Smartcool Systems Inc.

Consolidated Financial Statements
December 31, 2008 and 2007
(expressed in Canadian dollars)

PRICEWATERHOUSECOOPERS

PricewaterhouseCoopers LLP
Chartered Accountants
PricewaterhouseCoopers Place
250 Howe Street, Suite 700
Vancouver, British Columbia
Canada V6C 3S7
Telephone +1 604 806 7000
Facsimile +1 604 806 7806

Auditors' Report

To the Shareholders of
Smartcool Systems Inc.

We have audited the consolidated balance sheets of **Smartcool Systems Inc.** as at December 31, 2008 and 2007 and the consolidated statements of operations, comprehensive loss and deficit and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at December 31, 2008 and 2007 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants

Vancouver, B.C.
April 23, 2009

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Smartcool Systems Inc.
Consolidated Balance Sheets
As at December 31, 2008 and 2007

(expressed in Canadian dollars)

	2008 $	2007 $
Assets		
Current assets		
Cash and cash equivalents	2,252,857	6,020,860
Short-term investments	25,608	227,536
Amounts receivable	284,675	197,494
Inventory (note 4)	1,142,923	351,267
Prepaid expenses and deposits	77,331	87,546
	3,783,394	6,884,703
Capitalized development costs (note 7)	93,241	-
Property and equipment (note 5)	308,850	304,220
Intangible assets (note 6)	4,095,541	2,124,386
	8,281,026	9,313,309
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	430,172	333,122
Current portion of obligations under acquisition contract (note 8)	268,440	138,117
Current portion of capital leases (note 9)	17,499	14,924
Current portion of deferred tenant inducement	9,707	8,148
	725,818	494,311
Obligations under acquisition contract (note 8)	540,669	-
Capital leases (note 9)	9,145	26,644
Deferred tenant inducement	74,653	84,360
	1,350,285	605,315
Shareholders' Equity		
Share capital (note 10(b))	25,218,213	22,573,211
Share purchase warrants (note 10(e))	1,176,580	1,666,760
Contributed surplus (note 10(g))	2,548,113	2,099,851
Deficit	(22,012,165)	(17,631,828)
	6,930,741	8,707,994
	8,281,026	9,313,309

Nature of operations and liquidity risk (note 1)

Commitments (note 12)

Subsequent event (note 18)

Approved by the Board of Directors

__________ Director   Lee Wallerton __________ Director

See accompanying notes to the consolidated financial statements.

Smartcool Systems Inc.

Consolidated Statements of Operations, Comprehensive Loss and Deficit

For the years ended December 31, 2008 and 2007

(expressed in Canadian dollars)

	2008 $	2007 $
Revenue	1,175,168	447,275
Cost of sales	427,891	257,696
	747,277	189,579
Operating expenses		
Survey and testing costs	2,782	108,308
General and administrative expenses	4,414,684	2,741,892
Stock-based compensation	449,639	1,229,257
Research and development	57,233	54,853
Amortization	450,095	302,937
	5,374,433	4,437,247
Loss before undernoted	(4,627,156)	(4,247,668)
Other (income) expense		
Impairment of intangible asset	-	116,914
Interest expense	78,907	80,064
Interest income	(112,877)	(151,503)
Foreign exchange (gain) loss	(222,302)	30,138
	(256,272)	75,613
Loss and comprehensive loss for the year	(4,370,884)	(4,323,281)
Deficit - Beginning of year	(17,631,828)	(13,308,547)
Change in accounting for inventories	(9,453)	-
Deficit - End of year	(22,012,165)	(17,631,828)
Loss per share		
Basic and diluted	(0.11)	(0.13)
Weighted average number of common shares outstanding - basic and diluted	39,404,989	32,869,858

See accompanying notes to the consolidated financial statements.

Smartcool Systems Inc.

