary controller causing the unit to shed load for a period of time to reduce the amount of energy the system is using. The ESM™ is able to provide this set point shift/load shifting through the full range of ambient conditions and not just at low ambient conditions.

### **Competitive Advantage**

There are no direct competitors at this time, and those few products that are geared towards energy efficiency in the air conditioning and refrigeration market do not provide the same package of benefits as does the ESM™ or ECO<sup>3</sup>™. Most other products aiming to save energy on air conditioning and refrigeration systems do not target the compressors, despite the compressors being responsible for most of the energy consumed

by the system. Smartcool's products target the compressors specifically, and are miles ahead of the competition with thanks to a solid technical foundation and certain unique features.

The ECO<sup>3</sup>™ has been developed using the experience gained through distribution of the ESM™, a product that has already met a high level of success with 26,000 units installed around the world. Case studies from ESM™ installations in all of Smartcool's targeted vertical markets show a large, satisfied customer base. As reported previously, Smartcool's ESM™ has also undergone significant independent third party testing, including field and laboratory tests by Oak Ridge National Laboratory (ORNL) on behalf of Wal-Mart, the University of Miami on behalf of Florida Power and Light (FPL) and Los Angeles Department of Water and Power (LADWP). All of the results from these tests have been positive and have verified the effectiveness of the technology. Experience gained from the development and marketing of the ESM™ has allowed the ECO<sup>3</sup>™ to be created and launched into the market with a solid and credible foundation. This gives potential customers additional confidence in the company and the technology, leading them to choose Smartcool over other alternatives.

Certain features of the ECO<sup>3</sup>™ also give it an advantage over potential competitors. It is the only product on the market that can save energy on the cooling and heating cycles of compressor driven heat pumps. These types of heat pumps are very common, particularly in areas where cooling may not be necessary year round such as in British Columbia. The ECO<sup>3</sup>™ has exclusive access to this large market, as it provides the most effective energy efficiency device for customers with these types of units. The IP64 rating and simple installation cut down on additional costs for the customer, as extra protection and long labour hours are not necessary.

### **First Quarter Review**

The first few months of 2009 have presented challenges to Smartcool that are being met head on. A world-wide economic downturn has definitely seen our customers reassess their own capital spending but it has also seen such business' realize the economic benefits of energy efficiency. We believe that industry is starting to benefit from the release of stimulus package funding which is allowing capital spending programs, previously on hold, to be implemented.

The launch of our new product, the ECO<sup>3</sup>™, has been very well accepted and initial orders of the product have seen significant energy savings provided to customers through our distribution network. The new product, that services smaller air conditioning and refrigeration systems, has a unique feature that also optimizes both the cooling and heating cycles of compressor driven heat pump systems. This allows for better economics for installations in areas that require both heating and cooling. There are literally millions of systems all over the world that would benefit from the ECO<sup>3</sup>™ and through our distribution network we will look to access these opportunities that previously did not make economic sense with our more sophisticated ESM™ technology. In addition to distributing the ECO<sup>3</sup>™ via our pre-existing distribution channels, the company has also signed distribution agreements with a further eight groups located throughout the world and is currently negotiating with several others.

Smartcool has seen commitment to the ESM™ and ECO<sup>3</sup>™ technologies with new distribution agreements being signed in Chile and South Africa. Both agreements were dependent on satisfactory savings results from on-site assessments of the technology. Upon successful completion, both groups have now become distributors. The company has also entered into a distribution agreement with 2M Energy Solutions Ltd. covering the island of Malta.

Further endorsement of the technology has come from Sainsburys, the U.K.'s third largest grocer, who has been aggressively implementing a far reaching green program within their stores. Smartcool's technology has now been installed in twenty five stores and we are currently exploring a more extensive rollout.

As is the nature of our business, we continue to be involved in many assessment programs in several different vertical markets and we are confident that the savings we provide with our technology will generate revenues throughout 2009.

## **Financial Overview**

Revenue for the first quarter of 2009 was \$225,556, compared to \$422,663 for the same period of the prior year. Total assets at the end of the period were \$6,963,567 compared to \$8,891,785 at the end of first quarter of 2008. Net loss was \$1,404,535 (\$0.03 per share) for the quarter, compared to \$745,733 (\$0.02 per share) for the same period in 2008.

The Company had \$1,237,166 in cash and cash equivalents and short-term investments of \$26,176 at the end of the first quarter, compared to \$5,352,640 in cash and cash equivalent and short-term investments of \$51,278 at the end of the first quarter of 2008.

