



CONSOLIDATED FINANCIAL STATEMENTS

For the nine months ended September 30, 2010 and 2009

(expressed in Canadian Dollar)

NOTICE OF NO AUDITOR REVIEW OF INTERIM FINANCIAL STATEMENTS

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

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

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

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

(expressed in Canadian dollars)

	September 30 2010	December 31 2009
	\$	\$
ASSETS		
Current assets		
Cash and cash equivalents	518,079	147,051
Short-term investments	-	101,646
Restricted cash (note 3)	104,343	-
Accounts receivable	982,524	657,841
Inventory	560,354	717,857
Prepaid expenses and deposits	97,686	242,302
	<u>2,262,986</u>	<u>1,866,696</u>
Capitalized development costs (note 7)	-	39,961
Property and equipment (note 5)	128,176	207,720
	-	-
Intangible assets (note 6)	<u>3,299,301</u>	<u>3,639,843</u>
	<u>5,690,462</u>	<u>5,754,220</u>
LIABILITIES		
Current liabilities		
Accounts payable and accrued liabilities	422,564	552,034
Current portion of obligations under contracts (note 8)	520,100	263,190
Current portion of capital leases (note 9)	-	9,144
Current portion of debentures (note 10)	216,843	-
Current portion of deferred tenant inducement	11,711	10,820
	<u>1,171,218</u>	<u>835,188</u>
Obligations under acquisition contract (note 8)	244,668	582,602
Debentures (note 10)	313,682	-
Deferred tenant Inducement	<u>54,828</u>	<u>63,834</u>
	<u>1,784,397</u>	<u>1,481,625</u>
SHAREHOLDERS' EQUITY		
Share capital (note 11(b))	26,063,452	25,639,345
Share purchase warrants (note 11(d))	119,824	52,514
Contributed surplus (note 11(f))	4,303,592	3,983,831
Deficit	<u>(26,580,803)</u>	<u>(25,403,095)</u>
	<u>3,906,066</u>	<u>4,272,595</u>
	<u>5,690,462</u>	<u>5,754,220</u>
Nature of operations and liquidity risk (note 1)		
Commitments (note 12)		
Approved by the Board of Directors	<u>"George Burnes"</u> George Burnes	<u>"Jeffrey Lowe"</u> Jeffrey Lowe

See accompanying notes to the consolidated financial statements

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

(expressed in Canadian dollars)

	Three months ended September 30		Nine months ended September 30	
	2010	2009	2010	2009
	\$	\$	\$	\$
Revenue	1,098,949	681,811	2,871,739	1,418,211
Cost of sales	304,764	222,475	904,110	477,912
	794,184	459,336	1,967,629	940,299
Operating Expenses				
General and administrative expenses	751,037	809,018	2,263,803	3,042,874
Stock-based compensation	51,908	8,190	267,247	115,883
Research and development	13,321	19,523	42,350	65,591
Amortization	135,104	150,449	425,135	453,313
	951,371	987,180	2,998,535	3,677,661
Loss before undernoted	(157,186)	(527,844)	(1,030,906)	(2,737,363)
Other (income) expense				
Interest expense	59,736	18,825	158,875	61,795
Interest Income	(277)	(680)	(4,557)	(5,990)
Foreign exchange loss (gain)	43,081	(74,890)	(7,516)	12,195
	102,540	(56,745)	146,802	68,001
Loss and comprehensive loss for the period	(259,725)	(471,100)	(1,177,708)	(2,805,364)
Deficit, beginning of period	(26,321,077)	(24,346,429)	(25,403,095)	(22,012,165)
Change in accounting for inventory			-	0
Deficit, end of period	(26,580,802)	(24,817,529)	(26,580,803)	(24,817,529)
Loss per share				
Basic and diluted	(0.01)	(0.01)	(0.03)	(0.07)
Weighted average number of common shares outstanding - basic and diluted	46,821,396	44,321,396	45,438,612	42,305,265

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

(expressed in Canadian dollars)