Consolidated Statements of Cash Flows

For the years ended December 31, 2008 and 2007

(expressed in Canadian dollars)

	2008 $	2007 $
Cash flows from operating activities		
Loss and comprehensive loss for the year	(4,370,884)	(4,323,281)
Items not affecting cash		
Amortization of property and equipment	121,738	82,050
Amortization of intangibles	328,357	220,887
Amortization of research and development	13,320	-
Stock-based compensation	449,639	1,229,257
Deferred tenant inducement	(8,148)	(7,034)
Impairment of intangible asset	-	116,914
Accretion of obligations under acquisition contract	73,876	76,929
Foreign exchange gain on obligations under acquisition contract	(84,924)	(26,062)
Other	(9,453)	12,000
	(3,486,479)	(2,618,340)
Changes in non-cash working capital items		
Accounts receivable	(87,181)	(103,768)
Inventory	(791,656)	(259,461)
Prepaid expenses and deposits	10,215	31,957
Accounts payable and accrued liabilities	97,050	109,617
	(4,258,051)	(2,839,995)
Cash flows from financing activities		
Shares and warrants issued for cash - net of cash issue costs	9,653	6,894,265
Shares issued on exercise of options	10,050	239,688
Shares issued on exercise of warrants	1,603,106	1,422,600
Repayment of obligations under acquisition contract	(185,133)	(1,082,840)
Repayment of capital lease obligations	(14,924)	(7,974)
	1,422,752	7,465,739
Cash flows from investing activities		
Acquisition of intangible asset	(901,703)	-
Sale of short-term investment	201,928	19,186,751
Purchase of short-term investment	-	(18,310,432)
Purchase of property and equipment	(126,368)	(182,022)
Product developments	(106,561)	-
	(932,704)	694,297
(Decrease) increase in cash and cash equivalents	(3,768,003)	5,320,041
Cash and cash equivalents - Beginning of year	6,020,860	700,819
Cash and cash equivalents - End of year	2,252,857	6,020,860

Supplementary cash flow information (note 17)

See accompanying notes to the consolidated financial statements.

(expressed in Canadian dollars)

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 Alton, 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™) and ECO3™ to customers in North America and the sale of the ESM™ and ECO3™ to distributors worldwide.

The ESM™ and ECO3™ are manufactured by a third party in Australia and China and are 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™ and ECO3™ use the latest in microprocessor technology and software developments.

During the year ended December 31, 2008, the company incurred a loss of $4,370,884 and the company had an accumulated deficit of $22,012,165 as at December 31, 2008.

Though in prior years the company was able to raise capital to finance its operations, the company’s ultimate success and the recoverability of its intangible assets will depend on the company’s ability to successfully execute its business plan which includes the existence of a market for its products, achieving profitable operations, meeting its business acquisition obligations, and the continued support of the company's shareholders and employees.

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

(expressed in Canadian dollars)

2 Significant accounting policies

Basis of presentation

These consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (“GAAP”).

Principles of consolidation

The consolidated financial statements include the accounts of the company and its wholly owned subsidiaries, Smartcool USA, Smartcool International, and Smartcool EMEA. All significant inter-company transactions and balances have been eliminated.

Use of estimates

The preparation of financial statements in conformity with Canadian GAAP requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the period. Actual results may differ from those estimates.

Cash and cash equivalents

Cash and cash equivalents consist of cash on deposit and highly liquid investments that are readily convertible into cash with maturities of three months or less when purchased. At December 31, 2008 and 2007, cash and cash equivalents consisted mainly of bank redeemable term investment certificates.

Short-term investments

Short-term investments consist of interest-bearing term deposits that have maturity dates of more than three months, and are carried at cost, which approximates fair value. Interest is recognized in the consolidated statements of operations and deficit as earned.

Inventory

Inventory is recorded at the lower of cost and net realizable value. Cost of inventory includes invoiced cost from the manufacturer.

