SMARTCOOL™ SYSTEMS INC

CONSOLIDATED FINANCIAL STATEMENTS

For the six months ended June30, 2010 and 2009

(expressed in Canadian Dollar)

NOTICE OF NO AUDITOR REVIEW OF INTERIM FINANCIAL STATEMENTS

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

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

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

Smartcool Systems Inc.
Consolidated Balance Sheets
As at June 30, 2010 and December 31, 2009

(expressed in Canadian dollars)

	June 30 **2010**	December 31 **2009**
	$	$
ASSETS		
Current assets		
Cash and cash equivalents	472,368	147,051
Short-term investments	-	101,646
Restricted cash (note 3)	42,351	-
Accounts receivable	1,234,323	657,841
Inventory	670,846	717,857
Prepaid expenses and deposits	70,956	242,302
	2,490,844	1,866,696
Capitalized development costs (note 7)	13,321	39,961
Property and equipment (note 5)	145,607	207,720
	-	-
Intangible assets (note 6)	3,412,790	3,639,843
	6,062,562	5,754,220
LIABILITIES		
Current liabilities		
Accounts payable and accrued liabilities	611,544	552,034
Current portion of obligations under contracts (note 8)	358,022	263,190
Current portion of capital leases (note 9)	-	9,144
Current portion of debentures (note 10)	42,351	-
Current portion of deferred tenant inducement	10,820	10,820
	1,022,737	835,188
Obligations under acquisition contract (note 8)	401,069	582,602
Debentures (note 10)	466,449	
Deferred tenant Inducement	58,424	63,834
	1,948,679	1,481,625
SHAREHOLDERS' EQUITY		
Share capital (note 11(b))	26,063,452	25,639,345
Share purchase warrants (note 11(d))	119,824	52,514
Contributed surplus (note 11(f))	4,251,684	3,983,831
Deficit	(26,321,077)	(25,403,095)
	4,113,883	4,272,595
	6,062,562	5,754,220

Nature of operations and liquidity risk (note 1)
Commitments (note 12)

Approved by the Board of Directors	"George Burnes"	"Jeffrey Lowe"
	George Burnes	Jeffrey Lowe

See accompanying notes to the consolidated financial statements

Smartcool Systems Inc.
Consolidated Statements of Operations, Comprehensive Loss and Deficit
For the six months ended June 30, 2010 and 2009

(expressed in Canadian dollars)

	Three months ended June 30		Six months ended June 30	
	2010	**2009**	**2010**	**2009**
	$	$	$	$
Revenue	1,137,863	510,844	1,772,790	736,400
Cost of sales	303,779	176,527	599,346	255,437
	834,083	334,317	1,173,444	480,963
Operating Expenses				
General and administrative expenses	802,461	990,454	1,512,766	2,233,856
Stock-based compensation	71,146	9,364	215,339	107,693
Research and development	14,666	23,538	29,029	46,068
Amortization	141,864	152,763	290,031	302,864
	1,030,137	1,176,119	2,047,165	2,690,481
Loss before undernoted	(196,053)	(841,802)	(873,721)	(2,209,519)
Other (income) expense				
Interest expense	64,468	22,859	99,139	42,970
Interest Income	(647)	(1,921)	(4,280)	(5,310)
Foreign exchange loss (gain)	(10,092)	66,989	(50,597)	87,085
	53,729	87,927	44,262	124,746
Loss and comprehensive loss for the period	(249,782)	(929,730)	(917,983)	(2,334,265)
Deficit, beginning of period	(26,071,295)	(23,416,700)	(25,403,095)	(22,012,165)
Change in accounting for inventory			-	0
Deficit, end of period	(26,321,077)	(24,346,430)	(26,321,077)	(24,346,430)
Loss per share				
Basic and diluted	**(0.01)**	**(0.02)**	**(0.02)**	**(0.06)**
Weighted average number of common shares outstanding - basic and diluted	**45,145,572**	**41,389,597**	**44,735,761**	**41,286,121**

Smartcool Systems Inc.
Consolidated Statements of Cash Flows
For the six months ended June 30, 2010 and 2009

(expressed in Canadian dollars)