	Three months ended September 30		Nine months ended September 30	
	2010	2009	2010	2009
	\$	\$	\$	\$
Cash flows from operating activities				
Loss and comprehensive loss for the year	(259,726)	(471,100)	(1,177,708)	(2,805,364)
Items not affecting cash:				
Amortization of property and equipment	22,480	36,782	84,593	111,195
Amortization of intangible assets	112,624	113,667	340,543	342,118
Amortization of capitalized development costs	13,320	13,320	39,960	39,960
Stock-based compensation	51,908	8,190	267,247	115,883
Deferred tenant inducement	(2,705)	(2,705)	(8,115)	(7,001)
Accrued interest on debentures	21,726	-	60,765	-
Accretion of obligation under acquisition contract	19,517	18,123	59,807	57,357
Foreign exchange gain on obligations under acquisition contract	17,016	(92,896)	(31,457)	(36,322)
Changes in non-cash working capital items:				
Accounts receivable	251,799	(179,926)	(324,684)	(250,164)
Inventory	110,492	144,229	157,503	314,632
Prepaid expenses and deposits	(26,730)	(207,496)	144,616	(212,756)
Accounts payable and accrued liabilities	(188,980)	194,271	(129,470)	59,454
	142,742	(425,540)	(516,399)	(2,271,007)
Cash flows from investing activities				
Purchase of short-term investment	-	-	-	(402,822)
Sale of short-term investment	-	99,321	101,646	175,608
Purchase of property & equipment	(5,048)	(2,938)	(5,048)	(50,987)
	(5,048)	96,383	96,597	(278,201)
Cash flows from financing activities				
Shares and warrants issued for cash-net of issue costs	-	-	460,941	473,646
Shares issued on exercise of options	-	-	-	-
Shares issued on exercise of warrants	-	-	-	-
Debenture issued for cash	-	-	552,750	-
Repayment of obligations under acquisition contract	(29,991)	-	(109,374)	-
Repayment of capital lease obligations	-	(4,458)	(9,144)	(12,860)
	(29,991)	(4,458)	895,173	460,786
Increase (Decrease) in cash and cash equivalents	107,703	(333,616)	475,372	(2,088,423)
Cash and cash equivalents, beginning of period	514,719	498,050	147,051	2,252,857
Cash and cash equivalents, end of period	622,422	164,434	622,422	164,434
Cash and cash equivalents consist of:				
Deposits with banks			622,422	164,434
Guaranteed investment certificates			-	-
			622,422	164,434

Supplementary cash flow Information (note 17)

See accompanying notes to the consolidated financial statements

1 Nature of operations and liquidity risk

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

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

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

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

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

During the nine months ended September 30, 2010, the company incurred a loss of \$1,179,423 (2009 - \$3,390,930) and the company had an accumulated deficit of \$26,582,518 as at September 30, 2010 (2009 - \$25,403,095).

To date the company has been able to raise capital to finance its operations whenever necessary. The company's ultimate success and the recoverability of its intangible assets will depend on the company's ability to successfully execute its business plan which includes the existence of a market for its products, achieving profitable operations, meeting its business acquisition obligations, and the continued support of the company's shareholders and employees.

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

2 Significant accounting policies

Basis of presentation

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

These interim financial statements follow the same accounting policies and methods of their application as the company's annual audited financial statements for the year ended December 31, 2009.

Future Accounting Standards

Business Combinations

In January 2009, the CICA issued Section 1582 "Business Combinations" which establishes principles and requirements of the acquisition method for business combinations and related disclosures. The purchase price is to be based on trading data at the closing date of the acquisition, not the announcement date of the acquisition, and most acquisition costs are to be expensed as incurred. This standard applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011 with earlier application permitted. The company plans to adopt this standard prospectively effective January 1, 2011. The adoption of this standard may have an impact on the accounting of future business combinations.

Consolidated Financial Statements

In January 2009, the CICA issued Section 1601 which establishes standards for the preparation of consolidated financial statements and Section 1602 which provides guidance on accounting for a non-controlling interest in a subsidiary in consolidated financial statements subsequent to a business combination. The company plans to adopt this standard prospectively effective January 1, 2011. The adoption of this standard may have an impact on the accounting of future business combinations.