(expressed in Canadian dollars)

Property and equipment

Property and equipment are stated at cost less amortization. Amortization is computed using the straight line method over the assets' estimated useful lives at the following rates:

Computer hardware and software	33%
Computer hardware and software under capital leases	33%
Testing and demonstration equipment	40%
Office equipment and furniture	20%
Leasehold improvements	term of the lease

Intangible assets

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

ESM™ 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 is recognized when the carrying amount of an asset exceeds the estimated undiscounted future cash flows expected to result from the use of the asset and its eventual disposition. The amount of the impairment loss to be recorded is 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 sale and installation of the ESM™ in North America is recognized when the ESM™ has been installed, title has been transferred, collectibility is reasonably assured and the fee is fixed and determinable. Revenue from the international distribution of the ESM™ is recognized when the equipment has been shipped, title has transferred, collectibility 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 is received in advance of all of these revenue recognition criteria being met.

(expressed in Canadian dollars)

Warranty costs

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

Research and development

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. The company has determined that as at December 31, 2008, development costs of $106,681 have met these criteria. These costs will be amortized on a straight-line basis over a two-year period, starting October 1, 2008.

Stock-based compensation

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 option 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 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.

Share purchase warrants

The company at times may issue common shares and share purchase warrants as a unit. In these circumstances, the unit price is allocated to common shares and warrants based on their relative fair values. The fair value of common shares is the market price on the date of issue and the fair value of warrants is determined using the Black-Scholes option pricing model.

Loss per share

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

(expressed in Canadian dollars)

Income taxes

The company follows the liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are determined based on differences between the financial reporting and tax bases of assets and liabilities and are measured using substantially enacted tax rates and laws that will be in effect when the difference are expected to reverse. The company records a valuation allowance against any portion of those future income tax assets that it believes will, more likely than not, fail to be realized.

Foreign currency translations

The company's foreign operations are considered integrated for accounting purposes. Foreign currency monetary assets and liabilities are translated into Canadian dollars at the exchange rate in effect at the balance sheet date and revenues and expenses are translated at the exchange rate prevailing on the transaction dates. Non-monetary items are translated at historical rates. Gains and losses arising from such translation are accounted for as foreign exchange gains or losses and reflected in the consolidated statements of operations, comprehensive loss and deficit.

Financial instruments - Recognition and measurement

The company has classified its financial instruments as follows:

a) Cash and cash equivalents: are designated as held for trading and carried at fair value

b) Accounts receivable: are designated as loans and receivables and measured at amortized cost.

c) Short-term investments: are classified as held to maturity and measured at amortized cost.

d) Account payable and accrued liabilities and obligations under acquisition contract are classified as financial liabilities and measured at amortized cost.

Comparative figures

Certain comparative figures have been reclassified, when necessary, to conform with the basis of presentation adopted in the current fiscal year.

Changes in accounting policies

Inventories

Effective January 1, 2008 the company prospectively adopted Canadian Institute of Chartered Accountants ("CICA") Handbook Section 3031. This section prescribes the accounting treatment for inventories and provides guidance on the determination of costs and its subsequent recognition as an expense, including any write-down to net realizable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

(expressed in Canadian dollars)

As a result of the adoption of this policy, the company has changed its inventory costing method from specific cost to weighted average cost and adjusted cost of inventory as at January 1, 2008 from $351,267 to $341,814. The deficit balance as at January 1, 2008 has been adjusted to $17,641,281 from $17,631,828.

Financial Instruments - Disclosure and Presentation

Effective January 1, 2008 the company adopted CICA Handbook Section 3862, Financial Instruments - Disclosures, and Section 3863, Financial Instruments - Presentation. Section 3862 requires disclosure of the significance financial instruments have on an entity's financial position and performance, the nature and extent of risks arising from financial instruments to which the entity is exposed and how the entity manages those risks. Section 3863, establishes standards for presentation of financial instruments and non-financial derivatives.

Section 3862 and section 3863 relate to disclosure and presentation only (see note 15) and did not have any impact on the company's financial results.

