

WATERFURNACE RENEWABLE ENERGY, INC.

QUARTERLY REPORT



SECOND QUARTER REPORT 2009



Management's Discussion and Analysis

Completed on August 6, 2009

(Thousands of U.S. dollars unless otherwise noted)

Reference notice

This Management Discussion and Analysis should be read in conjunction with WaterFurnace Renewable Energy, Inc.'s ("the Company") 2008 Consolidated Financial Statements and accompanying notes. These documents along with the additional information about the Company, including the Annual Information Form, are available on SEDAR at www.sedar.com.

Caution regarding forward-looking statements

There are comments in this report that are forward-looking statements. "Forward looking statements" include statements regarding the Company's expectations, hopes, intentions or strategies regarding the future. These statements reflect the Company's current expectations. They are subject to a number of risks and uncertainties, including, but not limited to, changes in the general market conditions. In light of the many risks and uncertainties, readers should understand that the Company cannot offer assurance that the forward-looking statements contained in this analysis will be realized.

Company overview

The Company is incorporated under the laws of Canada. Its subsidiary companies, WaterFurnace International, Inc. (WaterFurnace) and LoopMaster International, Inc. (LoopMaster), are Indiana corporations.

WaterFurnace manufactures and distributes geothermal water source heating and cooling systems for residential, commercial and institutional buildings.

LoopMaster installs geothermal loops for residential, institutional and commercial construction projects. LoopMaster operates as a subcontractor on large projects across the U.S. and residential projects in select markets.

Discussion of quarterly results

Net income for the quarter was up 6.5% or \$223 thousand compared to the second quarter last year due to stronger gross margins driven by residential sales, expense control and favorable material costs. Earnings per share increased from \$0.28 per share in the second quarter of 2008 to \$0.30 in the second quarter of 2009. This earnings performance was achieved despite the higher operating costs associated with the hiring of 14 additional people added late last year who represent a planned investment in sales, marketing and product development.

Net sales for the quarter were 5.0% lower than the second quarter last year. Sales in the U.S. were up 0.6% while sales in Canada were down 8.1% and sales outside North America were down 91.0%. Sales in the residential dealer and distributor channels were above 2008 while sales in the Company's commercial and international channels, as well as Canadian distributors, were down. LoopMaster sales for the quarter were 7.4% higher than last year. Pool heater business continues to be well below previous year and is tied directly to new housing starts. Sales interest in the U.S. remains very high following the increase in the federal tax credit announced in mid February, but that interest continues to be counterbalanced by consumer caution in the face of the recession. While the Company's dealers have seen increased quoting activity and interest, consumers are reticent to make the decision to purchase as the economy continues to be unstable. The Company remains optimistic as consumer awareness on the tax credits builds and geothermal technology continues to see favorable press and support.

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Discussion of quarterly results (continued)

The Company's bad debt write-offs remain low due to proactive account and credit management that began last fall. Inventory turns remain at expected levels and cash reserves continue to grow, although at a lower rate than last year. The Company is also continuing to make capital investments in operational and administrative infrastructure in line with its strategic focus.

Seasonality plays a role in quarterly sales and profitability. The first quarter is historically the lowest quarter for sales and profitability due to the decreased ability to install loops in northern climates during that period. Sales and profitability have improved in the second quarter and are historically highest in the third and fourth quarters.

Outlook

The Company expects the balance of the year to continue to follow what we have seen during the first half of the year. Commercial and international sales will lag last year, Canadian distributor sales are expected to remain soft and pool heaters will likely not experience an increase in demand. Residential sales, distributor sales and OEM sales into Canada are expected to moderately increase due to tax credits, increased geothermal exposure and uncertain energy costs. The Company does not expect material sales increases until the general economy shows signs of recovery and sustained growth. The Company maintains a bullish outlook long-term.

During these difficult economic times the Company is determined to strengthen its position in the geothermal marketplace. The Company is focused on product cost control, maintaining gross margins, and maintaining the current level of general and administrative expenses during this slow sales growth period. The Company is also leveraging its competitive advantage in the areas of delivery time, balance sheet strength and research and development to ensure it is well positioned for the growth in the geothermal market that the Company expects over the next five to ten years. This includes strategic investments in market penetration, new products and opening new channels of distribution while the economy remains soft thus placing the Company in a position of competitive strength when demand increases as the economy recovers.