Smartcool Systems Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2010 and 2009

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 \$104,343, 5% of cash revenue received from February 9 to September 30, 2010, has been designated as restricted cash in accordance with the debenture terms.

4 Inventories

	2010	2009
ESM™, ECO3™ and Peripherals	543,107	698,814
Other products	17,247	19,043
Total inventory	<u>560,354</u>	<u>717,857</u>

During the three and nine months ended September 30, 2010, total inventories of \$152,228 and \$464,359 have been recognized as cost of sales.

Smartcool Systems Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2010 and 2009

5 Property and equipment

	September 30, 2010		
	Cost	Accumulated	Net book
	\$	amortization	value
		\$	\$
Computer hardware and software	158,996	128,088	30,908
Testing and demonstration equipment	225,482	200,697	24,785
Office equipment and furniture	45,710	27,507	18,203
Leasehold improvements	116,318	62,038	54,280
	<u>546,506</u>	<u>418,330</u>	<u>128,176</u>
	December 31, 2009		
	Cost	Accumulated	Net book
	\$	amortization	value
		\$	\$
Computer hardware and software	158,995	100,963	58,032
Testing and demonstration equipment	220,434	157,317	63,117
Office equipment and furniture	45,710	22,143	23,567
Leasehold improvements	116,318	53,314	63,004
	<u>541,457</u>	<u>333,737</u>	<u>207,720</u>

As at September 30, 2010, assets under capital lease with total cost of \$49,543 and accumulated amortization of \$49,543 are included in property and equipment for net book value of \$0 (2009 - \$8,257).

Amortization expense for assets under capital lease recorded in the statement of operations, comprehensive loss and deficit for the three and nine months ended September, 2010 was \$0 and \$8,257 (2009 - \$16,515).

Smartcool Systems Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2010 and 2009

6 Intangible assets

	September 30, 2010		
	Cost	Accumulated	Net book
	\$	amortization	value
		\$	\$
North American distribution rights (a)	279,853	125,934	153,919
ESM™ brand (b)	56,100	-	56,100
ESM™ intellectual property (b)	124,100	52,743	71,357
Distribution agreements (b)	1,861,841	634,613	1,227,228
Supplier agreements (b)	113,650	48,301	65,349
United Kingdom distribution rights (c)	<u>2,299,100</u>	<u>573,752</u>	<u>1,725,348</u>
	<u>4,734,644</u>	<u>1,435,343</u>	<u>3,299,301</u>

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

Smartcool Systems Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2010 and 2009

b) ESM™ Intellectual Property and worldwide distribution rights

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

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

c) Distribution Rights from TECC Services

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

The remaining balance of £600,000GBP is due in scheduled instalments over four years with the last payment due on July 11, 2012. These instalments are non-interest bearing. At the acquisition date, the fair value of consideration was determined to be \$2,270,800 based on discounting the future payments at a rate of 16%. Transaction costs of \$28,300 were also incurred.

The purchase agreement was amended on December 21, 2009 where payments were rescheduled with the first payment due on January 16, 2010 and the last one on July 16, 2012. The parties also agreed that interest would accrue on £75,000 GBP at RBC prime rate plus 4% from January 16, 2009 and additionally on £75,000 GBP from July 16, 2009 until paid in full. As at September 30, 2010, the balance of £546,089 GBP, including accrued interest of £11,714 GBP, remained outstanding.

7 Capitalized development costs

There were no research and development activities in the third quarter. During the nine months ended September 30, 2010, the company incurred \$2,389 (2009 - \$31,772) of research and development costs that were fully expensed (2009 - \$31,772). No research and development costs were deferred in the period (2009 - \$0). Development costs of \$ 106,561 incurred in 2008 have been capitalized and amortized over a two year period, starting October 1, 2008 when the new products' commercial production was complete and they became available for sale. Amortization of \$13,320 and \$39,960 has been charged to expenses for the three and nine months ended September 30, 2010.