Capital Disclosures

Effective January 1, 2008 the company adopted CICA Handbook Section 1535, Capital Disclosures. Section 1535 requires the disclosure of (i) an entity's objectives, policies and processes for managing capital; (ii) quantitative data about what the entity regards as capital; (iii) whether the entity has complied with any capital requirements; and if it has not complied, the consequences of such non-compliance.

The new disclosure required by Section 1535 is included in note 16. The adoption of this standard did not have a material impact on the company's financial statements.

Assessing going concern

The Accounting Standards Board amended the CICA Handbook Section 1400, General Standards of Financial Statement Presentation, to include requirements for management to assess and disclose an entity's ability to continue as a going concern. Effective January 1, 2008, the company adopted this new standard. Management's assessment of the company's cash flows and revenue expectations throughout the year has lead to the conclusion that the adoption had no impact on the company's financial statements.

Future Accounting Standards

Goodwill and intangibles

In January 2008, the CICA issued 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 company will adopt this new requirement effective January 1, 2009 and is currently considering the impact this will have on its financial statements.

(expressed in Canadian dollars)

International Financial Reporting Standards

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

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

3 Business acquisition

On June 30, 2006, the company acquired the business and assets of Abbotly Technologies Pty. Limited ("Abbotly") for total consideration of AU$2,954,600 (CA$2,423,958). The assets included the brand and worldwide distribution rights of the ESM™, supplier agreements and distribution agreements.

The remaining payment under the agreement was made in May 2008.

4 Inventory

	2008 **$**	**2007** **$**
ESM™, ESM™ peripherals and ECO3™	1,119,053	351,267
Other products	23,870	-
	1,142,923	351,267

During the year ended December 31, 2008, total inventory of $293,782 (2007 - $126,562) have been recognized as expenses during the year.

(expressed in Canadian dollars)

5 Property and equipment

			2008
	Cost $	**Accumulated amortization $**	**Net book value $**
Computer hardware and software	156,839	57,652	99,187
Testing and demonstration equipment	190,841	89,956	100,885
Office equipment and furniture	46,302	12,160	34,142
Leasehold improvements	116,318	41,682	74,636
	510,300	201,450	308,850

			2007
	Cost $	**Accumulated amortization $**	**Net book value $**
Computer hardware and software	131,199	15,252	115,947
Testing and demonstration equipment	123,982	34,128	89,854
Office equipment and furniture	19,390	7,240	12,150
Leasehold improvements	116,318	30,049	86,269
	390,889	86,669	304,220

As at December 31, 2008, assets under capital lease with total cost of $49,543 and accumulated amortization of $24,772 are included in property and equipment and are classified under computer hardware and software.

Amortization expense for assets under capital lease recorded in the statements of operations, comprehensive loss and deficit for the year ended December 31, 2008 was $16,515 (2007 - $8,257).

(expressed in Canadian dollars)

6 Intangible assets

			2008
	Cost **$**	**Accumulated amortization** **$**	**Net book value** **$**
ESM™ brand (a)	56,100	-	56,100
ESM™ intellectual property (a)	124,100	31,025	93,075
North American distribution rights	279,853	76,960	202,893
Distribution agreements (a)	1,861,841	374,916	1,486,925
Supplier agreements (a)	113,650	28,412	85,238
United Kingdom distribution rights (b)	2,299,100	127,790	2,171,310
	4,734,644	639,103	4,095,541

			2007
	Cost **$**	**Accumulated amortization** **$**	**Net book value** **$**
ESM™ brand (a)	56,100	-	56,100
ESM™ intellectual property (a)	124,100	18,615	105,485
North American distribution rights	279,853	48,975	230,878
Distribution agreements (a)	1,861,841	226,520	1,635,321
Supplier agreements (a)	113,650	17,048	96,602
	2,435,544	311,158	2,124,386

a) ESM™ Intellectual Property and worldwide distribution rights

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

As one distributor became inactive in 2007, management performed a review of the carrying value of its distribution agreements. As a result of its assessment, the company recognized an impairment of $116,914 related to distribution agreements.

b) 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.

