



**CONSOLIDATED FINANCIAL STATEMENTS**

December 31, 2010 and 2009

(expressed in Canadian Dollar)

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## **Independent Auditor's Report**

To the Shareholders of Smartcool Systems Inc.

We have audited the accompanying consolidated financial statements of Smartcool Systems Inc., which comprise the consolidated balance sheets as at December 31, 2010 and 2009, and the consolidated statements of operations, comprehensive loss and deficit, and cash flows for the years then ended, and a summary of significant accounting policies and other explanatory information.

### **Management's Responsibility for the Consolidated Financial Statements**

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### **Auditor's Responsibility**

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

### **Opinion**

In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Smartcool Systems Inc. as at December 31, 2010 and 2009 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*(Signed) Deloitte & Touche LLP*

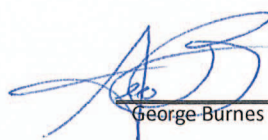
Chartered Accountants  
April 28, 2011  
Vancouver, Canada

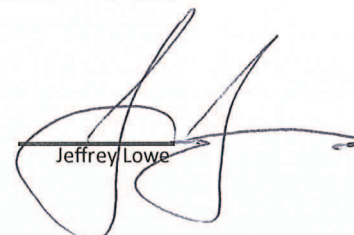
**Smartcool Systems Inc.**  
**Consolidated Balance Sheets**  
**As at December 31, 2010 and 2009**

(expressed in Canadian dollars)

	December 31 2010	December 31 2009
	\$	\$
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	443,972	147,051
Short-term investments	-	101,646
Restricted cash (note 3)	166,289	-
Accounts receivable	1,019,861	657,841
Inventory (note 4)	509,749	717,857
Prepaid expenses and deposits	75,487	242,302
	<u>2,215,358</u>	<u>1,866,697</u>
<b>Capitalized development costs (note 7)</b>	-	39,961
<b>Property and equipment (note 5)</b>	115,490	207,720
<b>Intangible assets (note 6)</b>	<u>3,184,309</u>	<u>3,639,843</u>
	<u>5,515,157</u>	<u>5,754,220</u>
<b>LIABILITIES</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	657,967	552,034
Current portion of obligations under contracts (note 8)	371,937	263,190
Current portion of capital leases (note 9)	-	9,144
Current portion of debentures (note 10)	386,290	-
Current portion of deferred tenant inducement	12,379	10,820
	<u>1,428,573</u>	<u>835,188</u>
<b>Obligations under acquisition contract (note 8)</b>	250,734	582,602
<b>Debentures (note 10)</b>	228,978	-
<b>Deferred tenant inducement</b>	<u>51,455</u>	<u>63,835</u>
	<u>1,959,740</u>	<u>1,481,625</u>
<b>SHAREHOLDERS' EQUITY</b>		
<b>Share capital (note 11(b))</b>	26,036,145	25,639,345
<b>Share purchase warrants (note 11(d))</b>	72,242	52,514
<b>Contributed surplus (note 11(e))</b>	4,405,305	3,983,831
<b>Deficit</b>	<u>(26,958,275)</u>	<u>(25,403,095)</u>
	<u>3,555,417</u>	<u>4,272,595</u>
	<u>5,515,157</u>	<u>5,754,220</u>
<b>Nature of operations and liquidity risk (note 1)</b>		
<b>Commitments (note 13)</b>		
<b>Subsequent Events (note 19)</b>		

Approved by the Board of Directors

  
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 years ended December 31, 2010 and 2009

(expressed in Canadian dollars)