Current liabilities at the end the quarter were \$834,425 which include the current portions of purchase obligations to TECC Services, capital leases and deferred tenant inducement totaling \$434,080. Long-term liabilities were \$504,608, consisting of acquisition obligations (\$428,343), balance of capital leases (\$4,317) and deferred tenant inducement (\$71,948).

## **Result of Operations**

### ***Revenue***

Revenue for the period was \$225,556, decreased by \$197,107 or 47%, compared to \$422,663 of the same period of 2008 with \$205,269 or 91% of total revenue relating to distribution sales (first quarter of 2008 - \$259,398) and \$20,287 or 9% relating to retail sales (first quarter of 2008 - \$163,265). Though the company's distribution network has constantly expanded resulting in a greater number of sales transactions in the first quarter, the majority of them were small in size due to the current challenging economic condition. Direct sales were slow for the same reason.

### ***Gross profit***

Gross profit for the period was \$146,646 or 65% of revenue compared to \$268,528 or 64% for the previous year. These results were within the expected range of gross margin.

### ***General and administrative expenses***

General and administrative expenses for the period were \$1,243,401 compared to \$775,043 of the same period of previous year. The increase reflected increased higher wages and salaries (\$602,532 compared to \$345,233 for the first quarter of 2008), greater travel expenses (\$181,537 compared to \$79,785 for the same period of 2008), increased technical consulting fees (\$42,270 compared to \$10,874 for the first quarter of 2008) and office expenses (\$69,094 compared to \$35,471 for the same period in 2008).

### ***Net loss***

Net loss for the first quarter was \$1,404,535 compared to \$745,733 for the same quarter in the prior year. The increase in net loss was primarily a result of greater operating expenses. The loss per share (basic and diluted) for the period \$0.03, compared to \$0.02 for the same period in 2008. Loss per share is calculated based on the weighted average number of common shares outstanding throughout the year.

### **Amortization**

Amortization expenses were \$149,639 for the quarter compared to \$78,031 for the same period in the prior year. Amortization on property and equipment was \$35,735 (first quarter of 2008 - \$27,990) and amortization of intangible assets was \$113,904 (first quarter of 2008 - \$50,041). The significant increase in intangible assets amortization was a result of the acquisition of distribution rights from TECC Services in July 2008.

### **Stock-based compensation**

Stock-based compensation costs for the period decreased to \$98,329 from \$240,842 for the same period in 2008. The period's expense consists of amortized costs of options granted in previous years plus the cost of re-pricing 1,895,000 options in February 2009. No options were granted in the period.

### **Capital expenditure**

Capital expenditures for the quarter were \$38,097, compared to \$29,294 for the same quarter of 2008. These expenditures were primarily for the acquisition of additional testing equipment needed at a couple of multiple site customers.

### **Intangible assets**

Smartcool acquired the intellectual property of the ESM™ and its world-wide distribution rights in the year 2006. The acquisition was closed on June 30, 2006 at a price of AU\$2,895,000. The purchase price has been fully paid. The acquired assets included four distribution contracts and several supplier agreements along with the intellectual property of the ESM™ and the ESM™ brand.

Smartcool 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") in July 2008. 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 remaining balance of £600,000GBP is due in scheduled instalments over four years with the last payment due on July 11, 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. As at March 31, 2009, £600,000GBP was still outstanding.

### **Summary of Quarterly Results**

	Jun 2007 (\$)	Sep 2007 (\$)	Dec 2007 (\$)	Mar 2008 (\$)	Jun 2008 (\$)	Sep 2008 (\$)	Dec 2008 (\$)	Mar 2009 (\$)
Total Revenues	197,809	54,107	183,578	422,663	120,373	204,793	427,339	225,556
Income/(Loss)	(768,358)	(1,066,472)	(1,584,963)	(745,733)	(1,039,987)	(1,337,484)	(\$1,247,679)	(1,404,535)
Income/(Loss) Per Share – basic & diluted	(0.02)	(0.03)	(0.13)*	(0.02)	(0.03)	(0.03)	(0.11)*	(0.03)

\*represents the loss per share (basic and diluted) for the fiscal years ended December 2007 and 2008

## Schedule of selling, general and administrative expenses

	Three months ended March 31, 2009	Three months ended March 31, 2008
Management and consulting fees	179,598	171,533
Salaries and benefits	602,532	345,233
Professional fees	11,204	13,908
Investor relations and media	71,970	49,514
Travel	181,537	79,785
Technical consulting	42,270	10,874
Rent, office and other expenses	154,290	104,196
<b>Total selling, general &amp; admin expenses</b>	<b>1,243,401</b>	<b>775,043</b>
Stock-based compensation	98,329	240,842
Survey and testing cost	-	871
Research & Development	22,530	1,032
Amortization	149,639	78,031
<b>Total operating expenses</b>	<b>1,513,899</b>	<b>1,095,819</b>

The company's general and administration expenses were \$1,243,401 for the first quarter of 2009 compared to \$745,043 for the same period in 2008.