(expressed in Canadian dollars)

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.

7 Capitalized development costs

During the year ended December 31, 2008, the company incurred $150,473 (2007 - $54,853) of research and development costs of which $43,913 (2007 - $54,853) were expensed and $106,561 (2007 - $nil) were deferred. The deferred costs will be 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 has been charged to operating expenses for the year ended December 31, 2008.

8 Obligations under acquisition contract

a) Abbotly

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

	$
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
Foreign exchange	13,993
Repayments	(185,133)
Balance - December 31, 2008	-

(expressed in Canadian dollars)

b) TECC Services

At December 31, 2008, the company owed £600,000GBP related to its acquisition of distribution rights from TECC Services. The amount is non-interest bearing and has been recorded at its present value using a discount rate of 16% as follows:

	$
Balance - July, 11, 2008	865,358
Accretion	40,853
Foreign exchange	(97,102)
Balance - December 31, 2008	809,109
Less: Current portion	(268,440)
	540,669

Required repayments are as follows:

	GBP £
January 11, 2009	75,000
July 11, 2009	75,000
January 11, 2010	75,000
July 11, 2010	75,000
January 11, 2011	75,000
July 11, 2011	75,000
January 11, 2012	75,000
July 11, 2012	75,000
	600,000
Less: Current portion	(150,000)
	450,000

In the event that the company defaults on a payment or disposes of all or substantially all of its assets, all outstanding payments will become due immediately.

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

(expressed in Canadian dollars)

9 Capital leases

In the year 2007, the company entered into two contractual lease agreements to finance the purchases of computer equipment. Both leases expire in June 2010 and have an implied annual interest rate of 16.17%. Interest paid in the year ended December 31, 2008 related to obligations under capital lease was $5,711 (2007 - $3,048).

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

	$
Capital lease payments	
2009	20,634
2010	9,610
	30,244
Amount representing interest at 16.17%	(3,600)
Balance of the obligations	26,644
Less: Current portion	(17,499)
	9,145

(expressed in Canadian dollars)

10 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, 2006	28,336,321	15,210,145
Private placement (i)	5,000,000	6,176,555
Shares for consulting services (c)	11,197	12,000
Options exercised (d)	793,419	343,439
Share purchase warrants exercised (e)	2,933,750	1,765,068
Share issuance costs	-	(933,996)
Balance - December 31, 2007	37,074,687	22,573,211
Share purchase warrants exercised (e)	3,329,250	2,088,234
Options exercised (d)	35,000	18,216
TECC acquisition (f)	743,709	530,636
Share issuance cost adjustment	-	7,916
Balance - December 31, 2008	41,182,646	25,218,213

i) On August 16, 2007, the company issued 5,000,000 Units at $1.50 per unit pursuant to a brokered private placement, for gross proceeds of $7,500,000. Finalized cash share issuance costs were $596,081. Each Unit consists of one common share and one-half share purchase warrant. Each full share purchase warrant entitles the holder to purchase one common share at a price of $1.90 until August 16, 2009. These warrants are transferable after December 17, 2007. A total value of $1,323,445 was allocated to them.

ii) During the year ended December 31, 2007, the company issued 371,419 warrants as part of the private placement commission to agents. The fair value of these warrants of $257,028 has been reflected within share issuance costs.

c) Shares for consulting services

On July 1, 2006, the company entered into a contract with a consulting firm where it is entitled to receive $2,000 a month of common shares of the company from July 1, 2006 until December 31, 2006. The contract was renewed under the same terms for another six months and expired on June 30, 2007. The issuance of shares for service under this contract was approved by the TSX Venture Exchange.