Events during the quarter

Bruce Ritchey retired as President and CEO in May of this year. Mr. Ritchey also resigned as a director of the Company as of his retirement date. Mr. Thomas F. Huntington was hired by the Company as its new President and CEO. The Board has named Thomas Huntington to the Board of Directors.

The senior management of WaterFurnace hosted U.S. Energy Secretary Steven Chu at its corporate headquarters in Fort Wayne, Indiana. During the visit management reviewed the positive environmental, energy and cost impacts of geothermal technology. Secretary Chu announced a major initiative to increase the development of green jobs and entice development of renewable, green products which will benefit the entire geothermal industry.

In May, the Company held its Annual Special and General Meeting of Shareholders at its corporate offices in Fort Wayne, Indiana. At the meeting, shareholders re-elected the current Board of Directors and approved a resolution allowing the Company to issue up to 250,000 shares of stock to satisfy future liabilities associated with the Company's deferred compensation plan.

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Summary of quarterly results (unaudited)

2009 Quarters ended	March 31	June 30		
Sales	\$ 23,674	\$ 29,772		
Net income	830	3,648		
Basic and diluted earnings per share	0.07	0.30		

2008 Quarters ended	March 31	June 30	September 30	December 31
Sales	\$ 23,813	\$ 31,330	\$ 39,964	\$ 42,708
Net income	1,582	3,425	5,248	5,119
Basic and diluted earnings per share	0.13	0.28	0.43	0.42

2007 Quarters ended	March 31	June 30	September 30	December 31
Sales	\$ 21,003	\$ 25,814	\$ 28,383	\$ 27,971
Net income	984	2,088	3,355	3,198
Basic and diluted earnings per share	0.08	0.17	0.28	0.26

Capital resources and liquidity

The Company expects to fund capital expenditures from available cash. The Company has \$10.2 million in cash and cash equivalents and short-term investments after paying \$4.7 million in dividends during the first six months of 2009. Accounts receivable days sales outstanding are at levels normal for our industry. Accounts payable are paid within terms and discounts are taken when available. The Company is aware of no legal proceedings or other issues that would have a significant impact on the financial condition of the Company.

During the second quarter of 2009, the Company elected to fund the balance of its deferred compensation liability by contributing \$2.6 million into the deferred compensation plan from cash and cash equivalents.

Financial instruments and credit risk

The Company's estimate of the fair value of cash and cash equivalents, short-term investments, receivables, and payables and accruals approximates the carrying value due to the short-term nature of these instruments. The Company's exposure to credit risk is limited to accounts receivable. The Company makes provisions for any doubtful accounts as required. The Company is not currently exposed to interest rate risks from bank loans and long-term debt. The Company is only exposed to interest rate risks from investment of cash and cash equivalents and short-term investments.

The Company has a policy regarding the investment of surplus cash. The policy calls for investments to have maturities of less than one year, slight or no risk of losing the invested principal and access to the principal amount prior to maturity. All investments made must have a high-grade rating and no investments outside the U.S. are allowed without approval from the Board of Directors. Currently, the Board has decided that excess cash may only be invested in U.S. Treasury bills, money market funds or similar accounts until the Board is satisfied that the banking and credit markets have strengthened.

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Contractual obligations

	2009	2010	2011	2012	2013	There- after	Total
Operating leases	\$ 136	\$ 79	\$ 68	\$ 62	\$ 53	\$ 36	\$ 434

The Company's contractual obligations consist of operating leases. In addition, the Company has a deferred compensation plan, detailed in Note 9 of the financial statements, which carries balances that vest in intervals of three to five years or upon normal retirement age which is defined in the deferred compensation plan as age 60.

Critical accounting estimates

The largest accounting estimate is the provision for warranty claims on products sold by the Company. The actual future costs to fulfill warranty expenses are unknown. The method used to establish the provision is to track the actual historical costs per unit covered and multiply it by the number of units still covered under the warranty policy to establish the total estimated liability, which is then reduced to its present value with a discount rate. The cost of labor on outstanding warranties is fixed, but the price of components can increase. A major assumption underlying the estimate is that failure rates will remain relatively the same in the future as they have in the past. The provision increased \$1.4 million during the first six months of 2009.