	<b>2010</b>	<b>2009</b>
	\$	\$
<b>Revenue</b>	4,209,645	2,402,081
<b>Cost of sales</b>	1,264,220	714,433
	<u>2,945,425</u>	<u>1,687,648</u>
<b>Operating Expenses</b>		
General and administrative expenses	3,272,909	4,033,161
Stock-based compensation	368,960	259,138
Research and development	51,509	85,052
Amortization	560,102	602,549
	<u>4,253,480</u>	<u>4,979,900</u>
<b>Loss before undernoted</b>	<u>(1,308,055)</u>	<u>(3,292,252)</u>
<b>Other (income) expense</b>		
Interest expense	211,165	89,727
Interest Income	(4,777)	(4,813)
Foreign exchange loss (gain)	12,542	13,764
	<u>218,930</u>	<u>98,678</u>
Income taxes	<u>28,195</u>	<u>-</u>
<b>Loss and comprehensive loss for the year</b>	(1,555,180)	(3,390,930)
<b>Deficit, beginning of year</b>	<u>(25,403,095)</u>	<u>(22,012,165)</u>
<b>Deficit, end of year</b>	<u>(26,958,275)</u>	<u>(25,403,095)</u>
<b>Loss per share</b>		
Basic and diluted	<u>(0.03)</u>	<u>(0.08)</u>
<b>Weighted average number of common shares outstanding - basic and diluted</b>	<u>45,787,149</u>	<u>42,807,917</u>

**Smartcool Systems Inc.**  
**Consolidated Statements of Cash Flows**  
**For the years ended December 31, 2010 and 2009**

(expressed in Canadian dollars)

	<b>2010</b>	<b>2009</b>
	\$	\$
<b>Cash flows used in operating activities</b>		
Loss for the year	(1,555,180)	(3,390,930)
Items not affecting cash:		
Amortization of property and equipment	104,568	147,090
Amortization of intangible assets	455,534	455,459
Amortization of capitalized development costs	39,961	53,280
Stock-based compensation	368,960	259,138
Deferred tenant inducement	(10,821)	(9,706)
Accrued interest on debentures	70,618	-
Accrued interest of obligation under acquisition contract	17,389	9,420
Accretion of obligation under acquisition contract	66,546	75,227
Foreign exchange gain on obligations under acquisition contract	(60,632)	(47,724)
Changes in non-cash working capital items:		
Accounts receivable	(362,020)	(373,166)
Inventory	208,108	425,066
Prepaid expenses and deposits	166,815	(164,971)
Accounts payable and accrued liabilities	105,933	121,862
	<u>(384,221)</u>	<u>(2,439,955)</u>
<b>Cash flows used in investing activities</b>		
Purchase of short-term investment	-	(401,646)
Sale of short-term investment	101,646	325,608
Purchase of property & equipment	(12,338)	(45,960)
Restricted cash	(166,289)	-
	<u>(76,981)</u>	<u>(121,998)</u>
<b>Cash flows from financing activities</b>		
Shares and warrants issued for cash-net of issue costs	460,941	473,646
Debenture issued for cash	552,751	-
Repayment of obligations under acquisition contract	(246,425)	-
Repayment of capital lease obligations	(9,144)	(17,500)
	<u>758,123</u>	<u>456,146</u>
Increase (decrease) in cash and cash equivalents	296,921	(2,105,806)
Cash and cash equivalents, beginning of year	147,051	2,252,857
<b>Cash and cash equivalents, end of year</b>	<u>443,972</u>	<u>147,051</u>
Cash and cash equivalents consist of:		
Deposits with banks	443,972	147,051
Guaranteed investment certificates	-	-
	<u>443,972</u>	<u>147,051</u>

**Supplementary cash flow information (note 18)**

*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 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™ & ECO3™) to end customers and the sale of the ESM™ & ECO3™ to distributors worldwide.

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

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

During the year ended December 31, 2010, the Company incurred a loss of \$1,555,180 (2009 - \$3,390,930) and the Company had an accumulated deficit of \$26,958,275 as at December 31, 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 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.

During the year ended December 31, 2010, management raised \$500,000 through issuance of equity and \$610,000 through issuance of convertible debentures demonstrating the Company's success with raising financing for future operations. On February 22, 2011, the Company completed a private placement raising gross proceeds of \$4,000,000 from the issuance of 13,333,330 units comprising of one common share and one half of one common share purchase warrant.

## **2 Significant accounting policies**

### **Basis of presentation**

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 inter-company transactions and balances have been eliminated.