### Liquidity and Capital Resources

Working capital at the end of the first quarter was \$1,756,836 compared to working capital of \$6,009,810 for the same period of 2008.

The company consumed cash resources of \$1,015,692 during the period, compared to \$668,220 for the first quarter of the previous year. Cash was used to mainly fund the operating loss for the period. The average monthly burn for the quarter was \$324,000 compared to \$301,000 for the first quarter of 2008.

Management believes cash generated from sales along with existing cash resources will enable the company to continue its operations, meet its acquisition obligations, and complete marketing strategies for the next twelve months. Management also expects that the effect of commercial, utility and government incentives, targeting energy efficiency and greenhouse gas reduction, will assist the Company in generating greater revenue opportunities.

Though in prior years the company was able to raise capital to finance its operations, the company's ultimate success and the recoverability of its intangible 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.

Due to the current economic crisis, the company might not be able to raise additional capital to expand its operations in the coming year. As a proactive action, the company has done a comprehensive review of its business development programs, operations and cash flow projections and taken certain cost reduction measures to ensure that it will have sufficient working capital to carry out its core business plan and meet its financial obligations over the next twelve months.

## Commitments

The company is committed to a number of financial obligations under premise lease, equipment lease and acquisition contracts. As at March 31, 2009, the company's commitments and obligations were as follows:

Contractual Obligations	Total	Payment Due by Period		
		Within 1 year	2-3 years	4-5 years
Premise lease	370,755	77,220	125,685	167,850
Capital lease	22,527	18,210	4,317	-
Acquisition obligations	833,838	405,495	312,215	116,128
Total contractual obligations	1,227,120	500,925	442,217	283,978

### a) Premise lease

On June 1, 2005, the company entered into an agreement to lease office facilities for 10 years.

In February 2008, the company entered into a new lease agreement to lease office facilities in Texas for 37 months commencing February 1, 2008 and expiring February 28, 2011, for monthly rent payments of \$1,800 per month, up to February 28, 2009 and monthly payments of \$1,908 thereafter.

The future minimum commitments for the company's office premises are:

	\$
2009	57,915
2010	77,220
2011	54,945
2012	51,300
2013 and thereafter	<u>129,375</u>
	<u>370,755</u>

For the three months ended March 31, 2009, the company's rent expense including certain operating expenses and property taxes was \$34,380 (2008 - \$133,836) and its sublease revenue was \$6,135 (2008 - \$23,676).

### b) Letter of credit

Upon the signing of the lease contract in June 2005, the company was required to secure its obligations with a letter of credit of \$100,000. The letter of credit is reduced by \$25,000 every year. As at March 31, 2009, the company had open letters of credit of \$25,000 (2008 - \$25,000).

### c) Equipment lease

In March 2007, the company signed two contractual agreements for the financing of computer equipment and software. Under these agreements, the company is required to make 36 monthly payments of \$1,013 and \$706 starting July 2007.

In July 2008, Smartcool USA entered into an office equipment lease agreement. Under this agreement, the company is required to make 24 monthly payments of \$369 starting August 2008.

#### d) 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 of 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. For the three months ended March 31, 2009, the company recorded royalties of US\$400 (2008 - US\$40,000). As at March 31, 2009, royalties of US\$400 were payable to Abbotly USA (2008 - US\$1,344).

#### **Transactions with Related Parties**

Consulting fees of \$63,660 were charged by directors of the company during the period (2008 - \$259,185). Consulting and management fees of \$26,000 were charged by three companies with common directors and officers during the quarter (2008 - \$90,997). The company rents its office in the United Kingdom from a company with a common director. During the three months ended March 31, 2009, rent expense was \$9,843 (2008 - \$21,539). These transactions were recorded at their exchange amounts and have been charged to general and administrative in the statement of operations. At March 31, 2009, £7,877GBP (CDN\$14,196) was owed to these related parties.

The company subleases its Vancouver office and other facilities to a company with a common director. During the three months ended March 31, 2009, sublease income was \$6,135 (2008 - \$23,676). At March 31, 2009, \$8,576 was owed from this related party (2008 - \$2,441).

