

# Smartcool Systems Inc.

## Management's Discussion and Analysis

For the three months ended June 30, 2009

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The following Management Discussion and Analysis ("MD&A"), dated August 27<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 and six months ended June 30, 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.

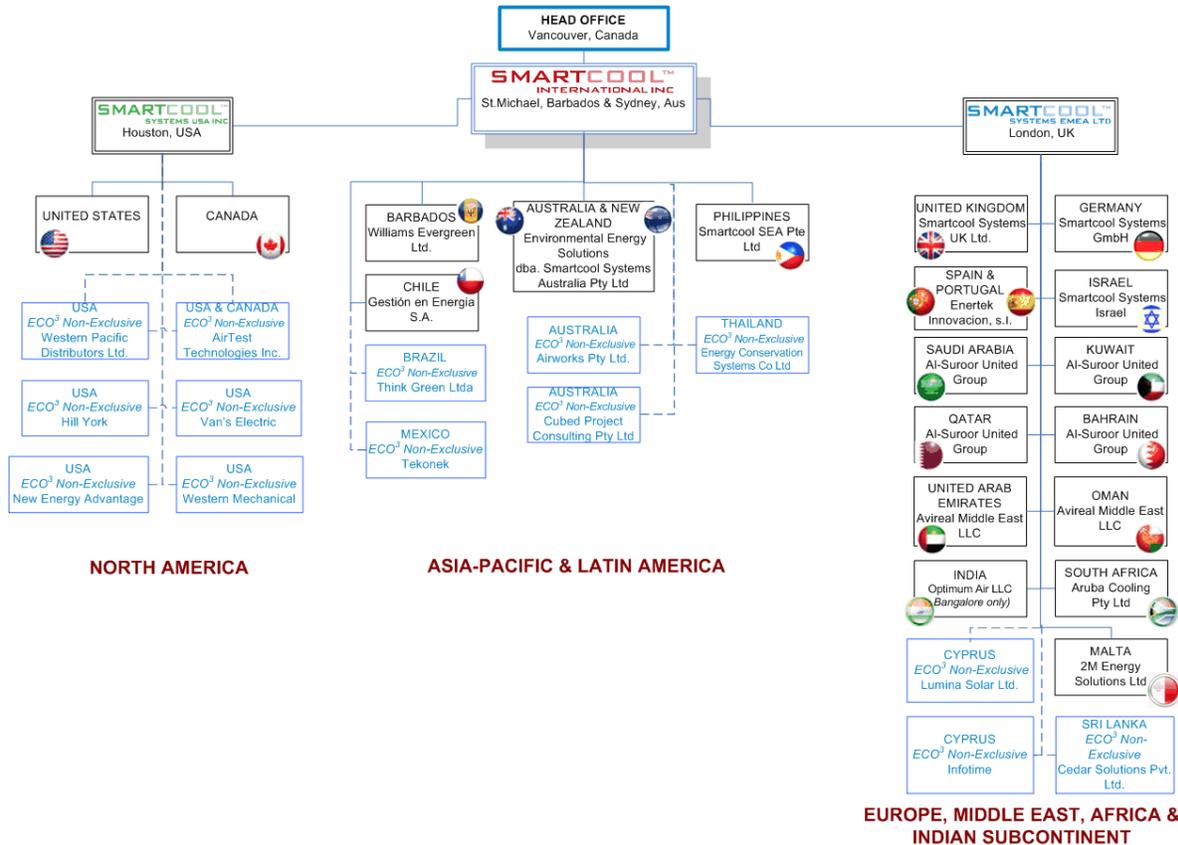
### Business Overview

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. and Canada (excluding B.C.). 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 16 people, with the management team and a full office of 8 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.

#### *Heat Pumps*

Heat pumps are a rapidly growing market in North America, and have been well-established for quite some time in Europe and Australia. With the increasing push towards greater energy efficiency by governments around the world, many new constructions in the residential and commercial sectors are choosing air source or geothermal heat pumps over traditional air conditioning and/or heating systems. It is estimated that 1 in

every 3 new homes in the US is built with a heat pump. These systems are gaining traction in many regions of North America thanks to their ability to provide both heating *and* cooling to buildings.

Smartcool's ECO<sup>3</sup>™ is ideally positioned to tackle the heat pump market, due to its unique ability to save energy on the heating and cooling cycles of compressor driven heat pumps. The recent completion of successful testing on ECO<sup>3</sup>™ units installed on heat pumps in Australia and in Canada shows strong results with considerable financial benefit to the customer.

