

# Smartcool Systems Inc. (TSX-V: SSC) Third Quarter Management Discussion and Analysis

For the three months ended September 30, 2011

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## Preface

Smartcool Systems Inc. publishes a Management Discussion and Analysis (MD&A) each quarter, to assist readers in assessing and understanding the company's progress as detailed in the consolidated quarterly financial statements. This discussion should be read in conjunction with the consolidated financial statements for the quarter, and is in no way a replacement for the information given in the financial statements.

### ***Forward Looking Statements***

This MD&A contains forward-looking information, including statements regarding the future results of operations and marketing activities. Forward looking statements generally can be identified by the use of forward looking terminology such as "may", "will", "expect", "intend", "anticipate", "plan", "foresee", "believe" or other similar phrases. Although these forward-looking statements are based on what management believes to be current and reasonable assumptions, they involve known and unknown risks, uncertainties and other factors that may cause the actual results and performance to differ materially from those stated, anticipated, or implied.

Readers are cautioned not to place undue reliance on forward-looking information as no assurances can be given to future results, performance, or achievements.

## Executive Summary

During the third quarter, Smartcool achieved a great deal of progress in the pursuit of its sales targets and overall business strategy. The acquisition of the UK distributor in the first quarter of 2011 is demonstrating value, as Smartcool is receiving improved margins on key accounts in Europe. Several rollouts of Smartcool's products continued to major customers in Europe, and Smartcool continued to support distribution efforts across North America, the Middle East, India, Southeast Asia and Australia.

Revenue this quarter was \$785,689, compared to \$1,098,949 for the third quarter of 2010. Total assets were \$9,241,341 compared to \$5,539,242 for the third quarter of 2010. Net loss for the quarter was \$1,103,805 (\$0.02 per share), compared to \$240,671 (\$0.01 per share) for the third quarter of 2010.

Smartcool is experiencing a delay in recording revenue on installation roll outs for some major accounts. Smartcool expects to see this delayed revenue produce a strong fourth quarter performance, when this revenue can be recorded.

### Summary of Major Developments

#### ***Growth in Sainsbury's Relationship***

During the third quarter, Smartcool experienced a significant change in its long-term relationship with Sainsbury's, the third largest supermarket chain in the UK. Due to the success of Smartcool's multi-phase rollout of the ESM to Sainsbury's stores, Smartcool was asked to expand the scope of its work to become the primary refrigeration energy efficiency contractor for the food retailer. This new role brings additional revenue to Smartcool, as it provides consulting and project management services while continuing the rollout of the ESM to Sainsbury's.

#### ***US Market Progress***

Smartcool made good progress in the US market during the third quarter, particularly in the Mid-West, New York and Florida. Total Energy Concepts, Smartcool's leading distributor in the Mid-West, continues its successful trend of increasing ECO<sup>3</sup> sales averaging 130% growth by revenue to Smartcool per quarter. Smartcool is gaining traction in New York, receiving attention from media there and achieving Market Partner status with Con Edison, the utility company servicing New York. In Florida, Smartcool continued the positive trend in ECO<sup>3</sup> sales, while laying the groundwork for a major new sales initiative to be launched in the Miami area in the fourth quarter.

***Expansion into new European Markets***

In the second quarter, Smartcool signed a new distributor in Eastern Europe. Bricks & Bits achieved success throughout the third quarter by initiating rollouts to some major clients in Poland. During the third quarter, Smartcool also began working closely with an experienced energy efficiency company to develop key accounts in France. Due to the high profile of these customers, Smartcool has as yet been unable to release details, however investors can expect further news on these developments during the fourth quarter.

**Smartcool News in Third Quarter**

All Smartcool press releases are available online at [www.smartcool.net](http://www.smartcool.net). Below is a list of news items released in the third quarter, including all press releases and some notable posts to Smartcool's blog:

- [Recap: Smartcool's CEO Interviewed on the Organic View](#) (blog post with media links)
- [Con Edison Grants Smartcool Market Partner Status](#)
- [Saudi Aramco Deploys Smartcool Energy Efficiency Technology](#)
- [Superpowers](#) (blog post)
- [Steady Growth for Smartcool in American Mid-West](#)

## Business Overview

Smartcool Systems Inc. is a clean technology company specializing in the development and distribution of energy efficiency solutions for air conditioning, refrigeration and heat pump systems (HVAC).

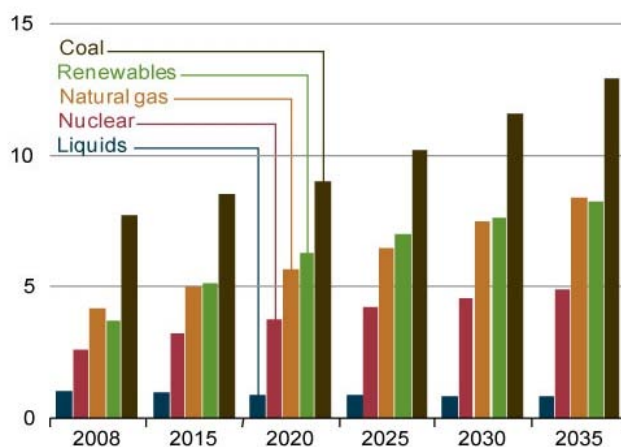
Smartcool was established in 2004, beginning as the North American distributor for the Energy Saving Module (ESM), a unique energy efficiency retrofit developed by Abbotly Technologies Pty Ltd of Australia. In 2006, Smartcool purchased the assets of Abbotly, including the intellectual property of the ESM, and became the sole manufacturer and master distributor. In 2009, Smartcool’s research and development cumulated in the delivery of the ECO<sup>3</sup> to market, a new product specifically designed to bring unprecedented energy efficiency to small scale HVAC systems.