Smartcool Systems Inc.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 September 30, 2010 and 2009

8 Obligations under acquisition contracts

a) Abbotly

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

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

Smartcool Systems Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2010 and 2009

b) TECC Services

At September 30, 2010, the company owed £546,089 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	(109,374)
Accretion	50,143
Accrued interest	9,664
Foreign exchange	(31,457)
Balance – September 30, 2010	<u>764,768</u>
Less: Current portion	<u>(520,100)</u>
	<u>244,668</u>

Required repayments are as follows:

	GBP
July 16, 2010	84,375
January 16, 2011	112,500
July 16, 2011	112,500
January 16, 2012	112,500
July 11, 2012	<u>112,500</u>
	534,375
Accrued interest on 103,125 GBP	<u>11,714</u>
Balance – September 30, 2010	546,089
Less: Current portion	<u>(321,089)</u>
	<u>£225,000</u>

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

9 Capital leases

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

10 Debentures

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

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

The debentures also entitle the holder to quarterly payments towards principal. The total of principal payments for each quarter is equal to 5% of total cash revenue received by the company in that quarter. The payment of quarterly principal payments owing during the first twelve-month period commencing from the closing date, however, may be delayed and paid on a date that is 13 months from the closing date. When such payments are delayed, the company is required to deposit into a separate trust account, on a quarterly basis, an amount equal to any first year quarterly principal payment that would otherwise have been payable. As at September 30, 2010, \$104,343 has been set aside for future principal payments (see note 4).

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

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

Smartcool Systems Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2010 and 2009

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

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

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

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

The liability component is measured at amortized cost. The interest expense for the three and nine months ended September 30, 2010, \$40,174 and \$87,153 respectively, were calculated by applying weighted average effective interest rate of 35% to the liability component. This high effective interest rate was a result of the allocation of a portion of the net proceeds to equity. Interest payment totals of \$18,448 and \$26,388 were paid during the three and nine months ended September 30, 2010. As at September 30, 2010, the carrying amount of these debentures was \$530,525.

Maturity date	February 9, 2013	March 19, 2013	April 29, 2013	May 4, 2013	Total
	\$	\$	\$	\$	\$
Debenture principal	250,000	85,000	200,000	75,000	610,000
Balance on issuance date	192,191	63,773	154,984	58,812	469,760
Accrued interest	44,343	13,364	21,965	7,481	87,153
Interest payment	(14,250)	(3,740)	(6,198)	(2,200)	(26,388)
Balance, September 30, 2010	222,284	73,397	170,751	64,093	530,525
Less: current portion	(88,870)	(30,216)	(71,096)	(26,661)	(216,843)
	133,414	43,181	99,655	37,432	313,682

11 Share capital

a) Authorized: unlimited common shares without par value

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

b) Issued common shares

	Shares	Amount \$
Balance - December 31, 2007	37,074,687	22,573,211
Share purchase warrants exercised (d)	3,329,250	2,088,234
Options exercised (c)	35,000	18,216
TECC acquisition (e)	743,709	530,636
Share issuance costs	-	7,916
	<u>41,182,646</u>	<u>25,218,213</u>
Balance – December 31, 2008	41,182,646	25,218,213
Private placement (i)	3,138,750	452,186
Share issuance costs (ii)	-	(31,054)
	<u>44,321,396</u>	<u>25,639,345</u>
Balance – December 31, 2009	44,321,396	25,639,345
Private placement (iii)	2,500,000	464,674
Share issuance costs (iv)	-	(40,567)
	<u>46,821,396</u>	<u>26,063,452</u>
Balance, September 30, 2010	46,821,396	26,063,452