### **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.

### **Quarter Review**

Although we have been significantly affected by the world wide economic slowdown, the second quarter revenue results have been extremely positive. Smartcool posted its best quarter of revenue since inception. The strategy of moving distributor support closer to regions and developing sales channels in new territories resulted in revenue growth world wide. The introduction of the ECO3tm in the first quarter has also provided distribution channels the opportunity to expand their marketing efforts to new customer applications with positive results during the second quarter.

Our UK office which supports distribution channels in the EMEA regions showed revenue growth which was 800% higher than the first quarter. Increased revenue from our distributors in India, Israel and Dubai indicates the sales process is moving from evaluations to customer purchases. In addition we have new sales channels in Cypress who have purchased ESM™ and ECO<sup>3</sup>™co product for this market.

Our Sydney office which supports distribution in Australia, New Zealand and SE Asia showed 10% revenue growth during the quarter. The largest improvement was in the Australian market with the distributor securing new accounts in the banking, hospitality and commercial sectors.

The Vancouver and Houston offices which support North America, Mexico and South America regions showed 178% revenue growth during the quarter. New distribution channels have been established in Brazil which is focusing sales initiatives in the fast food and banking sectors. A new sales channel in Mexico focusing on the

telecommunications sector has been established. In North America new ECO<sup>3™</sup> sales channels have been established focusing on telecommunications and public sector clients. New initiatives have also started in the Hawaiian market.

The second quarter also saw Smartcool address other financial realities of the economic slowdown which is the cost of operations. Even though revenue saw positive growth we continue to be concerned how the economic recovery will be sustained. We have evaluated our cost structure and felt it was necessary to reduce our staffing in North America by five people. As well reduction in travel and consulting services has been implemented.

This reduction in human resources supporting direct sales, we believe will not impede ongoing revenue growth due to the strategy of sourcing new channel partners focusing on ECO<sup>3™</sup> sales where the sales and technical support comes from their internal infrastructure with Smartcool providing the training and remote support. This will allow a higher volume of units sold due to the relationship these companies have with their customers.

We are also seeing the effect of the new stimulus packages in the US market and incentives are flowing through the utilities and directly from DOE to customers to encourage energy efficiency initiatives. More Energy Service companies are being established to source solutions for customers and access these funds. We are targeting these groups and have already seen the positive results in the second quarter. The ECO<sup>3™</sup> product provides these companies with an economic solution.

## **Financial Overview**

Revenue for the second quarter of 2009 was \$510,844 compared to \$120,373 for the same period of the prior year. Revenue for the first two quarters of 2009 was \$736,400 compared to \$543,036 for the same period of 2008. Net loss for the quarter was \$929,730 (\$0.02 per share) compared to \$1,039,986 (\$0.03 per share) for the same period in 2008. Net loss for the half year was \$2,334,265 (\$0.06 per share), compared to \$1,785,719 (\$0.05 per share) for the same period of the previous year.

Total assets at the end of the period were \$6,476,394 compared to \$9,476,774 at the end of the second quarter of 2008. The Company had \$498,050 in cash and cash equivalents and short-term investments of \$352,143 at the end of the second quarter, compared to \$5,736,659 in cash and cash equivalent and short-term investments of \$25,000 at the end of the second quarter of 2008.

Current liabilities at the end the quarter were \$754,662 which include the current portions of purchase obligations to TECC Services, capital leases and deferred tenant inducement totaling \$459,308. Long-term liabilities were \$543,916, consisting of acquisition obligations \$474,672 and deferred tenant inducement \$69,244.

## **Result of Operations**

### **Revenue**

Revenue for the quarter was \$510,844, increased by \$390,471 or 324% from \$120,373 of the second quarter of 2008 with \$485,127 or 95% of total revenue relating to distribution sales (second quarter of 2008 - \$120,373) and \$25,717 or 5% relating to retail sales (second quarter of 2008 - \$0). Despite the economic challenge every business is facing, the company was able to increase its revenue and expand its customer base as the demand for green products continued to grow.

Revenue for the half year was \$736,400, increased by \$193,364 or 36%, compared to \$543,036 for the same period in 2008.

### **Gross profit**

Gross profit for the quarter was \$334,317 or 65% of revenue compared to \$51,316 or 43% for the same period of the previous year. Gross profit for the half year was \$480,963 or 65% of revenue compared to \$319,845 or 59% for the same period of the prior year.