### Energy Issues

Smartcool has focused on developing energy efficiency solutions to address the critical energy issues facing the world today and in the future. Electricity is a crucial part of the global economy and our communities. The worldwide demand for electricity has increased by 5.4% since 2010, with the developing countries averaging a 9.5% growth in demand. Coal continues to be the most widely used fuel for electricity generation, followed by natural gas. Electricity generated by these fossil fuels releases vast amounts of greenhouse gases into the atmosphere, contributing to climate change and general air pollution.

An instinctive solution is to switch to renewable energy sources, not only for environmental reasons but also due to issues of energy security. Electricity generation by renewable resources such as hydro, wind, waves and solar is increasing by an average of 3% each year thanks to government incentives. However, as the Energy Information Administration explains, “Although renewable energy sources have positive environmental and energy security attributes, most renewable technologies other than hydroelectricity are not able to compete economically with fossil fuels during the projection period except in a few regions or in niche markets.”<sup>1</sup>

EIA World Net Electricity Generation by Fuel  
2008-2035  
(in trillion kWh)



<sup>1</sup> Energy Information Administration, *International Energy Outlook 2011*, Published Sept. 19, 2011  
<http://www.eia.gov/forecasts/ieo/electricity.cfm>

On average, residential electricity rates around the globe have increased by 150% from 2005 to 2008.<sup>2</sup> Combined with environmental concerns surrounding fossil fuel generated electricity, it is clear that a solution to high energy consumption is urgently needed. Energy efficiency is the only option which is both cost effective and can be implemented rapidly.

### Smartcool's Energy Efficiency Solutions

Smartcool focuses on reducing the electricity used by refrigeration, air conditioning and heat pumps (HVAC). For target customer industries, such as supermarkets, these systems consume well over 50% of their total energy usage. Even for customers less dependent on HVAC, the systems still account for roughly 20% of their energy bill. The ability to save energy with Smartcool's energy efficiency technology represents a major opportunity to cut operating expenses any customer, typically giving them a return on their investment averaging 18 to 36 months. Electricity generated for buildings produces more greenhouse gases than any other source, so cutting HVAC energy consumption can also have a significant impact on the environment.

Smartcool's ECO<sup>3</sup> and ESM are retrofit products, meaning that they are installed by wiring in between the existing thermostat and the compressor in the HVAC system, rather than replacing any expensive equipment. Once installed, the products immediately begin monitoring the cooling cycle of the compressor to identify inefficiencies and opportunities for saving energy. Even the most modern systems have pre-existing inefficiencies that can only be resolved by the intellectual property provided in Smartcool's products. The ECO<sup>3</sup> and ESM dynamically adjust the cooling cycle to save customers energy without any impact to the temperature performance of the HVAC system.

The ECO<sup>3</sup>



With the ECO<sup>3</sup> and ESM, customers see all the benefits of energy efficiency, without any risks. The technology has undergone extensive independent third party testing by highly reputable organizations such as Oak Ridge National Laboratories, the University of Miami for Florida Power & Light, and the Los Angeles Department of Power & Water. These tests have proven unequivocally that the technology provides energy savings with no risks, as do over 30,000 installations worldwide.

The ESM



For more information on Smartcool's technology, visit [www.smartcool.net](http://www.smartcool.net)

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<sup>2</sup> Energy Information Administration, *Electricity Prices for Households*, Updated June 10, 2010  
<http://www.eia.gov/emeu/international/elecprih.html>

## The Market Strategy

Smartcool's ECO<sup>3</sup> and ESM are cost effective energy efficiency solutions for any air conditioning, refrigeration or heat pump system. There are no direct competitors. The few other energy efficiency products geared towards the HVAC market, do not offer the full package of benefits that the ECO<sup>3</sup> and ESM provide. Other products on the market do not provide the same degree of safety, and can cause temperature and humidity performance to be affected. They all lack the wide range of compatibility held by the ECO<sup>3</sup> and ESM, which can be installed on any HVAC system. Perhaps most significantly, other products cannot easily prove consistent energy savings. Smartcool's energy savings can be instantly verified on the product display screens, letting customers monitor energy savings as they happen. This is a critical feature for utility rebate qualification, which Smartcool has already received from major utilities like Florida Power & Light, Southern California Edison and Con Edison. These factors give Smartcool exclusive access to an immense market.

## Direct Sales

The company distributes its products directly to major clients, providing them with superior project management and service as they roll out Smartcool products to their facilities. For direct sales, Smartcool targets specific industries such as food retailers, telecommunications, commercial real estate and hospitality, where HVAC energy usage tends to represent a very high percentage of a client's operating budget. In Europe, Smartcool has built a strong portfolio of direct sales to Fortune 500 clients such as Sainsbury's, Tesco and Colt.