- i) On June 24, 2009, the company issued 3,138,750 Units at \$0.16 per unit pursuant to a non-brokered private placement, for gross proceeds of \$502,200. Each Unit consists of one common share and one-half warrant. Each full share purchase warrant entitles the holder to purchase one common share at a price of \$0.30 until June 24, 2010. These warrants are not transferable. A total value of \$50,014 was attributed to the warrants. Cash share issuance costs were \$28,554 and noncash share issuance costs were \$5,950. Total issuance cost of \$31,054 was allocated to common shares and \$3,450 to warrants.
- ii) On June 24, 2009, the company issued 163,000 warrants as part of the private placement commission to agents. The fair value of these warrants of \$5,950 has been reflected within share issuance costs.
- iii) On June 1, 2010, the company issued 2,500,000 Units at \$0.20 per unit pursuant to a non-brokered private placement, for gross proceeds of \$500,000. Each Unit consists of one common share and one-half warrant. Each full share purchase warrant entitles the holder to purchase one common share at a price of \$0.35 until June 1, 2011. These warrants are not transferable. A total value of \$35,325 was attributed to the warrants. Issuance costs were \$43,621, consisting of cash share issuance costs of \$39,059 and noncash share issuance costs of \$4,562. 93% of total issuance cost (\$40,568) was allocated to common shares and 7% (\$3,053) to warrants.

Smartcool Systems Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2010 and 2009

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

c) Stock options

Under the company's stock option plan, the company may grant stock options to employees, directors, officers and consultants. The maximum number of shares to be awarded under the plan is 9,364,279. As at September 30, 2010, all outstanding options have vesting periods of up to 18 months and an exercise period of up to five years. 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 disinterested shareholders at 2010 annual general meeting and accepted for filing by the TSX Venture Exchange.

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

	Number of options	Weighted average exercise price \$
	<u> </u>	<u> </u>
Balance - December 31, 2007	5,306,000	0.77
Granted	385,000	0.50
Cancelled	(318,750)	1.20
Forfeited	(6,250)	1.28
Expired	(350,000)	1.50
Exercised	<u>(35,000)</u>	<u>0.26</u>
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	<u>(636,000)</u>	<u>0.30</u>
Balance - December 31, 2009	5,719,000	0.33
Granted	650,000	0.31
Cancelled	(25,625)	0.28
Forfeited	<u>(116,875)</u>	<u>0.41</u>
Balance – September 30, 2010	<u>6,226,500</u>	<u>0.32</u>

Smartcool Systems Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2010 and 2009

No options were granted in the three months ended September 30, 2010. During the nine months ended September 30, 2010, the company granted 650,000 (2009 –1,080,000) options to officers and employees. 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 three months ended September 30, 2010 was \$51,908 (2009 - \$259,138), of which \$35,284 was related to employees (2009 – \$153,075) and 16,624 (2009 expense - \$106,063) was related to consultants.

Stock-based compensation expense for the nine months ended September 30, 2010 was \$267,247, of which \$222,742 related to employees and \$44,505 related to consultants.

Options outstanding at September 30, 2010 were as follows:

Exercise price \$	Options outstanding			Options exercisable	
	Number outstanding	Weighed average remaining contractual life (years)	Weighed average exercise price \$	Number outstanding	Weighed average exercise price \$
0.10 - 0.20	781,500	3.90	0.14	467,000	0.15
0.21 - 0.28	515,000	0.35	0.25	515,000	0.25
0.30 - 0.36	3,730,000	2.65	0.31	2,965,000	0.31
0.40 - 0.48	700,000	0.91	0.42	700,000	0.42
0.54 - 0.64	400,000	1.93	0.57	400,000	0.57
0.72- 0.96	100,000	1.39	0.84	100,000	0.84
	<u>6,226,500</u>	<u>2.35</u>	<u>0.32</u>	<u>5,147,000</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	2.45%	2.34%-2.76%
Dividend yield	0%	0%
Volatility	98.60%	97.67%-98.73%
Expected life	4.5 years	4.5-5 years

Smartcool Systems Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2010 and 2009

d) Share purchase warrants

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

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

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

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

e) Shares issued under TECC acquisition agreement

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

Smartcool Systems Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2010 and 2009

f) Contributed surplus

At September 30, 2009, the company's contributed surplus comprised the following:

	\$
Balance - December 31, 2007	2,099,851
Stock option expense	449,639
Stock option exercised	(8,166)
Expiry of warrants	<u>6,789</u>
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	267,247
Expired of warrants	<u>52,514</u>
Balance – September 30, 2010	<u><u>4,303,592</u></u>

12 Commitments

a) Premise lease

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

In February 2008, the company entered into a lease agreement to lease office facilities in Texas for 37 months commencing February 1, 2008 and expiring February 28, 2011, for monthly rent payments of \$1,800 per month, up to February 28, 2009 and monthly payments of \$1,908 thereafter.