Results for the current year were within the expected range of gross margin while gross profit for the same periods last year were low because of a number of unsuccessful test installations.

### **General and administrative expenses**

General and administrative expenses for the three months were \$990,454 compared to \$905,640 of the same period of the previous year, an increase of \$84,814 or 9%. The increase was mainly due to greater consulting fees (\$204,270 compared to \$137,497) and travel expenses (\$118,118 compared to \$98,700).

General and administrative expenses for the half year were \$2,233,856 compared to \$1,680,684 for the same period of 2008, an increase of \$553,172 or 61%. The increase was mainly due to greater salaries and wages (\$1,062,850 compared to \$798,429) and travel expenses (\$299,655 compared to \$178,485).

Though the company has taken serious actions to reduce costs, the result will not fully show until the third quarter.

### **Net loss**

Net loss for the second quarter was \$929,730 compared to \$1,039,986 for the same quarter in the prior year, a decrease of \$110,256, thanks to growth in revenue. The loss per share (basic and diluted) for the three months was \$0.02, compared to \$0.03 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 \$152,763 for the quarter compared to \$77,120 for the same period in the prior year. Amortization on property and equipment was \$38,677 (second quarter of 2008 - \$27,081) and amortization of intangible assets was \$114,086 (second quarter of 2008 - \$50,039). The significant increase in intangible assets amortization was a result of the acquisition of distribution rights from TECC Services in July 2008.

Amortization for the half year was \$302,864 compared to \$155,151 for the same period of 2008.

### **Stock-based compensation**

Stock-based compensation costs for the quarter decreased to \$9,364 from \$101,586 for the same period in 2008. Stock-based compensation costs for the half year period decreased to \$107,693 from \$342,428 for the same period in the previous year. The half year'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 during the first six months of the year.

### **Capital expenditure**

Capital expenditures for the quarter were \$9,952, compared to \$61,065 for the same quarter of 2008. Capital expenditures for the two quarters were \$48,049, compared to \$90,359 for the same period of the prior year. These expenditures were primarily for the purchase of small testing equipment.

### **Intangible assets**

Smartcool acquired the intellectual property of the ESM<sup>TM</sup> 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<sup>TM</sup> and the ESM<sup>TM</sup> brand.

Smartcool acquired the exclusive rights to distribute the ESM<sup>TM</sup> 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 June 30, 2009, £600,000GBP was still outstanding.

## Summary of Quarterly Results

	Sep 2007	Dec 2007	Mar 2008	Jun 2008	Sep 2008	Dec 2008	Mar 2009	Jun 2009
	(\$)	(\$)	(\$)	(\$)	(\$)	(\$)	(\$)	(\$)
Total Revenues	54,107	183,578	422,663	120,373	204,793	427,339	225,556	510,844
Income/(Loss)	(1,066,472)	(1,584,963)	(745,733)	(1,039,987)	(1,337,484)	(\$1,247,679)	(1,404,535)	(929,730)
Income/(Loss) Per Share – basic & diluted	(0.03)	(0.13)*	(0.02)	(0.03)	(0.03)	(0.11)*	(0.03)	(0.02)

\*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 June 30, 2009	Six months ended June 30, 2009
Management and consulting fees	175,692	355,290
Salaries and benefits	460,318	1,062,850
Professional fees	33,718	44,923
Investor relations and media	30,229	80,176
Travel	118,118	299,655
Technical consulting	28,578	70,848
Rent, office and other expenses	143,801	320,114
<b>Total selling, general &amp; admin expenses</b>	<b>990,454</b>	<b>2,233,856</b>
Stock-based compensation	9,364	107,693
Survey and testing cost	-	-
Research & Development	23,538	46,068
Amortization	152,763	302,864
<b>Total operating expenses</b>	<b>1,176,119</b>	<b>2,690,481</b>

The company's general and administration expenses were \$990,454 for the second quarter of 2009 compared to \$905,640 for the same period in 2008.

## Liquidity and Capital Resources

Working capital at the end of the second quarter was \$1,505,557 compared to working capital of \$6,528,803 for the same period of 2008.

The company consumed cash resources of \$739,116 during the period, compared to net cash generation of \$384,019 for the same period of the previous year. Cash was used to mainly purchase a GIC (\$350,000) and fund the operating loss for the period. The average monthly burn for the quarter was \$291,000 compared to \$280,000 for the second quarter of 2008.

Management believes the existing cash resource, including cash generated from the June 2009 private placement, and growing revenue 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 the company has been able to raise capital to finance its operations from time to time, its 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.