## Distribution Sales

Smartcool has developed an intricate network of distributors to target regional markets. Distributors are provided both technical and sales training by Smartcool and receive ongoing support. Distributors have the advantage of detailed regional

knowledge, allowing them to build strong client portfolios across the residential sector as well as in industries like food retail, climate controlled storage, hospitality and commercial real estate. Smartcool’s distributors have proven highly successful in Australia, India, the Philippines, UAE, Saudi Arabia, Eastern Europe, France, Spain, South Africa, and the US (particularly Florida, California and the Mid-West). Distributors have also proven instrumental in launching key accounts for Smartcool, like Telefonica, GE Healthcare, Dell, Saudi Aramco, 7-Eleven, JW Marriott and more.

**Corporate Structure**

Smartcool has gone through several phases of growth to reach its current structure. Smartcool Systems Inc. is the publicly traded parent company, with three wholly owned subsidiaries: International, USA and EMEA. Smartcool International Ltd. holds the intellectual property and is the master distributor of Smartcool’s product line. Smartcool Systems USA Inc. distributes the technology within the United States, using a network of local distributors to deliver the products to market.

Smartcool Systems EMEA was formed in 2008 and is the master distributor for Europe, the Middle East, Africa and the Indian Sub-Continent. In February 2011, Smartcool EMEA acquired all the outstanding shares of Smartcool Systems UK Ltd., a previously independent distributor with extensive technical expertise in Smartcool products.



Smartcool EMEA now conducts business as Smartcool Systems UK Ltd., directly managing a large portfolio of well established customer accounts. This improves gross revenue and profitability for Smartcool. Another significant factor in the acquisition is leveraging the considerable technical abilities of the UK team to assist in continuing the research and development of the Smartcool product line, and providing the best possible service and support to Fortune 500 clients and distribution channels. Smartcool EMEA / UK is headquartered in Alton, UK, providing Smartcool a strong base from which to serve Europe, its fastest growing market.

## Financial Overview

Despite a challenging global economy, Smartcool continues to develop its distribution network and win key accounts in target markets.

During the third quarter, revenue was \$785,689, compared to \$1,098,949 for the third quarter of 2010. Total assets were \$9,241,341 compared to \$5,539,242 for the third quarter of 2010. Net loss for the quarter was \$1,103,805 (\$0.02 per share), compared to \$240,671 (\$0.01 per share) for the third quarter of 2010.

	Dec 2010 (\$)	Mar 2011 (\$)	Jun 2011 (\$)	Sep 2011 (\$)
Total Revenues	1,337,906	943,958	276,398	785,689
Loss	(381,270)	(578,824)	(1,253,291)	(1,103,805)
Loss Per Share – basic & diluted	(0.01)	(0.01)	(0.02)	(0.02)
	Dec 2009 (\$)	Mar 2010 (\$)	Jun 2010 (\$)	Sep 2010 (\$)
Total Revenues	983,870	634,927	1,137,863	1,098,949
Loss	(585,565)*	(751,757)*	(246,073)*	(240,671)*
Loss Per Share – basic & diluted	(0.01)	(0.02)	(0.01)	(0.01)

\* IFRS adjusted

### Selected Annual Information

The following is selected information on Smartcool's financial performance for the past three years:

	Dec. 31, 2008	Dec. 31, 2009	Dec. 31, 2010
Revenue	\$1,175,168	\$2,402,081	<b>\$4,209,645</b>
Selling, General & Administrative	\$4,417,466	\$4,033,161	<b>\$3,272,909</b>
Net loss	\$(4,370,884)	\$(3,390,930)	<b>\$(1,619,771)</b>
Net loss – Per Share (Basic and Diluted)	\$(0.11)	\$(0.08)	<b>\$(0.04)</b>
Total Assets	\$8,281,026	\$5,754,220	<b>\$5,343,272</b>
Total Long Term Liabilities	\$624,467	\$646,436	<b>\$531,167</b>
Cash Dividends	<b>\$0</b>	<b>\$0</b>	<b>\$0</b>

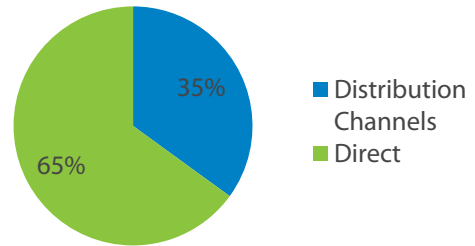
**Summary of Operating Results**

**Revenue**

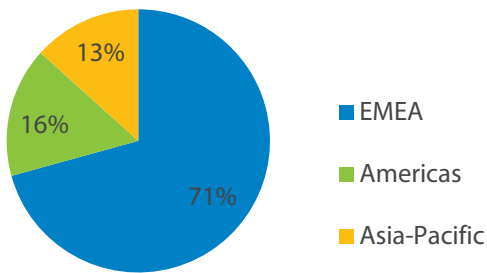
Delays of multi-site installations experienced by both Smartcool and its distributors have resulted in a decrease in the quarter’s revenue. Management expects these installation projects that have started in the fall, will show the company’s revenue stream trending upward starting in the fourth quarter of 2011.