The other important estimate is the determination of the provision for doubtful accounts. This includes reviewing all accounts receivable for payment history and any current events that may have an impact on collection.

Off-balance sheet arrangements

The Company has no off-balance sheet arrangements.

Share capital

Unlimited common shares without par value are authorized. As of August 6, 2009, there were 12,092,432 common shares issued and outstanding. As of August 6, 2009, no stock options were outstanding.

Transactions with related parties

The Company did not have any related party transactions during the first six months of 2009 or during the year 2008.

Internal controls over financial reporting

It is the opinion of the Company's Chief Executive Officer and Chief Financial Officer that the Company's internal controls over financial reporting provide a reasonable level of assurance that fiscal reporting will be free of material errors or misstatements. The Company maintains a system of internal controls that are monitored by senior management and tested on a quarterly basis. As of the end of the most recent quarter, internal control monitoring and testing has not produced any areas of concern for management. A set of control systems, no matter how well conceived or operated, can only provide reasonable, not absolute, assurance that the objectives of the control system are met.

Management's Discussion and Analysis

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Future adoption of International Financial Reporting Standards (IFRS)

The Accounting Standards Board (AcSB) has announced that Canadian publicly accountable enterprises will be required to adopt IFRS for fiscal years beginning on or after January 1, 2011. As a result, the Company will adopt IFRS on or before January 1, 2011. The Company's first IFRS compliant financial statements will be for the first quarter of 2011, or sooner if management decides to adopt early. Currently, management is assessing and evaluating the effects and any changes required of IFRS implementation upon its operations, internal controls and financial reporting.

Consolidated Statements of Income & Retained Earnings

(Unaudited—Thousands of U.S. dollars except share data unless otherwise noted)

	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Sales	\$ 29,772	\$ 31,330	\$ 53,446	\$ 55,143
Cost of sales	18,793	20,782	35,454	37,314
Gross profit	10,979	10,548	17,992	17,829
Operating expenses	4,885	4,728	10,250	9,508
Research and development expenses (Note 17)	552	575	1,215	944
Income before interest and income taxes	5,542	5,245	6,527	7,377
Interest income	2	34	8	93
Interest expense	(5)	(8)	(8)	(18)
Income before income taxes	5,539	5,271	6,527	7,452
Income taxes (Note 18)	1,891	1,846	2,049	2,445
Net income	\$ 3,648	\$ 3,425	\$ 4,478	\$ 5,007
Earnings per share (Note 19)				
Basic and diluted	\$ 0.30	\$ 0.28	\$ 0.37	\$ 0.41
Weighted average number of shares (Note 19)				
Basic	12,092,432	12,089,959	12,092,432	12,088,696
Diluted	12,092,432	12,091,709	12,092,432	12,090,882
Retained earnings, beginning of period	\$ 10,381	\$ 4,923	\$ 11,842	\$ 5,504
Net income	3,648	3,425	4,478	5,007
Dividends (Note 20)	(2,419)	(2,291)	(4,710)	(4,454)
Retained earnings, end of period	\$ 11,610	\$ 6,057	\$ 11,610	\$ 6,057

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Balance Sheets

(Unaudited—Thousands of U.S. dollars unless otherwise noted)

	June 30, 2009	December 31, 2008
Assets		
Current assets		
Cash and cash equivalents	\$ 3,808	\$ 6,029
Short-term investments	6,368	5,316
Receivables (Note 2)	15,393	18,797
Inventory (Note 4)	7,346	8,714
Other current assets (Note 5)	2,852	2,433
Total current assets	35,767	41,289
Capital assets (Note 6)	4,569	4,643
Other assets (Note 7)	2,575	2,080
Total Assets	\$ 42,911	\$ 48,012
Liabilities		
Current liabilities		
Payables and accruals	\$ 6,853	\$ 10,542
Income taxes payable	347	2,027
Provision for warranty claims - current portion (Note 8)	2,048	1,824
Total current liabilities	9,248	14,393
Deferred compensation (Note 9)	185	1,085
Provision for warranty claims (Note 8)	7,003	5,827
Total Liabilities	16,436	21,305
Shareholders' Equity		
Share capital (Note 12)	14,865	14,865
Retained earnings	11,610	11,842
Total Shareholders' Equity	26,475	26,707
Total Liabilities & Shareholders' Equity	\$ 42,911	\$ 48,012