### **Use of estimates**

The preparation of financial statements in conformity with Canadian generally accepted accounting principles 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. Significant estimates are used for, but not limited to, assessment of impairment of intangible assets and recoverability of long-lived assets, determination of present value of obligations under acquisition contract, valuation of stock options and warrants, recoverability of accounts receivable, the determination of valuation allowance for income tax assets, and depreciation and amortization rates and methods.

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, 2010 and December 31, 2009, there were no cash equivalents.

### **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 amortized cost. Interest is recognized in the consolidated statement of operations, comprehensive loss and deficit, using the effective interest method.

### **Inventory**

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

Smartcool Systems Inc.  
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**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	33%
Computer software	20%
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
United Kingdom 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 the 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™ & ECO3™ is recognized when the ESM™ & ECO3™ have 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™ & ECO3™ 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 the above revenue recognition criteria being met.

### **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 \$106,561 have met these criteria. These costs have been amortized on a straight-line basis over a two year period from October 1, 2008 to September 30, 2010.

### **Stock-based compensation**

The fair value of all stock options granted to employees and non-employees 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, share capital is credited by the sum of the consideration paid and the related portion previously recorded in contributed surplus. At the time of grant, the expense is determined based on estimated forfeiture rate. The expense will be adjusted to recognize the effect of actual forfeitures as they occur.

### **Share purchase warrants**

The Company has issued common shares and share purchase warrants as a unit. The unit price is allocated to common shares and warrants based on their relative fair values. The fair value of common shares is the market price on the date of issue and the fair value of warrants is determined using the Black-Scholes option pricing model.

### **Loss per share**

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

### **Income taxes**

The Company follows the asset and 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 substantively 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.

As at December 31, 2010, tax assets from net operating losses carried forward and temporary differences amounted to \$4,125,000. Valuation allowance of the same amount has been recognized.

### **Foreign currency translation**

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. Foreign currency transactions are translated at the Canadian dollar rate prevailing on the transaction dates. Gains and losses arising from such translation are accounted for as foreign exchange gains or losses and reflected in the consolidated statement 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) Short-term investments: are classified as held to maturity and measured at amortized cost.
- c) Amounts receivable: are designated as loans and receivables and measured at amortized cost.

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d) Accounts payable and accrued liabilities, obligations under acquisition contract and debentures are classified as other financial liabilities and measured at amortized cost.

### Future Accounting Standards

#### *International Financial Reporting Standards*

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

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

### 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 \$166,289, 5% of cash revenue received from February 9 to December 31, 2010, has been designated as restricted cash in accordance with the debenture terms.

### 4 Inventory

	<b>2010</b>	<b>2009</b>
ESM™, ECO3™ and Peripherals	497,216	698,814
Other products	12,533	19,043
Total inventory	<u>509,749</u>	<u>717,857</u>

During the year ended December 31, 2010, total inventories of \$767,791 have been recognized as cost of sales (2009 - \$559,842).

Smartcool Systems Inc.  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
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**5 Property and equipment**

	<b>December 31, 2010</b>		
	<b>Cost</b>	<b>Accumulated</b>	<b>Net book</b>
	<b>\$</b>	<b>amortization</b>	<b>value</b>
		<b>\$</b>	<b>\$</b>
Computers	158,996	131,093	27,903
Testing and demonstration equipment	234,242	211,182	23,060
Office equipment and furniture	42,404	29,249	13,155
Leasehold improvements	116,318	64,946	51,372
	<u>551,960</u>	<u>436,470</u>	<u>115,490</u>
	<b>December 31, 2009</b>		
	<b>Cost</b>	<b>Accumulated</b>	<b>Net book</b>
	<b>\$</b>	<b>amortization</b>	<b>value</b>
		<b>\$</b>	<b>\$</b>
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
	<u>541,457</u>	<u>333,737</u>	<u>207,720</u>

As at December 31, 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 year ended December 31, 2010 was \$8,257 (2009 - \$16,515).