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

	\$
2010	17,293
2011	54,105
2012	51,300
2013	52,875
2013 and thereafter	<u>76,500</u>
	<u><u>252,703</u></u>

Smartcool Systems Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2010 and 2009

For the three and nine months ended September 30, 2010, the company's rent expense including certain operating expenses and property taxes was \$41,795 and \$123,710 (2009 - \$174,667) and its sublease revenue was \$3,000 and \$13,467 (2009 - \$24,928).

b) Equipment lease

In March 2007, the company signed two contractual agreements for the financing of computer equipment and software. Under these agreements, the company is required to make 36 monthly payments of \$1,013 and \$706 starting July 2007. These leases expired in June 2010.

In July 2008, Smartcool USA entered into an office equipment lease agreement. Under this agreement, the company is required to make 24 monthly payments of \$369 starting August 2008. This lease expired in August 2010.

c) Abbotly USA

Under the terms of the North American distribution rights acquisition, the company is required to pay a 20% royalty on products identified in the Assignment and Assumption agreement dated March 27, 2006 and purchased from Abbotly Pty for North American sales. The initial term of the agreement was to expire on March 3, 2008. Smartcool, under its rights in the Assignment and Assumption agreement, has renewed the licensing agreement for another five year term. The company has purchased all of the remaining inventory from Abbotly USA as required under this agreement and is now required to purchase a minimum of \$200,000 of products identified in the Assignment and Assumption agreement from Abbotly Pty per year for purposes of the royalty calculation. For the three and nine months ended September 30, 2010, the company recorded royalty expense of \$0 and US\$40,000, respectively. As at September 30, 2010, royalties of US\$24,000 were payable to Abbotly USA (Year 2009 – US\$11,200).

Smartcool Systems Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2010 and 2009

13 Segmented information

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

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

	Three months ended September 30, 2010		Nine months ended September 30, 2010	
	Amount \$	Revenue %	Amount \$	Revenue %
Europe, Middle East, Africa	785,592	71	1,973,390	69
Australia	99,799	9	265,390	9
South East Asia	93,855	9	129,584	4
Americas	119,703	11	503,375	18
Total revenue	<u>1,098,949</u>	<u>100</u>	<u>2,871,739</u>	<u>100</u>

During the three months ended September 30, 2010, revenue from three customers exceeded 10% of the company's total revenue. These customers contributed 21%, 20%, and 16% respectively. During the previous year, revenue from one individual customer exceeded 10% of the company's total revenue. This customer contributed 22%.

Property and equipment are located in:

	<u>2010</u>	<u>2009</u>
Canada	69%	55%
USA	14%	28%
Other	17%	17%
Total	<u>100%</u>	<u>100%</u>

14 Related party transactions

During the three and nine months ended September 30, 2010, consulting fees of \$30,248 and \$89,967 were charged by directors of the company (2009 - \$254,317). Consulting fees of \$33,000 and \$98,500 were charged by two companies with common directors during the above periods (2009 - \$76,000).

Smartcool Systems Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2010 and 2009

The company rents its office in the United Kingdom from a company with a common director. During the three and nine months ended September 30, 2010, rent expense was \$8,733 and \$26,510 (2009 – \$39,721). These transactions have been charged to general and administrative in the statement of operations. The company also utilizes installation services from a company with a common director. During the three and nine months ended September 30, 2010, installation and material expenses charged by this related party were \$55,047 and \$253,959 (2009 - \$0). These transactions have been charged to cost of sales in the statement of operations. At September 30, 2010, \$44,963 was owed to these related parties. (December 31, 09 - £8,129GBP)

The company subleases its Vancouver office and other facilities to a company with a common director. During the three and nine months ended September 30, 2010, sublease income was \$3,000 and \$13,467 (2009 - \$24,928). At September 30, 2010, no amounts were owed from this related party (December 31, 09 - \$2,100).