	Three months ended June 30		Six months ended June 30	
	2010	**2009**	**2010**	**2009**
	$	$	$	$
Cash flows from operating activities				
Loss and comprehensive loss for the year	(249,782)	(929,730)	(917,983)	(2,334,265)
Items not affecting cash:				
Amortization of property and equipment	27,371	38,677	62,113	74,413
Amortization of intangible assets	114,493	114,086	227,918	228,451
Amortization of capitalized development costs	13,320	13,320	26,640	26,640
Stock-based compensation	71,146	9,364	215,339	107,693
Deferred tenant inducement	(2,705)	(2,260)	(5,410)	(4,297)
Accrued interest on debentures	28,706	-	39,039	-
Accretion of obligation under acquisition contract	19,324	20,198	40,290	39,234
Foreign exchange gain on obligations under acquisition contract	19,207	50,885	(48,473)	56,575
Changes in non-cash working capital items:				
Accounts receivable	(688,485)	(211,775)	(576,483)	(70,239)
Inventory	64,102	143,298	47,010	170,403
Prepaid expenses and deposits	48,052	(13,632)	171,346	(5,261)
Accounts payable and accrued liabilities	(32,403)	(104,990)	59,510	(134,817)
	(567,654)	(872,559)	(659,142)	(1,845,469)
Cash flows from investing activities				
Purchase of short-term investment	-	(352,143)	-	(352,143)
Sale of short-term investment	55,007	26,176	101,646	25,608
Purchase of property & equipment	-	(9,952)	-	(48,049)
Product development	-	-	-	-
	-	-		
	55,007	(335,919)	101,646	(374,584)
Cash flows from financing activities				
Shares and warrants issued for cash-net of issue costs	460,941	473,646	460,941	473,646
Shares issued on exercise of options	-	-	-	-
Shares issued on exercise of warrants	-	-	-	-
Debenture issued for cash	247,500	-	552,750	-
Repayment of obligations under acquisition contract	-	-	(79,383)	-
Repayment of capital lease obligations	(4,317)	(4,284)	(9,144)	(8,401)
	704,125	469,362	925,164	465,245
Increase (Decrease) in cash and cash equivalents	191,477	(739,116)	367,668	(1,754,808)
Cash and cash equivalents, beginning of period	323,241	1,237,166	147,051	2,252,857
Cash and cash equivalents, end of period	514,719	498,050	514,719	498,050

Cash and cash equivalents consist of:

Deposits with banks	514,719	498,050
Guranteed invesment certificates	-	-
	514,719	498,050

Supplementary cash flow Information (note 17)

See accompanying notes to the consolidated financial statements

1 Nature of operations and liquidity risk

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

In 2004, the company incorporated a wholly owned subsidiary, Smartcool Systems (USA) Inc. ("Smartcool USA"), under the laws of Nevada. Smartcool International Inc. ("Smartcool International"), another wholly owned subsidiary, was incorporated in Barbados in June 2006. In April 2008, the company completed the incorporation of its new subsidiary, Smartcool Systems (EMEA) Ltd. ("Smartcool EMEA"), headquartered in London, England.

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

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

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

During the six months ended June 30, 2010, the company incurred a loss of $917,983 (2009 - $3,390,930) and the company had an accumulated deficit of $26,321,077 as at June 30, 2010 (2009 - $25,403,095).

To date the company has been able to raise capital to finance its operations whenever necessary. The company's ultimate success and the recoverability of its 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.

The recent global recession had presented a great challenge to Smartcool but with proactive actions the company has effectively managed its resources and was able to renegotiate its acquisition obligations. The company has also been successful in obtaining new financing this year. Operating results of the second quarter of 2010 indicates that the company is approaching its short-term goal of breaking even. While working towards positive cash flow from operations, management is confident that the company will have sufficient resources to carry out its business plan and meet its financial obligations in the next twelve months.

2 Significant accounting policies

Basis of presentation

The interim consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles ("Canadian GAAP"), on the same basis as the audited financial statements for the year ended December 31, 2009. These interim financial statements include all adjustments, which, in the opinion of management, are necessary for the fair presentation of the results of operations for the interim periods presented. Results for the six months ended June 30, 2010 are not necessarily indicative of the results to be expected for the full year. These unaudited interim statements do not include all the disclosures required for annual financial statements, and should be read in conjunction with the company's annual audited financial statements for the year ended December 31, 2009.
These interim financial statements follow the same accounting policies and methods of their application as the company's annual audited financial statements for the year ended December 31, 2009.