Smartcool Systems Inc.  
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**6 Intangible assets**

	<b>December 31, 2010</b>		
	<b>Cost</b>	<b>Accumulated</b>	<b>Net book</b>
	<b>\$</b>	<b>amortization</b>	<b>value</b>
		<b>\$</b>	<b>\$</b>
North American distribution rights (a)	279,853	132,930	146,923
ESM™ brand (b)	56,100	-	56,100
ESM™ intellectual property (b)	124,100	55,845	68,255
Distribution agreements (b)	1,861,841	671,771	1,190,070
Supplier agreements (b)	113,650	51,143	62,507
United Kingdom distribution rights (c)	2,299,100	638,646	1,660,454
	<u>4,734,644</u>	<u>1,550,335</u>	<u>3,184,309</u>

	<b>December 31, 2009</b>		
	<b>Cost</b>	<b>Accumulated</b>	<b>Net book</b>
	<b>\$</b>	<b>amortization</b>	<b>value</b>
		<b>\$</b>	<b>\$</b>
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
	<u>4,734,644</u>	<u>1,094,801</u>	<u>3,639,843</u>

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%

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b) ESM™ Intellectual Property and worldwide distribution rights

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

Management has performed a review of the carrying value of its distribution agreements. As a result of its assessment, in 2008 the Company recognized an impairment of \$116,914 related to distribution agreements. As a result of this impairment recognition, the total cost of distribution rights was reduced by \$148,799 to \$1,835,701. As at December 31, 2010, distribution rights consist of:

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

No impairments were recorded in 2009 and 2010.

c) Distribution Rights from TECC Services

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

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

The purchase agreement was amended on December 21, 2009 where payments were rescheduled with the first payment due on January 16, 2010 and the last one on July 16, 2012. The parties also agreed that interest would accrue on £75,000 GBP at RBC prime rate plus 4% from January 16, 2009 and additionally on £75,000 GBP from July 16, 2009 until these amounts are fully paid. The amendment had no material impact on the company's financial position and no gain or loss was recognized in 2009. As at December 31, 2010, the balance of £464,759 GBP, including accrued interest of £14,759 GBP, remained outstanding.

## 7 Capitalized development costs

During the year ended December 31, 2010, the Company incurred \$11,549 (2009 - \$31,772) of research and development costs that were fully expensed (2009 - \$31,772). No research and development costs were deferred in the year (2009 - \$0).

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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 \$39,961 has been charged to expenses for the year ended December 31, 2010 (2009 - \$53,280).

**8 Obligations under acquisition contracts**

**a) TECC Services**

At December 31, 2010, the Company owed £464,759 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	<u>809,109</u>
Accretion	75,227
Accrued interest	9,420
Foreign exchange	(47,964)
Balance – December 31, 2009	<u>845,792</u>
Payment	(246,425)
Accretion	66,546
Accrued interest	17,389
Foreign exchange	(60,631)
Balance – December 31, 2010	<u>622,671</u>
Less: Current portion	<u>(371,937)</u>
	<u>250,734</u>

Required repayments are as follows:

	GBP	CDN\$
January 16, 2011	112,500	174,521
July 16, 2011	112,500	174,521
January 16, 2012	112,500	174,521
July 16, 2012	<u>112,500</u>	<u>174,521</u>
	450,000	698,084
Accrued interest on 2009 late payments	<u>14,759</u>	<u>22,896</u>
Balance – December 31, 2010	464,759	720,980
Less: Current portion	<u>(239,759)</u>	<u>(371,938)</u>
	<u>£225,000</u>	<u>349,042</u>

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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 loss 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 ended June 30, 2010 related to obligations under capital leases was \$136 and \$467 (2009 - \$3,135). These leases expired in June 2010 and as at December 31, 2010 had an outstanding balance of \$0.

## 10 Debentures

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

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

The 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 December 31, 2010, total principal payments of \$166,289 have been deferred.

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

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

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

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

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

The equity component of \$8,101 has been credited to equity, Share Purchase Warrants (note 11(d)).