Commitments and contingencies, respectively (Notes 10 and 11)

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Cash Flows

(Unaudited—Thousands of U.S. dollars unless otherwise noted)

Increase (decrease) in cash and cash equivalents

	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Operating				
Net income	\$ 3,648	\$ 3,425	\$ 4,478	\$ 5,007
Add back non-cash items:				
Depreciation (Note 6)	169	147	335	284
Gain on disposal of capital assets	(1)	—	(18)	—
Change in provision for warranty claims	423	286	1,400	1,128
Change in deferred compensation	336	112	1,229	257
Change in future income taxes	(425)	(198)	(901)	(602)
Net cash before working capital adjustments	4,150	3,772	6,523	6,074
Net change in non-cash working capital (Note 13)	(1,495)	(1,314)	(117)	(3,620)
	<u>2,655</u>	<u>2,458</u>	<u>6,406</u>	<u>2,454</u>
Financing				
Funding of deferred compensation plan	(2,630)	—	(2,630)	—
Repayment of long-term debt	—	(65)	—	(65)
Issue of capital stock	—	34	—	34
Payment of dividends	(2,419)	(2,291)	(4,710)	(4,454)
	<u>(5,049)</u>	<u>(2,322)</u>	<u>(7,340)</u>	<u>(4,485)</u>
Investing				
Change in short-term investments	(1)	1,020	(1,052)	3,520
Purchase of capital assets	(88)	(39)	(293)	(91)
Proceeds on disposal of capital assets	12	—	52	1
Change in other assets	3	3	6	6
	<u>(74)</u>	<u>984</u>	<u>(1,287)</u>	<u>3,436</u>
Net increase (decrease) in cash and cash equivalents	(2,468)	1,120	(2,221)	1,405
Cash and cash equivalents, beginning of period	6,276	2,306	6,029	2,021
Cash and cash equivalents, end of period	<u>\$ 3,808</u>	<u>\$ 3,426</u>	<u>\$ 3,808</u>	<u>\$ 3,426</u>

The accompanying notes are an integral part of these consolidated financial statements.

Notes to the Consolidated Financial Statements

(Unaudited—Thousands of U.S. dollars unless otherwise noted)

1. Summary of significant accounting policies

WaterFurnace Renewable Energy, Inc. is a public company incorporated under the laws of Canada and listed on the Toronto Stock Exchange. The Company operates in the geothermal and water source heating and cooling industry, mainly in the United States.

These interim consolidated financial statements do not include all disclosures normally provided in annual consolidated financial statements and should be read in conjunction with the annual audited consolidated financial statements for the year ended December 31, 2008.

(a) Generally accepted accounting principles

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles.

(b) Reporting and functional currency

The functional currency is the U.S. dollar which is the unit of measurement for the majority of the Company's business transactions and accordingly, the U.S. dollar is used for reporting.

(c) Basis of consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary companies, WaterFurnace International, Inc. and LoopMaster International, Inc., both of which are U.S. corporations. All significant inter-company balances are eliminated on consolidation.

(d) Use of estimates

In preparing the Company's consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and reported revenues and expenses during the reporting period. Actual results could differ from those estimates.

(e) Cash and cash equivalents

Cash and cash equivalents include cash on hand, cash balances with banks and short-term investments with original maturity of 90 days or less which are classified as held for trading.

(f) Short-term investments

Short-term investments are classified as held for trading and are carried at fair value. Short-term investments include taxable and tax-exempt money market funds with floating interest rates. The change in fair value is included in interest income.

(g) Financial instruments

The financial instrument standards require that all financial instruments be classified into one of the following categories:

Financial assets	Financial liabilities
Held for trading	Held for trading
Held to maturity	Other financial liabilities
Available for sale	
Loans and receivables	

Notes to the Consolidated Financial Statements

(Unaudited—Thousands of U.S. dollars unless otherwise noted)

1. Summary of significant accounting policies (continued)

(g) Financial instruments (continued)

Financial assets and liabilities are initially recognized at fair value with subsequent measurement based on classification. The classification depends on the purpose for which the financial instruments were acquired, their characteristics and choice where applicable.