Smartcool sells its products both directly to major customers, and through a network of independent distributors. Revenue from sales to distributors for the quarter was \$274,950 compared to \$514,074 for the same quarter of 2010. Direct sales were \$510,739 compared to \$584,875 for the same quarter of 2010.

**Revenue by Channel**



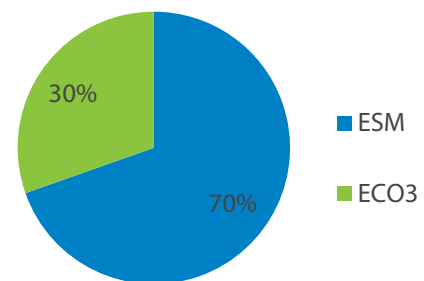
**Revenue by Region**



Revenue from the EMEA (Europe, Middle East, Africa, & India) region contributed \$555,548 of the quarter’s total revenue compared to \$785,592 in the same quarter of 2010. Revenue from the Asia-Pacific region was \$104,721, as compared to \$193,654 in the same quarter of 2010. The Americas region contributed \$125,420, compared to \$119,703 for the same quarter of 2010.

The ESM solution is Smartcool’s original product, and due to its complexity is generally reserved for direct sales and only the most experienced and well-resourced distributors. Revenue for the ESM solution was \$546,822 compared to \$948,962 for the same quarter of 2010. The ECO<sup>3</sup> has proven to be a mass market solution, and much of Smartcool’s efforts in the third quarter focused on developing successful distribution channels. Revenue for the ECO<sup>3</sup> was \$238,867 compared to \$149,987 for the same quarter of 2010.

**Revenue by Product**



**Gross profit**

Gross profit for the quarter was \$239,815 compared to \$794,185 for the third quarter of 2010. Profit margin of 31% was well below the expected range due to two factors. The equipment used for the first number of stores in the rollout with Sainsbury was acquired when the acquisition of Smartcool UK was completed. The adjusted cost

base of this equipment was recorded at a higher cost than Smartcool’s normal cost of manufacturing. Also a timing difference between installation expenses (\$165,458) payable to sub-contractors that were recognized in the quarter while revenue to the end customer was billed in the subsequent quarter, resulting in higher- than-normal cost of sales.

Gross margin for the third quarter of 2010 was 72%, within the expected range.

**General and administrative expenses**

General and administrative (“G & A”) expenses were \$979,218 compared to \$751,038 for the same quarter of 2010. Salaries for the quarter were \$524,501, compared to \$357,611 for the same quarter of 2010. The increase in salaries was attributable to Smartcool UK acquisition. Professional fees, for the quarter was \$78,585 compared to \$4,750 for the same quarter of 2010. The increase in fees was attributable to the establishment of a solid transfer pricing policy for the company and an adjustment of legal costs pertaining to Smartcool UK acquisition as well.

	Q3 2011	Q3 2010
Management and consulting fees	\$91,838	\$111,671
Salaries and benefits	524,501	357,611
Professional fees	78,585	4,750
Investor relations and media	35,009	33,047
Travel	91,381	126,472
Rent, office and other expenses	157,904	117,487
Total selling, general & admin expenses	979,218	751,038
Stock-based compensation	61,041	51,908
Research & Development	23,941	13,321
Amortization	194,821	135,104
<b>Total operating expenses</b>	<b>\$1,259,021</b>	<b>\$951,371</b>

**Net loss**

Net loss for the quarter was \$1,103,805, compared to \$240,671 for the same quarter of 2010, due to both reduction in revenue and increase in operating expenses.

The loss per share (basic and diluted) for the second quarter was \$0.02, compared to \$0.01 for the same quarter of 2010. Loss per share is calculated based on the weighted average number of common shares outstanding throughout the quarter.

**Comprehensive loss**

Comprehensive loss of \$958,299 consists of net operating loss (\$1,103,805) and foreign currency translation adjustment \$145,506. As the functional currencies of Smartcool EMEA, Smartcool UK and Smartcool USA are different from the reporting currency (Canadian dollar), their monetary assets and liabilities as well as non-monetary assets and liabilities in the consolidated financial statements must be translated into the reporting currency based on September 30, 2011 exchange rate under IFRS. This method of foreign currency translation resulted in the above adjustment which is classified as a component of equity. Comprehensive loss for the third quarter of 2010 was \$238,451.

**Amortization**

Amortization expenses were \$194,821 for the quarter compared to \$135,104 for the same quarter of 2010. Amortization on property and equipment was \$22,101 (Third quarter of 2010 - \$22,480) and amortization of intangible assets was \$172,719 (Third quarter of 2010 - \$112,624). Amortization of intangible assets was higher for the quarter as new assets have been acquired as part of the February 28, 2011 business combination.

**Stock-based compensation**

Stock-based compensation costs for the quarter were \$61,041, compared to \$51,908 for the same quarter of 2010. The increase was attributable to the amortization of options granted to UK employees and a consultant in the second quarter this year.

**Capital expenditures**

Capital expenditures for the quarter were \$15,378 (Third quarter of 2010 - \$5,048). These expenditures were for the acquisition of testing equipment and office equipment.