The liability component is measured at amortized cost. The interest expense for the year ended December 31, 2010 was \$115,306, was calculated by applying weighted average effective interest rate of 26% to the liability component. Interest payment total of \$44,688 was paid during the year ended December 31, 2010. As at December 31, 2010, the carrying amount of these debentures was \$615,268.

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	223,165	75,550	178,830	67,105	544,650
Accrued interest	54,555	16,193	32,588	11,970	115,306
Interest payment	(21,750)	(6,290)	(12,198)	(4,450)	(44,688)
Balance, December 31, 2010	255,970	85,453	199,220	74,625	615,268
Less: current portion	(168,163)	(52,114)	(120,737)	(45,276)	(386,290)
	<u>87,807</u>	<u>33,339</u>	<u>78,483</u>	<u>29,349</u>	<u>228,978</u>

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**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, 2008	41,182,646	25,218,213	
Private placement (i)	3,138,750	452,186	
Share issuance costs (i)	-	(31,054)	
Balance – December 31, 2009	<u>44,321,396</u>	<u>25,639,345</u>	
Private placement (iii)	2,500,000	440,286	
Share issuance costs (iv)	-	(43,486)	
Balance, December 31, 2010	<u>46,821,396</u>	<u>26,036,145</u>	

- 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 \$67,852 was attributed to the warrants. Issuance costs were \$47,196, consisting of cash share issuance costs of \$39,059 and noncash share issuance costs of \$8,137. 93% of total issuance cost (\$43,486) was allocated to common shares and 7% (\$3,710) 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 \$8,137 has been reflected within share issuance costs.

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**c) Stock options**

Under the Company's stock option plan, the Company may grant stock options to employees, directors, officers and consultants. The maximum number of shares to be awarded under the plan is 9,364,279. In October 2010, the stock option plan was amended to extend the option term to a maximum period of ten years. This amendment has been approved by shareholders at 2010 annual general meeting and accepted for filing by the TSX Venture Exchange. As at December 31, 2010, all outstanding 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:

	<b>Number of options</b>	<b>Weighted average exercise price \$</b>
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	1,640,000	0.27
Cancelled	(25,625)	0.28
Forfeited	(126,875)	0.40
Expired	(680,000)	0.33
Balance – December 31, 2010	<u>6,526,500</u>	<u>0.31</u>

During the year ended December 31, 2010, the Company granted 1,560,000 (2009 – 1,080,000) options to officers and employees and 80,000 (2009 – 634,000) to consultants. None of these options had an exercise price lower than the stock price at the date of grant (2009 – 0).

Stock-based compensation expense for the year ended December 31, 2010 was \$368,960 (2009 - \$259,138), of which \$314,860 was related to employees (2009 – \$153,075) and \$54,100 (2009 expense - \$106,063) was related to consultants.

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Options outstanding at December 31, 2010 were as follows:

Exercise price \$	Options outstanding			Options exercisable	
	Number	Weighed average remaining contractual life (years)	Weighed average exercise price \$	Number	Weighed average exercise price \$
0.10 - 0.20	776,500	3.65	0.14	600,500	0.14
0.22 - 0.25	1,225,000	4.07	0.24	505,000	0.24
0.30 - 0.33	3,325,000	2.70	0.31	2,780,000	0.31
0.40 - 0.48	700,000	0.66	0.42	700,000	0.42
0.54 - 0.60	400,000	1.68	0.57	400,000	0.57
0.72 - 0.96	100,000	1.14	0.84	100,000	0.84
	<u>6,526,500</u>	<u>2.77</u>	<u>0.31</u>	<u>5,085,500</u>	<u>0.33</u>

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	1.71%-2.45%	2.34%-2.76%
Dividend yield	0%	0%
Volatility	93.57%- 98.60%	97.67%-98.73%
Expected life	3.8 – 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, 2008	2,500,000	1,176,580
Expired	(2,500,000)	(1,176,580)
Issued	1,732,375	52,514
Balance – December 31, 2009	<u>1,732,375</u>	<u>52,514</u>
Expired	(1,732,375)	(52,514)
Issued	2,424,200	75,953
Warrant issue costs		(3,711)
Balance – December 31, 2010	<u>2,424,200</u>	<u>72,242</u>