Future Accounting Standards

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.

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. Management has performed an analysis to identify differences between the company's current accounting policies and IFRS. The impact of IFRS convergence on its financial statements has not been quantified yet as accounting policies are still being finalized. Management continues to analyze accounting changes and should be able to address the impact quantitatively later in the year.

3 Restricted cash

Earlier this year, the company issued units of participation subordinated secured debentures and warrants through a private placement. Under the terms of the debenture, the holders are entitled to receive quarterly payments towards the principal amount. The total of quarterly payments is equal to 5% of the gross cash revenue received by the company in each quarter. The payment of quarterly principal payments owing during the first twelve-month period commencing from the closing date, however, may be delayed and paid on a date that is 13 months from the closing date. When such payments are delayed, the company is required to deposit into a separate trust account, on a quarterly basis, an amount equal to any first year quarterly principal payment that would otherwise have been payable.
Total cash of $42,351, 5% of cash revenue received from February 9 to June 30, 2010, has been designated as restricted cash in accordance with the debenture terms.

4 Inventories

	2010	**2009**
ESM™, ECO3™ and Peripherals	652,343	698,814
Other products	18,503	19,043
Total inventory	670,846	717,857

During the three and six months ended June 30, 2010, total inventories of $203,893 and $312,311 have been recognized as cost of sales.

5 Property and equipment

	June 30, 2010		
	Cost $	Accumulated amortization $	Net book value $
Computer hardware and software	158,995	122,426	36,569
Testing and demonstration equipment	220,434	188,598	31,836
Office equipment and furniture	45,710	25,696	20,014
Leasehold improvements	116,318	59,130	57,188
	541,457	395,850	145,607

	December 31, 2009		
	Cost $	Accumulated amortization $	Net book value $
Computer hardware and software	158,995	100,963	58,032
Testing and demonstration equipment	220,434	157,317	63,117
Office equipment and furniture	45,710	22,143	23,567
Leasehold improvements	116,318	53,314	63,004
	541,457	333,737	207,720

As at June 30, 2010, assets under capital lease with total cost of $49,543 and accumulated amortization of $49,543 are included in property and equipment for net book value of $0 (2009 - $8,257).
Amortization expense for assets under capital lease recorded in the statement of operations, comprehensive loss and deficit for the three and six months ended June, 2010 was $4,128 and $8,257 (2009 - $16,515).

6 Intangible assets

	June 30, 2010		
	Cost $	Accumulated amortization $	Net book value $
North American distribution rights (a)	279,853	118,938	160,915
ESM™ brand (b)	56,100	-	56,100
ESM™ intellectual property (b)	124,100	49,640	74,460
Distribution agreements (b)	1,861,841	597,237	1,264,604
Supplier agreements (b)	113,650	45,460	68,190
United Kingdom distribution rights (c)	2,299,100	510,579	1,788,521
	4,734,644	1,321,854	3,412,790

	December 31, 2009		
	Cost $	Accumulated amortization $	Net book value $
North American distribution rights (a)	279,853	104,945	174,908
ESM™ brand (b)	56,100	-	56,100
ESM™ intellectual property (b)	124,100	43,435	80,665
Distribution agreements (b)	1,861,841	523,456	1,338,385
Supplier agreements (b)	113,650	39,777	73,873
United Kingdom distribution rights (c)	2,299,100	383,188	1,915,912
	4,734,644	1,094,801	3,639,843

a) North American distribution rights

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

Consideration paid for the acquisition was US$180,000 ($201,953). 500,000 share purchase warrants with an exercise price of $0.27 and a 20% royalty on certain products purchased from Abbotly as long as Smartcool Systems USA still holds the distribution rights. The warrants were valued at $77,900 at the transaction date using the Black-Scholes model and the following assumptions:

Expected life	2 years
Volatility	109%
Risk-free interest rate	4.06%
Dividend yield	0%

b) ESM™ Intellectual Property and worldwide distribution rights

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

Management has performed a review of the carrying value of its distribution agreements. As a result of its assessment, in 2008 the company recognized an impairment of $116,914 related to distribution agreements. No impairment was recorded in 2009.

c) Distribution Rights from TECC Services

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

The remaining balance of £600,000GBP is due in scheduled instalments over four years with the last payment due on July 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.