The Company manages financial instruments according to changes in business and economic conditions and classifies them as follows:

Type of financial instruments	Category	Measurement
Cash and cash equivalents	Held for trading	Fair value
Short-term investments	Held for trading	Fair value
Receivables	Loans and receivables	Amortized cost using the effective interest method
Payables and accruals	Other financial liabilities	Amortized cost using the effective interest method

Changes in the fair value of held for trading instruments are recognized in the statement of income. Transaction costs related to held for trading instruments are expensed as incurred. Transaction costs related to loans and receivables and other financial liabilities are capitalized and amortized using the effective interest method.

The Company's estimate of the fair value of cash and cash equivalents, short-term investments, receivables and payables and accruals approximates the carrying value due to the short-term nature of these instruments.

(h) Inventory

Inventory, calculated substantially on a first-in, first-out basis, is recorded at the lower of cost and net realizable value. The cost of finished goods inventory is comprised of material, labor and manufacturing overhead. Excess or obsolete inventory is reserved for as required. Due to the high level of inventory turns and short-term nature of inventory holdings, the Company does not write inventory up or down due to changes in the market value of commodities.

(i) Capital assets

The Company assesses the carrying value of capital assets whenever events or changes in business circumstances indicate the carrying value of the asset may not be fully recoverable. This assessment of recoverability is based on management's estimate of undiscounted future operating cash flow. If the sum of the undiscounted cash flows is less than the carrying value of the related asset, then the Company will record a write-down of the asset to the extent that the carrying value exceeds the fair value of the asset.

Depreciation is computed using the straight-line method over the estimated useful lives of the assets. The estimated useful life for the building is 40 years and other components range from 7 to 15 years. The estimated useful lives for equipment generally run 3 to 7 years. Construction in progress is not depreciated as it is not available for use.

Notes to the Consolidated Financial Statements

(Unaudited—Thousands of U.S. dollars unless otherwise noted)

1. Summary of significant accounting policies (continued)

(j) Income taxes

The Company provides for income taxes using the liability method of tax allocation. Under this method, future income tax assets and liabilities are determined based on deductible or taxable temporary differences between financial statement values and tax values of assets and liabilities using substantively enacted income tax rates expected to be in effect for the year in which the differences are expected to reverse. Future tax benefits, such as loss carry forwards, are recognized only to the extent that such benefits are more likely than not to be realized during the carry forward period.

Research tax credits relating to capital asset purchases and research and development expenditures are accounted for as reductions of the cost of such assets and expenses, respectively. Research tax credits are recorded when there is reasonable assurance they will be realized.

(k) Foreign currency translation

Monetary assets and liabilities are translated at the exchange rate in effect at the balance sheet date. Non-monetary assets and liabilities are translated at historical exchange rates. Operating revenues and expenses are translated at the average exchange rates prevailing during the year, except for amortization, which is translated at the same rates as those used in the translation of the corresponding assets. Translation gains or losses are included in net income. The functional and reporting currency of both the parent company and its self sustaining foreign subsidiaries is the U.S. dollar.

(l) Warranty

A provision for potential warranty claims is provided at the time sales are recognized and adjusted periodically based on warranty terms and costs incurred compared to total expected costs. The method used to establish the provision is to track the actual historical costs per unit covered and multiply it by the number of units still covered under the warranty policy to establish the total estimated liability, which is then reduced to its present value with a discount rate. The cost of labor on outstanding warranties is fixed, but the price of components can increase. A major assumption underlying the estimate is that failure rates will remain relatively the same in the future as they have in the past.

(m) Revenue recognition

The Company records equipment sales at time of shipment. Residential installation sales are recorded on the completed contract method. Commercial installation sales are recorded on the percentage of completion basis, based on costs incurred compared to total expected costs. The Company manages its credit and collection policies and procedures such that it is reasonably assured of collecting receivables.

(n) Comprehensive income

Comprehensive income is net income because the Company does not have comprehensive income.

A statement of comprehensive income has not been included as the Company did not have any other comprehensive income or loss.

Notes to the Consolidated Financial Statements

(Unaudited—Thousands of U.S. dollars unless otherwise noted)

1. Summary of significant accounting policies (continued)

(o) Earnings per share

Earnings per share is calculated using the weighted average number of shares outstanding during the year. Diluted earnings per share is calculated using the treasury stock method. This method recognizes the use of proceeds that could be obtained upon the exercise of options and assumes that any proceeds would be used to purchase common shares at the average market price during the period. The incremental shares, or the difference between the number of shares assumed issued and the number of shares assumed purchased are included in the denominator of the diluted earnings per share computation. Options have a dilutive effect only when the average market price of the common shares during the period exceeds the exercise price of the options.