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Share purchase warrants outstanding as at December 31, 2010 were as follows:

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

**e) Contributed surplus**

At December 31, 2010, the Company's contributed surplus comprised the following:

	\$
Balance – December 31, 2008	2,548,113
Stock option expense	259,138
Expiry of warrants	<u>1,176,580</u>
Balance – December 31, 2009	3,983,831
Stock option expense	368,960
Expiry of warrants	<u>52,514</u>
Balance – December 31, 2010	<u>4,405,305</u>

**12 Income taxes**

At December 31, 2010, the Company has unused non-capital losses of approximately \$14,234,000 available to reduce taxable income of future years. The losses will expire as follows:

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

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Future income tax assets and liabilities comprise the following:

	<b>2010</b>	<b>2009</b>
	<b>\$</b>	<b>\$</b>
Future income tax assets		
Non-capital losses	3,944,000	3,482,000
Share issuance costs	42,000	74,000
Other timing differences	139,000	112,000
	<u>4,125,000</u>	<u>3,668,000</u>
Future income tax liabilities	-	-
Less: Valuation allowance	<u>(4,125,000)</u>	<u>(3,668,000)</u>
	<u>-</u>	<u>-</u>

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

	<b>2010</b>	<b>2009</b>
	<b>\$</b>	<b>\$</b>
Statutory income tax rate (2010 - 28%; 2009 - 29%)	(411,140)	(1,017,280)
Utilization of tax loss carry-forward	(28,195)	-
Permanent and other differences	293,223	380,642
Tax rate differences	(310,888)	44,638
Change in valuation allowance	457,000	592,000
	<u>-</u>	<u>-</u>

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

In assessing the realizability of 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 uncertainty regarding the realization of future tax assets as at December 31, 2010, a full valuation allowance has been provided.

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### 13 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:

	\$
2011	53,970
2012	51,300
2013	52,875
2014	54,000
2015	22,500
	<u>234,645</u>

For the year ended December 31, 2010, the Company's rent expense including certain operating expenses and property taxes was \$167,273 (2009 - \$174,667) and its sublease revenue was \$16,467 (2009 - \$24,928).

b) Abbotly USA

Under the terms of the North American distribution rights acquisition, the Company is required to pay a 20% royalty on products identified in the Assignment and Assumption agreement dated March 27, 2006 and purchased from Abbotly Pty for North American sales. The initial term of the agreement was to expire on March 3, 2008. Smartcool, under its rights in the Assignment and Assumption agreement, has renewed the licensing agreement for another five year term. The Company has purchased all 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 year ended December 31, 2010, the Company recorded royalty expense of US\$40,000. As at December 31, 2010, royalties of US\$12,000 were payable to Abbotly USA (Year 2009 – US\$11,200).

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

	Total	Less than 1 year	1-2 years
	\$	\$	\$
Accounts payable and accrued liabilities	657,967	657,967	-
Debentures	615,268	386,290	448,978
Obligations under acquisition contracts	622,671	371,937	250,734
Total	1,895,906	1,416,194	699,712

#### 14 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:

	2010		2009	
	Amount \$	Revenue %	Amount \$	Revenue %
Europe, Middle East, Africa	2,582,723	61	952,773	40
Australia	473,387	11	240,970	10
South East Asia	511,708	12	534,982	22
Americas	641,827	16	673,356	28
Total revenue	4,209,645	100	2,402,081	100

During the year ended December 31, 2010, revenue from three customers exceeded 10% of the Company's total revenue. These customers contributed 14%, 12%, and 11% respectively. During the previous year, revenue from one individual customer exceeded 10% of the Company's total revenue. This customer contributed 22%.