The purchase agreement was amended on December 21, 2009 where payments were rescheduled with the first payment due on January 16, 2010 and the last one on July 16, 2012. The parties also agreed that interest would accrue on £75,000 GBP at RBC prime rate plus 4% from January 16, 2009 and additionally on £75,000 GBP from July 16, 2009 until paid in full. As at June 30, 2010, the balance of £563,353 GBP, including accrued interest of £10,228 GBP, remained outstanding.

7 Capitalized development costs

During the three and six months ended June 30, 2010, the company incurred $1,346 and $2,389 (2009 - $31,772) of research and development costs that were fully expensed (2009 - $31,772). No research and development costs were deferred in the period (2009 - $0). Development costs of $ 106,561 incurred in 2008 have been capitalized and amortized over a two year period, starting October 1, 2008 when the new products' commercial production was complete and they became available for sale. Amortization of $13,320 and $26,640 has been charged to expenses for the three and six moths ended June 30, 2010.

8 Obligations under acquisition contracts

a) Abbotly

On May 31, 2008, the company fulfilled its obligation to Abbotly Pty related to its acquisition of Abbotly in 2006. The obligation amount was non-interest bearing and had been recorded at its present value using a discount rate of 9.7% as follows:

	$
Balance - June 26, 2006	1,419,950
Accretion	36,992
Repayments	(440,790)
Foreign exchange	153,938
Balance - December 31, 2006	1,170,090
Accretion	76,929
Repayments	(1,082,840)
Foreign exchange	(26,062)
Balance - December 31, 2007	138,117
Accretion	33,023
Repayment	(185,133)
Foreign exchange	13,993
Balance – December 31, 2008	-

b) TECC Services

At December 31, 2009, the company owed £605,568 GBP related to its acquisition of distribution rights from TECC Services. The obligation amount of £600,000 GBP was originally non-interest bearing and has been recorded at its present value using a discount rate of 16%. The purchase agreement was then amended on December 21, 2009 to accrue interest on 150,000 GBP at RBC prime rate plus 4% and adjust timing and amount of repayments (note 6(c)).

	$
Balance – July 11, 2008	865,358
Accretion	40,853
Foreign exchange	(97,102)
Balance - December 31, 2008	809,109
Accretion	75,227
Accrued interest	9,420
Foreign exchange	(47,964)
Balance – December 31, 2009	845,792
Payment	(79,383)
Accretion	33,034
Accrued interest	7,256
Foreign exchange	(47,608)
Balance – June 30, 2010	759,091
Less: Current portion	(358,022)
	401,069

Required repayments are as follows:

	GBP
July 16, 2010	103,125
January 16, 2011	112,500
July 16, 2011	112,500
January 16, 2012	112,500
July 11, 2012	112,500
	553,125
Accrued interest on 103,125 GBP	10,228
Balance – June 30, 2010	563,353
Less: Current portion	(225,853)
	£337,500

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

9 Capital leases

In 2007, the company entered into two contractual lease agreements to finance the purchases of computer equipment. Both leases have an implied annual interest rate of 16.17%. Interest paid in the three and six months six months ended June 30, 2010 related to obligations under capital leases was $136 and $467 (2009 - $3,135). These leases expired in June and as at June 30, 2010 had an outstanding balance of $0.

10 Debentures

On January 13, 2010, Smartcool announced that it intended to offer units consisting of secured participating debentures and share purchase warrants at a price of $5,000 per unit, for aggregate proceeds of minimum $250,000 and maximum of $600,000.

Each unit comprises of a debenture in the principal amount of $5,000 plus 8,600 warrants, issued at a price of $5,000 per unit. The debentures are for a term of three years and entitle the holder to receive distribution of $150 each quarter per $5,000 of principal amount with an additional distribution of $150 if the debenture is repaid in months 19 to 24 and two additional distributions (for a total of $300) if the debenture is repaid in months 15 to 36. The debentures also receive 5% of gross cash revenue to be paid towards the outstanding principal of the debenture each quarter. The debentures are secured by a general security agreement over the assets of the company.