**Liquidity and Capital Resources**

Since incorporation, the Company has financed its operations through the issuance of equity. During the first quarter of 2011, the Company issued 13,333,330 units (consisting of one common share and one-half warrant) for gross proceeds of \$4,000,000. A large portion of the capital raised has been used to pay for the acquisition of Smartcool UK.

As at September 30, 2011, the Company had \$327,301 in cash and cash equivalents.

Working capital deficit at the end of the third quarter was \$1,688,009 compared to working capital of \$786,619 at the end of the same quarter of 2010. Part of the obligations under Smartcool UK acquisition contract, scheduled for payments within a year are classified as current liabilities, can be deferred at the Company's discretion. These installments total £750,000GBP (Cdn\$1,217,325).

The Company consumed cash resources of \$527,212 during the quarter, compared to cash generation of \$140,302 for the same quarter of 2010. The average monthly burn for the quarter was \$176,000. The average monthly cash generation for the same quarter of 2010 was \$46,000. Cash resources consumed in the quarter was for the financing of operations while cash generated in the third quarter of 2010 was primarily from the collection of accounts receivables. To ensure the Company will have adequate cash resources for smooth operations, management has placed stronger emphasis on accounts receivable collection effort and announced a private placement to raise gross proceeds of \$500,000. Cash flow from operation is expected to improve significantly in the fourth quarter when some large receivables become due and the private placement is completed.

### **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 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 September 30, 2011, total principal payments of \$66,833 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.

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 13(d)).

The liability component is measured at amortized cost. Interest expenses for the three and nine months ended September 30, 2011 were \$32,640 and \$70,903 (September 30, 2010 - \$30,483 and \$39,077), calculated by applying weighted average effective interest rate of 26% to the liability component. Interest payment total of \$36,600 and principal payment total of \$115,269 were paid during the nine months ended September 30, 2011. As at September 30, 2011, the carrying amount of these debentures was \$534,302.

Maturity date	Feb. 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	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 Dec. 31, 2010	255,970	85,453	199,220	74,625	615,268
Accrued interest	37,585	13,750	34,050	12,810	98,195
Principal payment	(97,145)	(27,968)	(15,318)	(5,744)	(146,175)
Interest payment	(22,500)	(7,650)	(18,000)	(6,750)	(54,900)
Balance September 30, 2011	\$173,909	\$63,585	\$199,952	\$74,940	\$512,388
Less: current portion	(173,909)	(63,585)	(199,952)	(74,940)	(512,388)
Balance	-	-	-	-	-

## Outstanding Share Data

The authorized share capital of the Company is an unlimited number of common shares without par value. As at September 30, 2011 the Company had 60,808,726 common shares outstanding. The weighted average number of common shares outstanding for the three months ended September 30, 2011 was 60,808,726 (December 31, 2010 – 45,787,149)

The increase in average number of common shares outstanding was a result of the issuance of 13,333,330 common shares pursuant to February 22, 2011 private placement. As at November 28, 2011, the outstanding shares are 60,808,726 and diluted are 76,841,258.

## Warrants and Stock options

As at September 30, 2011, there were 9,342,532 share purchase warrants and 6,390,000 stock options outstanding which collectively could result in the issuance of 16,032,532 common shares if these warrants and stock options are exercised. The outstanding options have a weighted average exercise price of \$0.33.

As at September 30, 2011 there were 5,084,375 exercisable options with a weighted average exercise price of \$0.34. During the quarter ended September 30, 2011, the company granted 30,000 options to an employee and 50,000 options to a consultant. As at November 28, 2011, there were 9,342,532 outstanding warrants and 6,690,000 outstanding options. The outstanding options have a weighted average exercise price of \$0.32.

## Intangible assets

The Company acquired \$2,278,350 of intangible assets in relation to the acquisition of Abbot Technology Pty Ltd.

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 September 30, 2011, distribution rights consist of:

ESM™ Distribution agreements	\$1,835,701
Other distribution rights	\$26,140
<b>Total</b>	<b>\$1,861,841</b>

No impairments were recorded in 2011 and 2010 and the impairment loss recognized in 2008 was not reversed upon transition to IFRS.

On July 11, 2008, the Company formed Smartcool EMEA, which acquired distribution rights for the ESM™ from T.E.C.C. Services Ltd. ("TECC"). TECC held exclusive rights to sell the ESM™ to existing distributors in the United Kingdom, Spain, Portugal, and the Middle East, as well as to develop new distributors in these regions. A consideration of £1,035,000GBP (CA\$1,738,750) was payable in cash and £265,000GBP (CA\$532,067) was payable in the form of common shares of the Company. Upon closing, payment of £435,000GBP (CA\$873,393) was made and 743,709 shares were issued. The remaining balance of £600,000GBP is due in scheduled installments over four years with the last payment due on July 16, 2012. These installments 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 September 30, 2011, the balance of £472,612GBP, including accrued interest of £22,612GBP, remained outstanding.

On February 28, 2011, the Company acquired \$3,768,164 of intangible assets in relation to the acquisition of Smartcool UK as described in the Business Overview. These intangible assets include the exclusive distribution rights of the ESM™ in the United Kingdom and Ireland. The acquisition gives EMEA direct access to customers in the region, thereby improving the company's profitability.