In light of the current economic crisis, the company has done a comprehensive review of its business development programs, operations and cash flow projections and taken certain cost reduction measures. In June 2009, the company also raised additional capital of \$500,000 through a private placement. Management believes with these resources and growing revenue the company will be able to carry out its core business plan in 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 June 30, 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	349,876	75,217	119,634	155,025
Capital lease	18,243	18,243	-	-
Acquisition obligations	904,917	430,245	432,270	42,402
Total contractual obligations	1,273,036	523,705	551,904	197,427

#### 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	37,608
2010	75,217
2011	56,376
2012	51,300
2013 and thereafter	<u>129,375</u>
	<u>349,876</u>

For the three and six months ended June 30, 2009, the company's rent expense including certain operating expenses and property taxes was \$34,673 and \$69,053 (2008 - \$133,836) and its sublease revenue was \$6,189 and \$12,325 (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 which was reduced by \$25,000 every year. The letter of credit expired on April 14, 2009.

#### 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 and six months ended June 30, 2009, the company recorded royalties of US\$1,824 and US\$2,224 (2008 - US\$40,000). As at June 30, 2009, royalties of US\$1,824 were payable to Abbotly USA (2008 - US\$1,344).

**Transactions with Related Parties**

During the three and six months ended June 30, 2009, consulting fees of \$63,921 and \$127,581 were charged by directors of the company (2008 - \$259,185). Consulting and management fees of \$30,000 and \$56,000 were charged by three companies with common directors and officers during the three and six months ended June 30, 2009 (2008 - \$90,997). The company rents its office in the United Kingdom from a company with a common director. During the three months ended June 30, 2009, rent expense was \$9,912 (2008 - \$21,539). Rent expense for the six month period was \$19,754. These transactions were recorded at their exchange amounts and have been charged to general and administrative in the statement of operations. At June 30, 2009, £10,233GBP (CDN\$19,567) was owed to these related parties.

The company subleases its Vancouver office and other facilities to a company with a common director. For the three and six months ended June 30, 2009, sublease income was \$6,190 and \$12,324, respectively (2008 - \$23,676). At June 30, 2009, \$4,145 was owed from this related party (2008 - \$2,441).

Total purchases of £5,350GBP were made by a company with a common director during the quarter (2008 - £108,101GBP) and are recorded as sales in the statement of operations. As at June 30, 2009, £7,908GBP 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 June 30, 2009 the company had 44,321,396 common shares outstanding. The weighted average numbers of common shares outstanding for the three and six months ended June 30, 2009 were 41,389,597 and 41,286,121 shares.

As at August 27, 2009, the outstanding shares are 44,321,396 and fully diluted are 53,068,771.

**Warrants and Stock options**

As at June 30, 2009, there were 4,232,375 share purchase warrants and 4,848,500 stock options outstanding which collectively could result in the issuance of 9,080,875 common shares if these warrants and stock options are exercised. The outstanding options have weighted average exercise price of \$0.36.

As at June 30, 2009 there were 4,676,000 exercisable options with a weighted exercise price of \$0.36.

In February 2009, 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 June 30, 2009 and risk exposures are disclosed in note 14 to the consolidated financial statements.

### Subsequent Event

Payments due to TECC Services under acquisition contract (note 8) have not been made as scheduled and the company is in discussions with TECC Services with respect to deferring these payments. No resolution of this matter has been concluded.

### 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 EIC-173 "Credit Risk 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 has done a preliminary analysis that identified differences between the company’s current accounting policies and IFRS and is currently considering the impact of IFRS convergence 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 an impact on the accounting of future business combinations.

### *Consolidated Financial Statements*

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 an impact on the accounting of future business combinations.

### *Financial Instruments - Disclosures*

In June 2009, the CICA amended Section 3862 to include additional disclosure requirements about fair value measurement for financial instruments and liquidity risk disclosures. These amendments require three level valuation that reflects the significance of the inputs used. Fair values of assets and liabilities included in Level 1 are determined by reference to quoted prices in active markets for identical assets and liabilities. Fair values of assets and liabilities included in Level 2 are determined based on inputs other than quoted prices for which all significant outputs are observable, either directly or indirectly. Fair values of assets and liabilities included in Level 3 are determined based on inputs that are unobservable and significant to the overall fair value

measurement. The adoption of this standard will not have a material impact on the company's consolidated financial statements.

## **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™.

### *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™ and ECO<sup>3</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™, and ECO<sup>3</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™ and ECO<sup>3</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.