The debentures also entitle the holder to quarterly payments towards principal. The total of principal payments for each quarter is equal to 5% of total cash revenue received by the company in that quarter. The payment of quarterly principal payments owing during the first twelve-month period commencing from the closing date, however, may be delayed and paid on a date that is 13 months from the closing date. When such payments are delayed, the company is required to deposit into a separate trust account, on a quarterly basis, an amount equal to any first year quarterly principal payment that would otherwise have been payable. As at June 30, 2010, $42,351 has been set aside for future principal payments (see note 4).

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

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

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

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

	$
Net proceeds of issue	552,750
Equity component	82,990
Liability component at date of issue	469,760

The equity component of $82,990 has been credited to equity, Share Purchase Warrants (note 9(d)).

The liability component is measured at amortized cost. The interest expense for the three and six months ended June 30, 2010, $36, 646 and $46,980 respectively, were calculated by applying weighted average effective interest rate of 35% to the liability component. This high effective interest rate was a result of the allocation of a portion of the net proceeds to equity.
Interest payment total of $7,940 was paid in April 2010. As at June 30, 2010, the carrying amount of these debentures was $508,800.

Maturity date	February 9, 2013	March 19, 2013	April 29, 2013	May 4, 2013	Total
	$	$	$	$	$
Debenture principal	250,000	85,000	200,000	75,000	610,000
Balance on issuance date	192,191	63,773	154,984	58,812	469,760
Accrued interest	26,623	7,020	8,886	4,451	46,980
Interest payment	(6,750)	(1,190)	-	-	(7,940)
Balance, June 30, 2010	212,064	69,603	163,870	63,263	508,800
Less: current portion	(26,444)	(3,929)	(8,711)	(3,267)	(42,351)
	185,620	65,674	155,159	59,996	466,449

11 Share capital

a) Authorized: unlimited common shares without par value

100,000,000 Class A preferred shares
100,000,000 Class B preferred shares

b) Issued common shares

	Shares	Amount $
Balance - December 31, 2007	37,074,687	22,573,211
Share purchase warrants exercised (d)	3,329,250	2,088,234
Options exercised (c)	35,000	18,216
TECC acquisition (e)	743,709	530,636
Share issuance costs	-	7,916
Balance – December 31, 2008	41,182,646	25,218,213
Private placement (i)	3,138,750	452,186
Share issuance costs (ii)	-	(31,054)
Balance – December 31, 2009	44,321,396	25,639,345
Private placement (iii)	2,500,000	464,674
Share issuance costs (iv)		(40,567)
Balance, March 31, 2010	46,821,396	26,063,452

i) On June 24, 2009, the company issued 3,138,750 Units at $0.16 per unit pursuant to a non-brokered private placement, for gross proceeds of $502,200. Each Unit consists of one common share and one-half warrant. Each full share purchase warrant entitles the holder to purchase one common share at a price of $0.30 until June 24, 2010. These warrants are not transferable. A total value of $50,014 was attributed to the warrants. Cash share issuance costs were $28,554 and noncash share issuance costs were $5,950. Total issuance cost of $31,054 was allocated to common shares and $3,450 to warrants.

ii) On June 24, 2009, the company issued 163,000 warrants as part of the private placement commission to agents. The fair value of these warrants of $5,950 has been reflected within share issuance costs.

iii) On June 1, 2010, the company issued 2,500,000 Units at $0.20 per unit pursuant to a non-brokered private placement, for gross proceeds of $500,000. Each Unit consists of one common share and one-half warrant. Each full share purchase warrant entitles the holder to purchase one common share at a price of $0.35 until June 1, 2011. These warrants are not transferable. A total value of $35,325 was attributed to the warrants. Issuance costs were $43,621, consisting of cash share issuance costs of $39,059 and noncash share issuance costs of $4,562. 93% of total issuance cost ($40,568) was allocated to common shares and 7% ($3,053) to warrants.

iv) On June 1, 2010, the company issued 125,000 warrants as part of the private placement commission to agents. The fair value of these warrants of $4,562 has been reflected within share issuance costs.

c) Stock options

Under the company's stock option plan, the company may grant stock options to employees, directors, officers and consultants. The maximum number of shares to be awarded under the plan is 8,864,279. The stock options have vesting periods of up to 18 months and an exercise period of up to five years.