The Company uses the services of a law firm of which a director is a partner. During the three and nine months ending September 30th, 2010, fees in the amounts of \$6,450 and \$35,028 were charged to the company for legal services provided. As at September 30, 2010, \$38,145 was owed to this related party.

During the three and nine months ended September 30, 2010, total sales of \$235,326 and \$414,369 were made to company with a common director (2009 – \$226,174). As at September 30, 2010, \$82,346 was owed from this related party (December 31, 2009 \$74,734).

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

Smartcool Systems Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2010 and 2009

15 Financial instruments

a) Financial Instruments

The company has classified its financial instruments as follows:

	2010	2009
	\$	\$
Financial assets:		
Held-for-trading, measured at fair value:		
Cash and cash equivalents	622,422	147,051
Loans and accounts receivable, recorded at amortized cost:		
Accounts receivable	982,524	657,841
Held-to-maturity, recorded at amortized cost:		
Short-term investments	-	101,646
Financial liabilities, recorded at amortized cost:		
Accounts payable and accrued liabilities	422,564	552,034
Acquisition obligations, debentures and other liabilities	1,295,293	854,937

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

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

	Three months ended	Nine months ended
	September 30, 2010	September 30, 2009
	\$	\$
Interest income from held-for-trading	277	1,195
Interest income from held-to-maturity	-	3,362
Interest expense from financial obligations	42,627	108,732
Interest expense from other financial liabilities	17,109	50,143

Fair value

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

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

Smartcool Systems Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 September 30, 2010 and 2009

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 (\$244,668) and debentures (\$313,682), having been discounted at 16% (see note 7(b)) and 35% (see note 10), respectively, is considered a close approximation of fair value.

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

Fair value measurement at September 30, 2010				
	September 30, 2010 Carrying value	Level 1	Level 2	Level 3
Financial assets	\$	\$		
Cash and cash equivalents	622,422	622,422	-	-
Total	622,422	622,422	-	-

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

b) Financial risk management

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

Credit risk

Credit risk is the risk of an unexpected loss if a customer or third party to a financial instrument fails to meet its contractual obligations and arises principally from the company's cash and cash equivalents, short-term investments and accounts receivable. The company limits its exposure to credit loss by placing its cash and cash equivalents and short-term investments with high credit quality financial institutions. Credit risk with respect to accounts receivable is limited due to the company's customer credit evaluation process. The company has \$982,524 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 September 30, 2010, the company's total account payable and accrued liabilities and current portion of obligation under acquisition contract and debentures were \$1,159,507 with \$538,612 due within 90 days and \$620,895 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.

Smartcool Systems Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2010 and 2009

As at September 30, 2010, 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	135,042	1,056	273,791	-
Accounts receivable	355,921	20,539	354,686	-
<u>Liabilities</u>				
Accounts Payable	72,864	34,369	57,902	7,291
TECC acquisition obligation, current			321,089	
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:

	USD	AUD	GBP	Euro
Gain (loss) on \$0.10 increase in CAD				
Monetary Assets	(49,096)	(2,160)	(62,848)	-
Monetary Liabilities	7,286	3,437	60,399	729
Net gain (loss)	(41,810)	1,277	(2,449)	729

Interest rate risk

The company is exposed to this risk as late payments under TECC acquisition obligations are subject to interest based on prime rate plus 4%. As at September 30, the total of such payments was £84,375GBP.

16 Capital management

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

The company's objectives when managing capital are:

- a) to effectively finance its operations and growth by meeting its operating and capital expenditure budgets;
- b) to maintain financial flexibility in order to meet financial obligations, including obligations under acquisition contracts;

Smartcool Systems Inc.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2010 and 2009

- 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.

17 Supplementary cash flow information

	Three months ended September 30, 2010	Nine months ended September 30, 2010
Interest paid in cash	18,492	37,414
Interest income received in cash	277	6,202
Income taxes paid in cash	-	-
Non-cash financing and investing activities		
Issuance of warrants for share issue costs	-	4,562
Issuance of warrants for debenture transaction costs	-	82,990