## Impairment

### ***Impairment of Long-Lived Assets***

Smartcool amortizes long-lived assets over the estimated useful life of the asset. Evaluation of all long-lived assets occurred periodically for impairment in accordance with Section 3062 and Section 3063 of the CICA Handbook.

Under IFRS, long-lived assets including property and equipment and intangible assets with a finite life are assessed for indications of impairment at the end of each reporting period. If such indications exist, then the recoverable amount of the asset or cash-generating unit ("CGU") is estimated.

An impairment loss is recognized when the carrying amount of the asset or CGU exceeds its recoverable amount. A CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of cash inflows from other assets or groups of assets. The recoverable amount of an asset or CGU is the greater

of its value in use and its fair value less costs to sell. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and risks specific to the asset or CGU.

Impairment losses are recognized in respects to CGU's are first allocated to reduce the carrying amount of any goodwill allocated to cash generating units, and then to reduce the carrying amount of the other assets in the unit on a pro-rata basis. Impairment losses are recognized in profit and loss for the period it is identified.

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 recoverable amount.

At December 31, 2010, to prepare for IFRS transition, we have conducted an impairment test on our definite lived intangibles assets. The intangible assets are ESM™ intellectual property, ESM™ distribution contracts and ESM™ supplier contracts that we acquired from Abbotly USA, Abbotly Technologies Pty and TECC Services. As our revenue is primarily derived from the sales of ESM™ products, revenue associated with the above intangible assets is readily identifiable. Revenue from existing distribution channels is projected based on minimum purchase requirements in conjunction with forecasts provided by the distributors themselves. Revenue expected from potential distribution channels is based on business development progress. Cost of goods sold projections are based on our expected margin and operating costs projections based on 2010 cost structures. The undiscounted cash flows supported the recoverability of our definite lived intangible assets.

Due to the above considerations, which are based on our best available information, we have not recorded any impairment on our long-lived assets in fiscal year 2010.

### ***Impairment of Intangible Assets***

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 recoverable amount.

### **Commitments**

#### **a. Premise lease**

The Company has entered into three lease agreements to lease office facilities in Vancouver and Alton, Hampshire. These leases will expire in five years. The future minimum lease payments commitments for the Company's office premises are:

	\$
2011	35,143
2012	108,109
2013	109,684
2014	110,809
2015	79,309
2016	9,466
	452,520

For the three and nine months ended September 30, 2011, the Company’s rent expense including certain operating expenses and property taxes was \$59,347 and \$161,270 (September 2010 - \$41,795 and \$123,710) and its sublease revenue was \$3,000 and \$9,000 (September 2010 - \$3,000 and \$13,467).

**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 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. The Company recorded royalties of US\$40,000 for the three and nine months ended September 30, 2011. As at September 30, 2011, royalties of US\$35,000 were payable to Abbotly USA (December 30, 2010 – US\$12,000).

**Transactions with Related Parties**

**a. Trading transactions**

The Company’s related parties consist of companies owned by executive officers and directors and key management as follows:

	<b>Nature of Transaction</b>
384518 BC Ltd.	Consulting
Windstone Financial	Consulting
Key Management	Consulting/General
Richards Buell Sutton	Legal Services
TECC	Rent
Magnum Energy Inc.	Rental income

The Company incurred the following expenses in connection with the companies owned by key management and directors. 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.

	Note	Three months ended		Nine months ended	
		September 30, 2011	September 30, 2010	September 30, 2011	September 30, 2010
		\$	\$	\$	\$
Consulting fees	(i)	62,483	60,496	183,666	179,934
Legal fees	(ii)	1,908	6,450	19,162	35,028
Rent expense	(iii)	-	8,733	12,777	26,510
Lease Income	(v)	(3,000)	(3,000)	(9,000)	(13,467)

**i.** During the three months ended September 30, 2011, consulting fees of \$29,483 were charged by directors of the Company (September 2010 - \$30,248). Consulting fees of \$33,000 were charged by two companies with common directors during the above periods (September 2010 - \$33,000).

During the nine months ended September 30, 2011, consulting fees of \$84,666 were charged by directors of the Company (September 2010 - \$89,967). Consulting fees of \$99,000 were charged by two companies with common directors during the above periods (September 2010 - \$98,500). As at September 30, 2011, \$47,403 was owed to these related parties (December 31, 2010 - \$11,635).

**ii.** The Company uses the services of a law firm of which a director is a partner. During the three and nine months ended September 30, 2011, fees in the amounts of \$1,908 and \$19,162 charged to the Company for legal services provided. As at September 30, 2011, \$5,218 was owed to this related party (December 31, 2010 - \$55,006).

**iii.** The Company rented its office in the United Kingdom from a company with a common director. During the nine months ended September 30, 2011, rent expense was \$12,777 (September 2010 - \$26,510). There was no rent expense in the three months ended September 30, 2011 (September 2010 - \$8,733). These transactions have been charged to general and administrative in the statement of operations, comprehensive loss and deficit. At September 30, 2011, no amounts were owed to this related party (December 31, 2010 - \$0).

**iv.** The Company subleases its Vancouver office and other facilities to a company with a common director. During the three and nine months ended September 30, 2011, sublease income was \$3,000 and \$9,000 (September

2010 - \$3,000 and \$13,467). At September 30, 2011, no amounts were owed from these related parties December 31, 2010 - \$1,000).