A summary of the company's stock option activity for employees, directors, officers and consultants is as follows:

	Number of options	**Weighted average exercise price $**
Balance - December 31, 2007	5,306,000	0.77
Granted	385,000	0.50
Cancelled	(318,750)	1.20
Forfeited	(6,250)	1.28
Expired	(350,000)	1.50
Exercised	(35,000)	0.26
Balance - December 31, 2008	4,981,000	0.67
Granted	1,714,000	0.25
Cancelled	(21,250)	0.40
Forfeited	(318,750)	0.66
Expired	(636,000)	0.30
Balance - December 31, 2009	5,719,000	0.33
Granted	650,000	0.31
Balance – June 30, 2010	6,369,000	0.33

No options were granted in the three months ended June 30, 2010. During the first six months of the year, the company granted 650,000 (2009 –1,080,000) options to officers and employees. None of those options had an exercise price lower than the stock price at the date of grant (2009 –0).

Stock-based compensation expense for the three months ended June 30, 2010 was $71,146 (2009 - $259,138), of which $130,387 was related to employees (2009 – $153,075). Expense reduction of $59,242 (2009 expense - $106,063) was related to consultants.

Stock-based compensation expense for the six months ended June 30, 2010 was 215,339, of which $187,459 related to employees and $27,880 related to consultants.

Options outstanding at June 30, 2010 were as follows:

	Options outstanding			Options exercisable	
Exercise price $	**Number outstanding**	**Weighed average remaining contractual life (years)**	**Weighed average exercise price $**	**Number outstanding**	**Weighed average exercise price $**
0.10 - 0.20	789,000	4.15	0.14	432,000	0.15
0.21 - 0.28	515,000	0.61	0.25	515,000	0.25
0.30 - 0.36	3,790,000	2.91	0.31	2,842,500	0.31
0.40 - 0.48	775,000	1.24	0.42	775,000	0.42
0.54 - 0.64	400,000	2.18	0.57	400,000	0.57
0.72- 0.96	100,000	1.64	0.84	100,000	0.84
	6,369,000	2.61	0.33	5,064,500	0.34

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

	2010	**2009**
Risk-free interest rate	2.45%	2.34%-2.76%
Dividend yield	0%	0%
Volatility	98.60%	97.67%-98.73%
Expected life	4.5 years	4.5-5 years

d) Share purchase warrants

A summary of the company's warrant activity is as follows:

	Number outstanding	Amount $
Balance - December 31, 2007	5,874,000	1,666,760
Expired	(44,750)	(6,789)
Exercised	(3,329,250)	(485,128)
Warrant issue cost adjustment		(1,737)
Balance - December 31, 2008	2,500,000	1,176,580
Expired	(2,500,000)	(1,176,580)
Issued	1,732,375	52,514
Balance – December 31, 2009	1,732,375	52,514
Expired	(1,732,375)	(52,514)
Issued	2,424,200	122,877
Warrant issue costs		(3,053)
Balance – June 30, 2010	2,424,200	119,824

Share purchase warrants outstanding as at June 30, 2010 were as follows:

Number of shares	Exercise price $	Expiry date
430,000	0.50	February 9, 2013
146,200	0.50	March 19, 2010
344,000	0.50	April 29, 2013
129,000	0.50	May 4, 2013
1,250,000	0.35	June 1, 2011
125,000	0.35	June 1, 2011
2,424,200		

e) Shares issued under TECC acquisition agreement

On July 11, 2008, the company acquired distributions rights from TECC Services (see note 6(b)). As part of the consideration, common shares of the company with value equal to £265,000GBP were issued. The share price was based on the average closing price of the company's shares on the TSX Exchange for 20 consecutive trading days, with the last of such trading day being the second day of preceding the date of closing.

f) Contributed surplus

At December 31, 2009, the company's contributed surplus comprised the following:

	$
Balance - December 31, 2007	2,099,851
Stock option expense	449,639
Stock option exercised	(8,166)
Expiry of warrants	6,789
Balance – December 31, 2008	2,548,113
Stock option expense	259,138
Expiry of warrants	1,176,580
Balance – December 31, 2009	3,983,831
Stock option expense	215,339
Expired of warrants	52,514
Balance – June 30, 2010	4,251,684

12 Commitments

a) Premise lease

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

In February 2008, the company entered into a 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:

	$
2010	36,199
2011	54,222
2012	51,300
2013	52,875
2013 and thereafter	76,500
	271,096

For the three and six months ended June 30, 2010, the company's rent expense including certain operating expenses and property taxes was $39,360 and $81, 915 (2009 - $174,667) and its sublease revenue was $4,117 and $10,467 (2009 - $24,928).

b) 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. These leases expired in June 2010.

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.

c) 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 six months ended June 30, 2010, the company recorded royalty expense of US$3,496. As at June 30, 2010, royalties of US$3,496 were payable to Abbotly USA (Year 2009 – US$11,200).

13 Segmented information

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

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

	Three months ended June 30, 2010		**Six months ended June 30, 2010**	
	Amount **$**	Revenue **%**	Amount **$**	Revenue **%**
Europe, Middle East, Africa	708,025	62	1,187,797	67
Australia	117,590	10	165,592	9
South East Asia	10,379	1	35,729	2
Americas	301,869	27	383,672	22
Total revenue	1,137,863	100	1,772,790	100

During the three months ended June 30, 2010, revenue from four customers exceeded 10% of the company's total revenue. These customers contributed 18.2%, 15.8%, 11.3% and 10.3% respectively. During the previous year, revenue from one individual customer exceeded 10% of the company's total revenue. This customer contributed 22%.

Property and equipment are located in:

	2010	2009
Canada	66%	55%
USA	17%	28%
Other	17%	17%
Total	100%	100%

14 Related party transactions

During the three and six months ended June 30, 2010, consulting fees of $28,986 and $59,719 were charged by directors of the company (2009 - $254,317). Consulting fees of $33,000 and $65,500 were charged by two companies with common directors during the above periods (2009 - $76,000). The company rents its office in the United Kingdom from a company with a common director. During the three and six months ended June 30, 2010, rent expense was $8,472 and $17,777 (2009 – $39,721). These transactions have been charged to general and administrative in the statement of operations. The company also utilizes installation services from a company with a common director. During the three and six months ended June 30, 2010, installation and material expenses were $55,509 and $198,912 (2009 - $0). These transactions have been charged to cost of sales in the statement of operations. At June 30, 2010, £59,120 GBP (CDN$93,717) was owed to these related parties. (December 31, 09 - £8,129GBP)

The company subleases its Vancouver office and other facilities to a company with a common director. During the three and six months ended June 30, 2010, sublease income was $4,117 and $10,467 (2009 - $24,928). At June 30, 2010, no amounts were owed from this related party (December 31, 09 - $2,100).

The Company uses the services of a law firm of which a director is a partner. During the three and six months ending June 30th, 2010, fees in the amounts of $8,173 and $28,578 were charged to the company for legal services provided.

During the three and six months ended June 30, 2010, total sales of $207,259 and $179,043 were made to company with a common director (2009 – $226,174). As at June 30, 2010, US$178,721 (CDN$189,551) was owed from this related party (December 31, 2009 $74,734).

These transactions are in the normal course of operations and are measured at the exchange amount, which is the amount of consideration established and agreed to by the related parties. Management is of the opinion that these transactions were undertaken under the same terms and conditions as transactions with arms-length parties.

15 Financial instruments

a) Financial Instruments

The company has classified its financial instruments as follows:

	2010	2009
Financial assets:	**$**	**$**
Held-for-trading, measured at fair value:		
Cash and cash equivalents	514,719	147,051
Loans and accounts receivable, recorded at amortized cost:		
Accounts receivable	1,234,323	657,841
Held-to-maturity, recorded at amortized cost:		
Short-term investments	-	101,646
Financial liabilities, recorded at amortized cost:		
Accounts payable and accrued liabilities	611,554	552,034
Acquisition obligations, debentures and other liabilities	1,267,891	854,937

Interest income from held-for-trading and held-to-maturity short-term investments and interest expense from acquisition obligations, debentures and other financial liabilities are recognized in other income (expenses).