(expressed in Canadian dollars)

d) 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 7,869,827. 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, 2006 (2,440,669 share options exercisable)	3,904,419	0.37
Granted	2,195,000	1.24
Exercised	(793,419)	0.30
Balance - December 31, 2007 (3,647,250 share options exercisable)	5,306,000	0.77
Granted	385,000	0.50
Forfeited	(325,000)	1.21
Expired	(350,000)	1.50
Exercised	(35,000)	0.26
Balance - December 31, 2008 (4,396,000 share options exercisable)	4,981,000	0.67

During the year ended December 31, 2008, the company granted 160,000 (2007 - 995,000) options to employees and 225,000 (2007 - 850,000) to non-employees. None of those options had an exercise price lower than the stock price at the date of grant (2007 - 985,000).

Stock-based compensation expense related to employees and non-employees for the year ended December 31, 2008 was $449,639 (2007 - $1,229,257), of which $29,835 (2007 - $362,434) related to non-employees.

Weighted average fair value of options granted to employees, officers, consultants during the year 2008 was $0.42 (2007 - $1.24).

(expressed in Canadian dollars)

Options outstanding at December 31, 2008 were as follows:

	Options outstanding			Options exercisable	
Exercise price $	**Number outstanding**	**Weighted average remaining contractual life (years)**	**Weighted average exercise price $**	**Number outstanding**	**Weighted average exercise price $**
0.10 - 0.20	90,000	4.82	0.17	22,500	0.17
0.21 - 0.28	1,101,000	1.36	0.23	1,101,000	0.23
0.33 - 0.48	1,225,000	2.37	0.40	1,187,500	0.40
0.54 - 0.89	520,000	3.56	0.60	355,000	0.63
0.90 - 1.10	585,000	2.95	0.91	585,000	0.91
1.11 - 1.42	1,460,000	3.70	1.20	1,145,000	1.20
	4,981,000	2.77	0.67	4,396,000	0.65

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:

	2008	**2007**
Risk-free interest rate	2.26% - 3.74%	3.91% - 4.60%
Dividend yield	0%	0%
Volatility	88.47% - 92.03%	93% - 100%
Expected life	4.5 - 5 years	1 - 5 years

(expressed in Canadian dollars)

e) Share purchase warrants

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

	Number outstanding	**Amount $**
Balance - December 31, 2006	5,941,331	577,357
Granted	2,871,419	1,581,433
Expired	(5,000)	-
Exercised	(2,933,750)	(343,427)
Warrants issue costs	-	(148,603)
Balance - December 31, 2007	5,874,000	1,666,760
Expired	(44,750)	(6,789)
Exercised	(3,329,250)	(485,128)
Warrants issue cost adjustment	-	1,737
Balance - December 31, 2008	2,500,000	1,176,580

As at December 31, 2008, there were 2,500,000 outstanding warrants. These warrants have an exercise price of $1.90 and will expire on August 16, 2009. Each warrant entitles the holder to purchase one common share of the company.

For year ended December 31, 2008, the company assigned a total fair value of $485,128 (2007 - $1,580,474) to warrants exercised during the year and transferred from share purchase warrants to share capital.

f) Shares issued under TECC acquisition agreement

On July 11, 2008, the company acquired distributions rights from TECC Service (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 preceding the date of closing.

(expressed in Canadian dollars)

g) Contributed surplus

At December 31, 2008, the company's contributed surplus comprised the following:

	$
Balance - December 31, 2006	754,510
Stock option expense	1,229,257
Agent stock option expense	219,835
Stock option exercise	(103,751)
Balance - December 31, 2007	2,099,851
Stock option expense	449,639
Stock option exercise	(8,166)
Expiry of warrants	6,789
Balance - December 31, 2008	2,548,113

11 Income taxes

At December 31, 2008, the company has unused non-capital losses of approximately $9,970,000 available to reduce taxable income of future years. The losses will expire as follows:

	$
2009	655,000
2010	494,000
2014	507,000
2015	979,000
2026	1,482,000
2027	2,713,000
2028	3,140,000
	9,970,000

(expressed in Canadian dollars)

Future income tax assets and liabilities comprise the following:

	2008 $	2007 $
Future income tax assets		
Non-capital losses	2,850,000	2,037,000
Share issuance costs	121,000	205,000
Other timing differences	109,000	51,000
	3,080,000	2,293,000
Less: Valuation allowance	(3,080,000)	(2,293,000)
	-	-

In assessing the realizability of future tax assets, management considers whether it is more likely than not that some portion or all of the future income tax assets will be realized. The ultimate realization of future tax assets depends upon the generation of future taxable income during the period in which those temporary differences become deductible. As management believes there is sufficient uncertainty regarding the realization of future tax assets for the year 2008, a full valuation allowance has been provided.

A reconciliation of the statutory income tax rate applied to the loss for the year to the income tax recovery is as follows:

	2008 $	2007 $
Statutory income tax rate (2008 - 30.5%; 2007 - 34.12%)	(1,333,120)	(1,475,103)
Permanent and other differences	554,014	405,208
Tax rate differences	(7,894)	157,895
Change in valuation allowance	787,000	912,000
	-	-

12 Commitments

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.

(expressed in Canadian dollars)

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

	$
2009	75,825
2010	77,220
2011	54,945
2012	51,300
2013 and thereafter	129,375
	388,665

For the year ended December 31, 2008, the company's rent expense including certain operating expenses and property taxes was $133,836 (2007 - $100,008) and its sublease revenue was $23,676 (2007 - $35,408).

b) Letter of credit

Upon the signing of the lease contract in June 2005, the company was required to secure its obligations with a letter of credit of $100,000. The letter of credit is reduced by $25,000 every year. As at December 31, 2008, the company had open letters of credit of $25,000 (2007 - $50,000).

c) Equipment lease

In July 2005, the company signed contractual lease agreements for equipment as follows:

- Telecommunication equipment for 40 months at $8,400 per annum
- Office equipment for 36 months at $14,800 per annum

These contracts expired in July 2008.

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.

(expressed in Canadian dollars)

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 nine months ended September 30, 2008, the company recorded royalties of US$12,112 and US$27,888. Payment of US$40,000 was made in July 2008. As at December 31, 2008, royalties of US$1,344 were payable to Abbotly USA (2007 - US$76,840).

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:

	2008		**2007**	
	Amount $	**Revenue %**	**Amount $**	**Revenue %**
United Kingdom	345,595	29	128,670	29
Australia	203,647	17	25,116	6
Israel	128,583	11	-	-
Barbados	127,416	11	-	-
Philippines	115,351	10	9,554	2
USA	86,294	7	45,897	10
Other	168,282	15	238,038	53
Total revenue	1,175,168	100	447,275	100

During the year ended December 31, 2008, revenue from five individual customers exceeded 10% of the company’s total revenue. These customers contributed 29%, 17%, 11%, 11% and 10%, respectively (2007 - 29%, 27%, 25%).

(expressed in Canadian dollars)

Property and equipment are located in:

	2008 **%**	**2007** **%**
Canada	38	57
USA	39	39
Other	23	4
Total	100	100

14 Related party transactions

Consulting fees of $259,185 were charged by directors of the company during the year (2007 - $62,200). Consulting and management fees of $90,997 were charged by three companies with common directors and officers during the year (2007 - $24,000). The company rents its office in the United Kingdom from a company with a common director. During the year ended December 31, 2008, rent expense was $21,539 (2007 - $nil). These transactions were recorded at their exchange amounts and have been charged to general and administrative in the statement of operations. At December 31, 2008, $15,298 (CDN$14,904) was owed to these related parties.

The company subleases its Vancouver office and other facilities to a company with a common director. During the year ended December 31, 2008, sublease income was $23,676 (2007 - $35,408). At December 31, 2008, $2,441 was owed from this related party (2007 - $nil).

Total purchases of £108,101GBP were made by a company with a common director during the year 2008 and are recorded as sales in the statement of operations. As at December 31, 2008, £71,147GBP was owed from this related party.