(p) Research and development

The Company expenses all research and development activities.

(q) Future adoption of International Financial Reporting Standards

The Accounting Standards Board has announced that Canadian publicly accountable enterprises will be required to adopt International Financial Reporting Standards (IFRS) for fiscal years beginning on or after January 1, 2011. As a result, the Company will adopt IFRS on or before January 1, 2011. The Company's first IFRS compliant financial statements will be for the first quarter of 2011, or sooner if management decides to adopt early. Currently, management has begun assessing and evaluating the effects and any changes required of IFRS implementation upon its operations, internal controls and financial reporting.

2. Financial instruments disclosure and presentation

Financial risk management

Risks that arise from financial instruments include liquidity risk, credit risk and market risk.

Liquidity risk

Liquidity risk is the risk that the Company will have difficulty meeting obligations associated with its financial liabilities. The Company manages liquidity risk through cash generated from operations in excess of dividends paid. Management does not foresee material or significant risk of the Company not meeting its financial obligations.

The Company is able to generate sufficient cash to fund expected growth and development needs. At June 30, 2009, the Company had \$3.8 million (\$6.0 million at December 31, 2008) in cash and cash equivalents and \$6.4 million (\$5.3 million at December 31, 2008) in short-term investments remaining after paying \$4.7 million in dividends during the first six months of 2009. Accounts payable are paid within terms and discounts are taken when available. The Company's policy regarding the investment of surplus cash calls for investments to have maturities of less than one year, slight or no risk of losing the invested principal and access to the principal amount prior to maturity with little or no penalty for liquidation. All investments must have a high-grade rating and no investments outside the U.S. are allowed without approval from the Board of Directors. Currently, the Board has decided that excess cash may only be invested in U.S. Treasury bills, money market funds or similar accounts until the Board is satisfied that the banking and credit markets have strengthened.

Notes to the Consolidated Financial Statements

(Unaudited—Thousands of U.S. dollars unless otherwise noted)

2. Financial instruments disclosure and presentation (continued)

Credit risk

The Company's exposure to credit risk is limited to accounts receivable. To minimize credit risk, the Company has established policies for evaluating customers and extending credit. Accounts receivable days sales outstanding are at levels normal for the Company's industry.

The Company makes provisions for any doubtful accounts as required. Management considers the reasons and history for each overdue account as well as economic conditions. When appropriate, the Company requires letters of credit, liens, bonds or personal guarantees from customers.

Receivables

	June 30, 2009	December 31, 2008
Trade receivables - current	\$ 12,735	\$ 12,258
Trade receivables - 1 to 89 days past current	2,364	6,352
Trade receivables - 90 plus days past current	554	617
Other receivables	41	34
Allowance for doubtful accounts	(301)	(464)
	<u>\$ 15,393</u>	<u>\$ 18,797</u>

Allowance for doubtful accounts

	Three months ended June 30, 2009	Six months ended June 30, 2009	Year ended December 31, 2008
Balance, beginning of period	\$ 352	\$ 464	\$ 220
Increase (decrease) in provision	48	(6)	252
Net adjustment for finance charges, write-offs and recoveries	(99)	(157)	(8)
Balance, end of period	<u>\$ 301</u>	<u>\$ 301</u>	<u>\$ 464</u>

Market risk

Market risk includes interest rate risk and foreign exchange risk.

Interest rate risk

Interest rate risk is the risk that the value or future cash flows of financial instruments will fluctuate due to changes in market interest rates. The Company currently is only exposed to interest rate risks from investment of its surplus cash.

The Company does not expect fluctuations in market interest rates to have a material impact on its results of operations and does not use derivative instruments to reduce its exposure to interest rate risk.

Notes to the Consolidated Financial Statements

(Unaudited—Thousands of U.S. dollars except share data unless otherwise noted)

2. Financial instruments disclosure and presentation (continued)

Foreign exchange risk

Sales and purchases are primarily denominated in U.S. dollars including sales outside of the United States. Foreign currency adjustments resulted in net losses of \$21 thousand and \$5 thousand for the three months ended June 30, 2009 and 2008, respectively. Foreign currency adjustments resulted in a net loss of \$30 thousand and a net gain of \$2 thousand for the six months ended June 30, 2009 and 2008, respectively.