The following summarizes interest income and expense for the first quarter of 2010:

	Three months ended June 30, 2010	Six months ended June 30, 2009
	$	**$**
Interest income from held-for-trading	647	918
Interest income from held-to-maturity	-	3,362
Interest expense from financial obligations	47,724	66,105
Interest expense from other financial liabilities	16,744	33,034

Fair value

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

Level 1: fair value is determined by reference to quoted prices in active markets for identical assets and liabilities.

Level 2: fair value is determined based on inputs other than quoted prices for which all significant outputs are observable, either directly or indirectly.

Level 3: fair value is determined based on inputs that are unobservable and significant to the overall fair value measurement.

The carrying value of cash and cash equivalents, short-term investments, amounts receivable, the current portion of obligations under acquisition contract, and accounts payable and accrued liabilities approximates the fair value because of the short-term nature of these instruments.

The carrying value of the long term portion of acquisition obligations ($373,896) and debentures ($250,514), has been discounted at 16% (see note 7(b)) and 35% (see note 10), respectively, is considered a close approximation of fair value.

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

	Fair value measurement at June 30, 2010			
	June 30, 2010 Carrying value	**Level 1**	**Level 2**	**Level 3**
Financial assets	**$**	**$**	**$**	**$**
Cash and cash equivalents	514,705	514,705	-	-
Total	514,705	514,705	-	-

	Fair value measurement at December 31, 2009			
	December 31, 2009 Carrying value	**Level 1**	**Level 2**	**Level 3**
Financial assets	**$**	**$**	**$**	**$**
Cash and cash equivalents	147,051	147,051	-	-
Total	147,051	147,051	-	-

b) Financial risk management

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

Credit risk

Credit risk is the risk of an unexpected loss if a customer or third party to a financial instrument fails to meet its contractual obligations and arises principally from the company's cash and cash equivalents, short-term investments and accounts receivable. The company limits its exposure to credit loss by placing its cash and cash equivalents and short-term investments with high credit quality financial institutions. Credit risk with respect to accounts receivable is limited due to the company's customer credit evaluation process. The company has $1,234,323 in accounts receivable which are subject to credit risk.

Liquidity risk

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

As at June 30, 2010, the company's total account payable and accrued liabilities and current portion of obligation under acquisition contract and debentures was $1,030,365 with $770,064 due within 90 days and $260,302 due within one year.

Market risk

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

Foreign currency risk

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

As at June 30, 2010, the company's monetary assets and liabilities denominated in foreign currencies are as follows:

	USD	AUD	GBP
Assets			
Cash and cash equivalents	125,728	3,734	63,671
Accounts receivable	775,592	2,469	252,488
Liabilities			
Accounts Payable	179,401	29,847	138,302
TECC acquisition obligation, current portion			225,853
TECC acquisition obligation, balance			337,500

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

Gain (loss) on $0.10 increase in CAD	USD	AUD	GBP
Monetary Assets	(90,132)	(620)	(31,616)
Monetary Liabilities	17,940	2,985	70,166
Net gain (loss)	(72,192)	2,365	38,550

Interest rate risk

The company is exposed to this risk as late payments under TECC acquisition obligations are subject to interest based on prime rate plus 4%. As at June 30, the total of such payments was £103,125GBP.

16 Capital management

The company's capital structure includes shareholders' equity consisting of issued common shares, warrants, contributed surplus and deficit.

The company's objectives when managing capital are:

a) to effectively finance its operations and growth by meeting its operating and capital expenditure budgets;

b) to maintain financial flexibility in order to meet financial obligations, including obligations under acquisition contracts;

c) to ensure its ability to carry out its strategic plans and take advantage of acquisition opportunities;

d) to provide an appropriate investment return to its shareholders.

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

The company is not subject to externally imposed capital requirements.

17 Supplementary cash flow information

	Three months ended June 30, 2010	Six months ended June 30, 2010 $
Interest paid in cash	16,770	18,922
Interest income received in cash	647	5,925
Income taxes paid in cash	-	-
Non-cash financing and investing activities		
Issuance of warrants for share issue costs	4,562	4,562
Issuance of warrants for debenture transaction costs	33,704	82,990