**Compensation of key management personnel**

The Company incurred the following expenses in connection with compensation of key management personnel.

	<b>September 30, 2011</b>	<b>December 31, 2010</b>
Short-term benefits	74,110	74,104
Share-based payments	131,609	205,728
<b>Total</b>	<b>205,719</b>	<b>279,832</b>

**Risk Management**

**a. Financial risk management**

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

**i. 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 trade and other 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 trade and other receivable is limited due to the Company’s customer credit evaluation process.

The Company has \$1,438,595 (2010 - \$1,019,861) in trade receivables which are subject to credit risk.

**ii. 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 is being obtained through issuance of equity.

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

	Total	1 year	2 years
	\$	\$	\$
Trade payables and accruals	1,436,43	1,379,	57,306
Finance leases	70,466	35,630	34,836
Debentures	512,388	512,38	-
Obligations under acquisition	2,322,57	2,322,	-
<b>Total</b>	<b>4,341,86</b>	<b>4,249,</b>	<b>92,142</b>

### iii. 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.

### iv. 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. Recently the Company has had most of its new purchases and sales contracts denominated in US dollars to partially reduce risk exposure.

As at September 30, 2011, the Company's monetary assets and liabilities denominated in foreign currencies are as follows:

	USD	AUD	GBP	Euro
<u>Assets</u>				
Cash and cash equivalents	107,186	50,659	4,086	61
Trade and other receivables	355,745	72,885	654,756	10,450
<b>Total</b>	<b>462,931</b>	<b>123,544</b>	<b>658,842</b>	<b>10,511</b>
<u>Liabilities</u>				
Total payables and accruals	137,109	127,749	446,395	107,434
Finance lease obligations	-	-	42,516	-
Acquisition obligations, current	-	-	1,472,612	-
Acquisition obligations, balance	-	-	-	-
<b>Total</b>	<b>137,109</b>	<b>127,749</b>	<b>1,961,523</b>	<b>107,434</b>

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

Gain (loss) on \$0.10 increase in CAD	USD	AUD	GBP	Euro
Monetary Assets	(46,293)	(12,354)	(65,884)	(1,051)
Monetary Liabilities	13,711	12,775	196,152	10,743
Net gain (loss)	(32,582)	(421)	130,268	9,692

#### v. 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 September 30, 2011, the total of such payments was £150,000GBP (CDN\$243,465).

The Company is exposed to this risk as late payments under Smartcool UK acquisition obligations are subject to interest based on Royal Bank of Canada prime rate. As at September 30, 2011, the total of such payments was £500,000GBP (CDN\$811,550).

#### Sensitivity analysis

Assuming a 100-basis point increase in RBC prime rate, as at September 30, 2011, the impact on income before income taxes would be a negative adjustment of £6,500GBP (CDN\$10,550).

#### **Operating Risks**

The business of the Company is subject to a number of risks and uncertainties associated with its business for the marketing and distribution of its products and services.

#### Distribution Network Development

The Company has continued to develop new sales and distribution networks around the world. A primary objective of the Company's business plan includes the identification and development of new networks, however there can be no assurances of the amount of revenue that will be generated from these efforts.

To help mitigate the risk, the Company requires new distributors to agree to purchase a minimum amount of inventory in each year of the agreement to retain territorial exclusivity. This provides the Company with predictable revenue from these territories.

## Competition Risk

Although the ESM™ and ECO3™ are unique products and the Company is not aware of any direct competitors, there is a possibility that new technologies will be developed that allow direct competition as energy saving activities gain more and more public support. This direct competition may adversely affect the Company's operating results and even its ability to sustain the business.

To mitigate the risk of competition, Smartcool engages in rigorous and ongoing competitive research, carefully monitoring any other potentially competitive products in the market. Smartcool also dedicates resources towards product development in order to stay ahead of any potential competitors and satisfy market demands.

## Reliance on Key Personnel

The Company is dependent on certain key members of its management team, and in particular Mr. George Burnes, CEO & President. If any of these individuals are unavailable for any reason, the ability of the Company in the short term to implement its business plan and continue successful development of product sales and distribution would be materially and adversely affected.

To help mitigate the risk, Smartcool is working towards full process documentation to assist in the scalability of the business and facilitate training of new personnel. Smartcool is also investing in software to assist with sharing knowledge, documents and best practices across the business.

## Concentration on a single supplier

The Company relies on Tiller Manufacturing for the manufacturing and development of its products, ESM™ and ECO3™. This puts the company at risk should any disruption to Tiller's business occur.

To mitigate this risk, Smartcool is bringing more product research and development in house, and is exploring the options for the manufacture of its products.

## **Subsequent events**

On November 15, 2011, the Company announced that it plans to offer through a non-brokered private placement up to 2,500,000 units at a price of \$0.20. Each unit consist of one common share and one half of one common share purchase warrant. Each whole common share purchase warrant will entitle the holder to acquire one common share at an additional price of \$0.30 per share at any time up to twelve months from the closing rate. The company may, at its discretion, pay a finder's fee of 7% of the gross proceeds. The proceeds from the offering of units will be used for general working capital and purchase of inventory.