Total purchases of £2,325GBP were made by a company with a common director during the period (2008 - £108,101GBP) and are recorded as sales in the statement of operations. As at March 31, 2009, £2,231GBP was owed from this related party.

#### **Outstanding Share Data**

The authorized share capital of the company is an unlimited number of common shares without par value. As at March 31, 2009 the company had 41,182,646 common shares outstanding. The weighted average number of common shares outstanding for the three months ended March 31, 2009 was 41,182,646 (March 2008 - 37,129,563) shares.

As at May 26, 2009, the outstanding shares are 41,182,646 and fully diluted are 48,638,646.

#### **Warrants and Stock options**

As at March 31, 2009, there were 2,500,000 share purchase warrants and 4,956,000 stock options outstanding which collectively could result in the issuance of 7,456,000 common shares if these warrants and stock options are exercised. The outstanding options have weighted average exercise price of \$0.36.

As at March 31, 2009 there were 4,669,750 exercisable options with a weighted exercise price of \$0.36.

During the period, 1,895,000 stock options were re-priced.

## Financial Instruments and Risk Management

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

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 2009, equity financing has been considered.

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. 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 have been mitigated by the use of foreign currency forward contracts. The company's exposure to interest risk is limited as it has no interest bearing debt.

Details of the company's financial instruments as at March 31, 2009 and risk exposures are disclosed in note 14 to the consolidated financial statements.

## Subsequent Events

On April 2, 2009, Smartcool International terminated its exclusive distribution agreement for the territory of Mexico with Precision Control Comercial, S.A. de C.V.

On April 16, 2009, Smartcool International appointed Aruba Cooling Pty Ltd., South Africa, to be its authorized, non-exclusive distributor within the territory of South Africa. The distribution agreement has a term of two years and can be renewed for an additional two year period.

## Critical Accounting Policies

### *Intangible assets*

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

ESM <sup>TM</sup> Intellectual property	10 years
North American distribution rights	10 years
European distribution rights	9 years
Distribution agreements	10 - 15 years
Supplier agreements	10 years

### *Impairment of long-lived assets*

Long-lived assets including property and equipment and intangible assets with a finite life are tested for impairment whenever events or changes in circumstances indicate that carrying value of an asset or asset group may not be recoverable. An impairment loss would be recognized when the carrying amount of an asset exceeds the estimated undiscounted future cash flow expected to result from the use of the asset and

its eventual disposition. The amount of the impairment loss to be recorded is calculated by the excess of the asset's carrying value over the fair value. Fair value is generally determined using a discounted cash flow analysis.

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 estimated fair value.

#### *Revenue recognition*

Revenue from the direct sale and installation of the ESM<sup>TM</sup> and ECO<sup>3TM</sup> in North America is recognized when the ESM<sup>TM</sup> has been installed, title has transferred, collectability is reasonably assured and the fee is fixed and determinable. Revenue from the worldwide distribution of the ESM<sup>TM</sup> and ECO<sup>3TM</sup> is recognized when the equipment has been shipped and title has transferred, collectability is reasonably assured and the fee is fixed and determinable. Provisions are established for estimated warranty costs at the time revenue is recognized. The company records deferred revenue when cash deposits are received in advance of all of these revenue recognition criteria being met.

#### *Research and development costs*

Research costs are expensed as incurred. Development costs are expensed as incurred unless they meet specific criteria under Canadian GAAP for deferral and amortization, which relate primarily to technical, market and financial feasibility.

#### *Stock-based compensation and other stock-based payments*

The company applies fair value accounting to the grant of stock options to employees, consultants and others. The value of these options is determined using the Black Scholes pricing model and the resulting value is charged to operations over the vesting period. For options granted to non-employees, the fair value is measured when performance is complete, a performance commitment is made or the options are fully vested and non forfeitable, whichever is the 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 contributed surplus is recorded when stock options are expensed. When stock options are exercised, capital stock is credited by the sum of the consideration paid and the related portion previously recorded in contributed surplus.

#### **Internal Controls over Financial Reporting and Disclosure Controls and Procedures**

The Chief Executive Officer and Chief Financial Officer make no representation relating to the establishment and maintenance of the company's disclosure controls and procedures and internal controls over financial reporting.