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**Property and equipment are located in:**

	<u>2010</u>	<u>2009</u>
Canada	68%	55%
UK	20%	28%
Other	12%	17%
Total	<u>100%</u>	<u>100%</u>

**15 Related party transactions**

During the year ended December 31, 2010, consulting fees of \$120,149 were charged by directors of the Company (2009 - \$254,317). Consulting fees of \$131,500 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 year ended December 31, 2010, rent expense was \$35,418 (2009 –\$39,721). These transactions have been charged to general and administrative in the statement of operations, comprehensive loss and deficit. The Company also utilizes installation services from a company with a common director. During the year ended December 31, 2010, installation and material expenses charged by this related party were \$253,959 (2009 - \$0). These transactions have been charged to cost of sales in the statement of operations, comprehensive loss and deficit. At December 31, 2010, £1,158GBP (CDN\$1,796) was owed to these related parties (December 31,2009 - £8,129GBP(CDN\$13,753)).

The Company subleases its Vancouver office and other facilities to a company with a common director. During the year ended December 31, 2010, sublease income was \$16,467 (2009 - \$24,928). At December 31, 2010, \$1,000 was owed from this related party (December 31, 2009 - \$2,100).

The Company uses the services of a law firm of which a director is a partner. During the year ended December 31, 2010, fees in the amounts of \$36,644 were charged to the Company for legal services provided. As at December 31, 2010, \$55,006 was owed to this related party.

During the year ended December 31, 2010, total sales of \$604,622 were made to company with a common director (2009 – \$226,174). As at December 31, 2010, \$97,051 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.

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**16 Financial instruments**

a) Financial Instruments

The Company has classified its financial instruments as follows:

	<b>2010</b>	<b>2009</b>
	\$	\$
<b>Financial assets:</b>		
Held-for-trading, measured at fair value:		
Cash and cash equivalents	443,972	147,051
Restricted cash	166,289	-
Loans and accounts receivable, recorded at amortized cost:		
Accounts receivable	1,019,861	657,841
Held-to-maturity, recorded at amortized cost:		
Short-term investments	-	101,646
<b>Financial liabilities, recorded at amortized cost:</b>		
Accounts payable and accrued liabilities	657,967	552,034
Acquisition obligations, debentures and other liabilities	1,237,939	854,937

As at December 31, 2010, accounts receivable totaling \$374,106 were over 30 days past due but not impaired.

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 year ended December 31, 2010:

	<b>2010</b>	<b>2009</b>
	\$	\$
Interest income from held-for-trading	1,416	2,542
Interest income from held-to-maturity	3,361	2,270
Interest expense from financial obligations	74,000	5,078
Interest expense from other financial liabilities	137,165	84,649

**Fair value**

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

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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 of \$250,735 (2009 - \$582,602) and debentures of \$228,978, having been discounted at 16% (see note 8(a)) and 26% (see note 10), respectively, are considered a close approximation of fair value.

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

<b>Fair value measurement at December 31, 2010</b>				
	<b>December 31, 2010 Carrying value</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Financial assets	\$	\$	\$	\$
Cash and cash equivalents	443,972	443,972	-	-
Total	443,972	443,972	-	-

<b>Fair value measurement at December 31, 2009</b>				
	<b>December 31, 2009 Carrying value</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
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 \$1,019,861 (2009 - \$657,841) 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 December 31, 2010, the Company's total account payable and accrued liabilities and current portion of obligation under acquisition contract and debentures were \$1,416,194 (2009 - \$824,368) with \$894,716 (2009 - \$688,339) due within 90 days and \$521,478 (2009 - \$139,029) 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.

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As at December 31, 2010, the Company's monetary assets and liabilities denominated in foreign currencies are as follows:

	<b>USD</b>	<b>AUD</b>	<b>GBP</b>	<b>Euro</b>
<u>Assets</u>				
Cash and cash equivalents	344,932	984	146,563	-
Accounts receivable	394,710	48,905	333,190	20,550
<u>Liabilities</u>				
Accounts Payable	60,682	63,015	50,203	141,344
TECC acquisition obligation, current			239,758	
TECC acquisition obligation, balance			225,000	

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:

	<b>USD</b>	<b>AUD</b>	<b>GBP</b>	<b>Euro</b>
Gain (loss) on \$0.10 increase in CAD				
Monetary Assets	(73,964)	(4,989)	(47,975)	(2,055)
Monetary Liabilities	6,068	6,301	51,496	14,134
Net gain (loss)	(67,896)	1,312	3,521	12,079

*Interest rate risk*

The Company is exposed to this risk as late payments under TECC acquisition obligations are subject to interest based on Royal Bank of Canada prime rate plus 4%. As at December 31, 2010, the total of such payments was £150,000 GBP.