(expressed in Canadian dollars)

15 Financial instruments

a) Financial Instruments

The company has classified its financial instruments as follows:

	2008 $	2007 $
Financial assets		
Held-for-trading - measured at fair value		
Cash and cash equivalents	2,252,857	6,020,860
Loans and accounts receivable, recorded at amortized cost		
Amounts receivable	284,675	197,494
Held-to-maturity, recorded at amortized cost		
Short-term investments	25,608	227,536
Financial liabilities - recorded at amortized cost		
Amounts payable and accrued liabilities	430,172	333,122
Acquisition obligations and other	835,753	179,685

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

The following summarizes interest income and expense for the year ended December 31, 2008:

	2008 $	2007 $
Interest income from held-for-trading	111,419	147,885
Interest income from held-to-maturity	1,458	3,618
Interest expense from financial obligations	5,792	3,134
Interest expense from other financial liabilities	73,115	76,930

Fair value

Fair value estimates of financial instruments are made at a specific point in time, based on relevant information about financial markets and specific financial instruments. As these estimates are subjective in nature, involving uncertainties and matters of significant judgment, they cannot be determined with precision. Changes in assumptions can significantly affect estimated fair value.

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 obligations under acquisition contract ($540,669), has been discounted at 16% (see note 10.b) and is considered a close approximation of fair value.

(expressed in Canadian dollars)

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 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. Credit risk with respect to amounts receivable is limited due to the company's customer credit evaluation process. The company has $526,672 invested in bank guaranteed investment certificates, $1,751,793 in cash and cash equivalents, and $284,675 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 2009, equity financing has been considered.

As at December 31, 2008, the company's total account payable, accrued liabilities and current portion of obligation under acquisition contract was $698,612 with $564,392 due within 90 days and $134,220 due within one year. Current portion of capital lease was $17,499 as at December 31, 2008.

Please see note 1 for further disclosure on liquidity risk.

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 have been mitigated through the use of foreign currency forward contracts.

(expressed in Canadian dollars)

As at December 31, 2008, the company's monetary assets and liabilities denominated in foreign currencies are as follows:

	US$	AU$	GBP
Assets			
Cash and cash equivalents	224,993	38,660	38,347
Accounts receivable	88,060	32,674	74,557
Liabilities			
Accounts payable	87,189	58,115	48,080
TECC acquisition obligation - current portion	-	-	150,000
TECC acquisition obligation - balance	-	-	450,000

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:

	US$	AU$	GBP
Gain (loss) on $0.10 increase in CA$			
Monetary assets	(31,305)	(7,133)	(11,290)
Monetary liabilities	8,719	5,812	64,808
Net gain (loss)	(22,586)	(1,321)	53,518

Interest rate risk

The company's exposure to this risk is limited as it has no interest bearing debt.

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;

(expressed in Canadian dollars)

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 if that is necessary and appropriate.

The company is not subject to externally imposed capital requirements.

17 Supplementary cash flow information

	2008 **$**	**2007** **$**
Interest paid in cash	5,792	3,048
Interest income received in cash	111,205	142,612
Non-cash financing and investing activities		
Issuance of warrants for share issue costs	-	257,029
Issuance of stock options for share issue costs	-	219,835
Issuance of warrants for intangible assets	530,636	-
Assets purchased under capital lease	-	49,542
Obligations under TECC intangible asset acquisition	865,351	-

18 Subsequent event

On March 3, 2009, Smartcool announced that the company intended to reduce the exercise price of 1,895,000 incentive stock options - with exercises ranging from $0.90 per common share to $1,40 per common share - to an exercise price of $0.30 per common share. The re-pricing of the stock options is subject to the TSX Venture Exchange approval as well as, in the case of insiders of the company, the approval of disinterested shareholders. The company intended to seek such disinterested shareholders' approval for the amendment to insiders' options at its next annual general meeting currently scheduled to take place during the summer of 2009. There will be no change to the expiry dates of the options.