## Critical Accounting Policies & Estimates

### ***Business combinations***

The identifiable assets, liabilities and contingent liabilities of a subsidiary, joint venture entity or an associate, which can be measured reliably, are recorded at their provisional fair values at the date of acquisition. Goodwill is the fair value of the consideration transferred (including contingent and previously held non-controlling interests) less the fair value of the Company's share of identifiable net assets on acquisition. Transaction costs incurred in connection with the business combination are expensed. Provisional fair values are finalized within twelve months of the acquisition date.

Where the fair value of the identifiable net assets acquired exceeds the cost of the acquisition, the surplus, which represents the discount on the acquisition, is recognized directly in the statement of operations and total comprehensive loss in the period of acquisition.

### ***Revenue Recognition***

Revenue from the sale and installation of the ESM™ and ECO3™ is recognized when the ESM™ & ECO3™ have been installed, significant risks and rewards of ownership of the equipment have been transferred to the customer, the Company does not retain continuing managerial involvement or effective control over the equipment, the sales price can be determined and probably collectible, and the cost of the transaction can be measured reliably.

Revenue from the international distribution of the ESM™ & ECO3™ is recognized when the equipment has been shipped, title has been transferred, the sales price has been determined and the cost of the equipment can be measured reliably. Revenue is also recognized when equipment has been ordered and laid away as instructed by the customer, the sales price has been determined and a significant portion of it has been paid. 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.

### ***Share-based Payments***

The fair value of all stock options granted to employees is determined using the Black-Scholes option pricing model, and the resulting value is charged to operations over the vesting period.

The fair value of options granted to non-employees is determined using fair value of the goods or services received. The resulting value is charged to operations when 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 equity reserve 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 equity reserve. 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.

The fair value of warrants issued to agents for their finder's fee is determined using the Black-Scholes option pricing model and the resulting value is charged to share issuance costs.

***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 with finite lives are amortized on a straight-line basis over their estimated 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

Total amortization for the three months ended September 30, 2011 of \$172,719 is included under Net loss for the period on the statement of operations.

***Accounting standards issued but not yet effective***

Standards issued but not yet effective up to the date of issuance of the Company's condensed consolidated financial statements are listed below.

**Financial Instruments – Disclosures:** The International Accounting Standard Board (the "IASB") has issued an amendment to IFRS 7, "Financial Instruments: Disclosures" (the "IFRS 7 amendment") requiring incremental disclosures regarding transfers of financial assets. The IFRS 7 amendment is effective for annual periods beginning on or after July 1, 2011. The Company will apply the amendment at the beginning of the 2012 financial year and does not expect the implementation to have a significant impact on disclosures

**Deferred Taxes – Recovery of Underlying Assets:** The IASB has issued an amendment to IAS 12, "Income Taxes" (the "IAS 12 amendment") that introduces an exception to the general measurement requirements of IAS 12 in respect of investment properties measured at fair value. This amendment is effective for annual periods beginning or after January 1, 2012. The Company will apply the amendment at the beginning of

the 2012 financial year and does not expect the implementation to have a material impact on the Company's financial statements.

**Financial Instruments:** The IASB has issued a new standard, IFRS 9, "Financial Instruments" ("IFRS 9") which will ultimately replace IAS 39, "Financial Instruments: Recognition and Measurement ("IAS 39"). The replacement of IAS 39 is a multi-phase project with the objective of improving and simplifying the reporting of financial instruments and the issuance of IFRS 9 is part of the first phase of this project. This standard becomes effective on January 1, 2013. The Company has not assessed the impact of this new standard.

**Consolidated Financial Statements:** The IASB has issued a new standard, IFRS 10, which establishes principles for the presentation and preparation of consolidated financial statements when an entity controls one or more other entities. IFRS 10 supersedes IAS 27 "Consolidated and Separate Financial Statements" and SIC-12 "Consolidation—Special Purpose Entities" and is effective for annual periods beginning on or after January 1, 2013. Earlier application is permitted. The company is currently evaluating the impact of this standard on its consolidated financial statements.

**Fair value measurements:** The IASB has issued IFRS 13, which defines fair value and sets out in a single IFRS framework for measuring fair value and requires disclosures about fair value measurements. The IFRS 13 applies to IFRSs that require or permit fair value measurements or disclosures about fair value measurements (and measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements), except in specified circumstances. IFRS 13 is to be applied for annual periods beginning on or after January 1, 2013. Earlier application is permitted. The company is currently evaluating the impact of this standard on its consolidated financial statements.

The IASB has issued an amendment to IAS 1 "Presentation of financial statements" ("IAS 1 amendment"), which requires the presentation of items of other comprehensive income ("OCI"), classified by nature, to be grouped into items that will not be reclassified subsequently to profit or loss; and items that will be reclassified subsequently to profit or loss when specific conditions are met. The IAS 1 amendment is effective for annual periods beginning on or after July 1, 2012. IAS 1 amendment is not applicable to the Company.

### **Additional Information**

Additional information relating to the Company, including the Company's latest Annual Financial Statements and news releases can be located on the Company's website at [www.smartcool.net](http://www.smartcool.net) or on the SEDAR website at [www.sedar.com](http://www.sedar.com).