*Sensitivity analysis*

Assuming a 100-basis point increase in RBC prime rate, as at December 31, 2010, the impact on income before income taxes would be a negative adjustment of £1,500 GBP (CDN\$2,327).

**17 Capital management**

The Company's capital structure includes debentures and shareholders' equity consisting of issued common shares, warrants, contributed surplus and deficit. As at December 31, 2010, the principal amount of debenture component was \$610,000 (2009 - \$0) and shareholders' equity was \$3,555,417 (2009 - \$4,272,595). The decrease in shareholders' equity was attributable to 2010 net loss, partially offset by additional share capital raised during the year.

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The Company's objectives when managing capital are:

- a) to effectively finance its operations and growth by meeting its operating and capital expenditure budgets;
- b) to maintain financial flexibility in order to meet financial obligations, including obligations under acquisition contracts;
- c) to ensure its ability to carry out its strategic plans and take advantage of acquisition opportunities;
- d) to provide an appropriate investment return to its shareholders and maintain investor, creditor and market confidence.

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

The Company is not subject to externally imposed capital requirements.

## 18 Supplementary cash flow information

	2010 \$	2009 \$
Interest paid in cash	58,737	5,078
Interest income received in cash	6,423	4,838
Income taxes paid in cash	-	-
<b>Non-cash financing and investing activities</b>		
Issuance of warrants for share issue costs	8,137	5,950
Issuance of warrants for debenture transaction costs	-	-

## 19 Subsequent events

### *Business acquisition*

In December 2010, the Company entered into a Letter of Intent for the acquisition of Smartcool Systems UK Ltd., a distributor of Smartcool Technologies.

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Under the terms of the proposed acquisition, Smartcool Systems EMEA Ltd, a wholly-owned subsidiary of the Company, will acquire all issued and outstanding shares in the capital of Smartcool Systems UK as well as assuming the obligations of all the Company's employment agreements.

Smartcool UK is one of the licensees of Smartcool technologies. Pursuant to a distribution agreement, Smartcool UK owns certain distribution rights to Smartcool products in the United Kingdom and Ireland. As such, this acquisition represents a vertical integration of the Company's current operations.

For consideration, Smartcool agreed to pay to Smartcool UK shareholders:

- an amount of £2,200,000 GBP, of which £1,200,000 GBP is paid on closing and the remainder paid in installments of £250,000 GBP every three months; and
- an amount equal to the net book value of Smartcool UK shares on December 31, 2010, which is approximately £500,000 GBP

The Company will also issue to the shareholders of Smartcool UK a total of 1,000,000 share purchase warrants for a price of \$0.30 per share. 25% of the warrants will be vested at closing, and the remainder will vest in 25% installments every six months. These warrants will expire two years from vesting date.

The acquisition was subject to the Company reaching a definitive legal agreement, raising sufficient capital to fund the acquisition, and obtaining approval from the TSX Venture Exchange. The Company received a conditional approval from the Exchange on February 16, 2011 and the final approval on March 1, 2011.

*Private placement*

On February 14, 2011, the Company announced that it proposed to offer through a non-brokered private placement up to 10,000,000 units at a price of \$0.30 per unit.

Each unit consists of one common share and one half of one non-transferrable common share purchase warrant. Each whole purchase warrant entitles the holder to acquire one common share at a price of \$0.45 at any time up to 24 months from the closing dates.

On January 17, the Company announced that it now offered up to 13,333,333 units to raise proceeds up to \$4,000,000 instead of \$3,000,000.

On February 22, 2011, this private placement was closed.