#### **Changes in Accounting Policies**

Effective January 2009, the company adopted the Canadian Institute of Chartered Accountants ("CICA") Handbook Section 3064 "Goodwill and Intangible Assets" which replaces Section 3062 "Goodwill and Other Intangible Assets" and Section 3450 "Research and Development Costs". This section establishes standards for recognition, measurement, presentation and disclosure of goodwill and intangible assets by profit-oriented enterprises subsequent to their initial measurement. The adoption of this new standard did not have a material impact on the consolidated financial statements of the company.

Effective January 1, 2009, the company adopted the CICA issued EIC-173 "Credit and the Fair Value of Financial Assets and Financial Liabilities". The EIC provides guidance on how to take into account the credit risk of an entity and counterparty when determining the fair value of financial assets and financial liabilities, including derivative instruments. The adoption of this EIC did not have a material impact on the consolidated financial statements of the company.

## **Future Accounting Standards**

### *International Financial Reporting Standards*

In February 2008, the Canadian Accounting Standards Board confirmed that International Financial Reporting Standards (“IFRS”) will replace Canadian GAAP for publicly accountable profit-oriented enterprises for interim and annual financial statements effective January 1, 2011.

The company will therefore be required to report using IFRS commencing with its unaudited interim financial statements for the three months ended March 31, 2011, which must include the interim results for the three months ended March 31, 2010 prepared on the same basis. IFRS uses a conceptual framework similar to Canadian GAAP, but there are some significant differences with regards to recognition, measurement and disclosures. The company is currently considering the impact of these standards on its financial statements.

### *Business Combinations*

In January 2009, the CICA issued Section 1582 “Business Combinations” which establishes principles and requirements of the acquisition method for business combinations and related disclosures. The purchase price is to be based on trading data at the closing date of the acquisition, not the announcement date of the acquisition, and most acquisition costs are to be expensed as incurred. This standard applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011 with earlier application permitted. The company plans to adopt this standard prospectively effective January 1, 2011. The adoption of this standard may have impact on the accounting of future business combinations.

In January 2009, the CICA issued Section 1601 which establishes standards for the preparation of consolidated financial statements and Section 1602 which provides guidance on accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. The company plans to adopt this standard prospectively effective January 1, 2011. The adoption of this standard may have impact on the accounting of future business combinations.

## **Risk Factors**

The business of the company is subject to a number of risks and uncertainties associated with its business for the marketing and distribution of the ESM<sup>TM</sup>.

### *Lack of Marketing Network*

At the current time the company has continued to develop new marketing networks throughout the world. A primary objective of the company’s business plan includes the identification and securing new networks however there can be no assurances of the amount of revenue that will be generated from these efforts. To mitigate the risk to a certain extent, the company when granting exclusive marketing rights for a territory will require a new distributor to agree to purchase a minimum amount of inventory in each year of the agreement to retain exclusivity. This provides the company with revenue from these territories.

### *Reliance on Key Personnel*

The company is dependent on certain key members of its management team, and in particular Mr. George Burnes, President, to complete the market development of the ESM<sup>TM</sup> and ECO<sup>3TM</sup>. If any of these individuals are unavailable for any reason, the ability of the company to implement its business plan in the short term would be materially and adversely affected. To mitigate the risk to a certain extent, key personnel in the companies’ subsidiaries have been added to complete new marketing initiatives in developing markets.

### *Concentration on a single product*

Presently, as the company is placing its sole focus on the distribution of the ESM<sup>TM</sup>, and ECO<sup>3</sup><sup>TM</sup>, any unfavorable change in the quality of the product or the introduction of similar products by competitors in the market would affect the company's competitive advantage to a great extent. To mitigate the risk to a certain extent, the company expanded the application of its technology and made available the ECO3 which allows for sales initiatives in new vertical markets and new distribution channels previously not available.

### *Currency risk*

Presently the company's major business dealings are transacted in foreign currencies. Direct sales are in the United States currency as well as the majority of sales to distributors are also in US currency. Any devaluation in these currencies would affect the company's future revenues. Also, a significant portion of the company's expenses are in Canadian and Australian currencies. As long as the majority of revenue remains in US currency, appreciation in the value of Canadian and Australia currencies relative to the US dollar would worsen that affect on net operating results. To mitigate this risk to certain extent, recently the company has had most of its new purchases and sales contracts denominated in US dollars.

### *Competition Risk*

Although the ESM<sup>TM</sup> and ECO<sup>3</sup><sup>TM</sup> are unique products and the company is not aware of any direct competitors, there is a possibility that new technologies will be developed that allow direct competition as energy saving activities gain more and more public support. These potential competitors may have greater resources and networking and the company may not be able to successfully compete with them. This direct competition may adversely affect the company's operating results and even its ability to sustain the business.