3. Capital disclosures

Capital includes shareholders' equity. At June 30, 2009, the Company had no bank loans or long-term debt. The Company's objective when managing capital is to safeguard the entity's ability to continue as a going concern and make the Company prosper so that it can provide a fair return for shareholders and benefits for other stakeholders. The Company sets the amount of capital required and manages the capital structure and makes adjustments to it in the light of changes in business and economic conditions.

The Company uses forecasted cash flow, projected investment in the growth of the business and capital expenditure needs to determine the level of dividend payments and cash needs. The Company targets a minimum value of cash and cash equivalents and short-term investments that is equal to or greater than two times the next estimated dividend payment which is calculated using the current number of outstanding shares times the rate paid for the most recently paid regular dividend. This ratio was approximately four to one at June 30, 2009.

4. Inventory

	June 30, 2009	December 31, 2008
Raw material	\$ 4,413	\$ 6,423
Finished goods	2,933	2,291
	<u>\$ 7,346</u>	<u>\$ 8,714</u>

5. Other current assets

	June 30, 2009	December 31, 2008
Future income taxes	\$ 2,610	\$ 2,213
Prepays and deposits	242	220
	<u>\$ 2,852</u>	<u>\$ 2,433</u>

Notes to the Consolidated Financial Statements

(Unaudited—Thousands of U.S. dollars unless otherwise noted)

6. Capital assets

Cost

	June 30, 2009	December 31, 2008
Land	\$ 450	\$ 450
Building and improvements	3,924	3,886
Equipment	5,394	4,836
Construction in progress	203	627
	<u>9,971</u>	<u>9,799</u>

Accumulated depreciation

Building and improvements	1,899	1,844
Equipment	3,503	3,312
	<u>5,402</u>	<u>5,156</u>

Net book value

Land	450	450
Building and improvements	2,025	2,042
Equipment	1,891	1,524
Construction in progress	203	627
	<u>\$ 4,569</u>	<u>\$ 4,643</u>

Depreciation

	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Depreciation in cost of sales	\$ 81	\$ 95	\$ 167	\$ 182
Depreciation in operating expenses	88	52	168	102
Total depreciation	<u>\$ 169</u>	<u>\$ 147</u>	<u>\$ 335</u>	<u>\$ 284</u>

7. Other assets

	June 30, 2009	December 31, 2008
Future income taxes	\$ 2,566	\$ 2,062
Licensing costs	2	5
Deposits and other	7	13
	<u>\$ 2,575</u>	<u>\$ 2,080</u>

Notes to the Consolidated Financial Statements

(Unaudited—Thousands of U.S. dollars unless otherwise noted)

8. Warranty reserve

	June 30, 2009	December 31, 2008
Current portion	\$ 2,048	\$ 1,824
Long-term portion	7,003	5,827
	<u>\$ 9,051</u>	<u>\$ 7,651</u>

9. Deferred compensation plan

	June 30, 2009	December 31, 2008
Plan assets	\$ 3,966	\$ 1,096
Plan liabilities	(4,151)	(2,682)
Plan net liability	<u>\$ (185)</u>	<u>\$ (1,586)</u>
Current portion in "Payables and accruals"	\$ —	\$ 501
Long-term portion as a separate line item	185	1,085
Plan net liability	<u>\$ 185</u>	<u>\$ 1,586</u>
Unvested additional awards balances not reflected in plan liabilities	<u>\$ 1,068</u>	<u>\$ 391</u>

	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Deferred compensation plan expenses	<u>\$ 260</u>	<u>\$ 85</u>	<u>\$ 509</u>	<u>\$ 86</u>
Deferred compensation awarded during the period	<u>\$ 259</u>	<u>\$ 18</u>	<u>\$ 1,262</u>	<u>\$ 212</u>

The Company has established an executive nonqualified "excess" deferred compensation plan for certain management employees. These employees can elect to defer a portion of their earnings, and these amounts vest immediately. At the Company's discretion, additional amounts may be awarded to the employees' accounts. These additional amounts are subject to a vesting of three to five years or upon normal retirement age which is defined in the deferred compensation plan as age 60.

The deferred compensation plan is not required to be funded, but the Company has established a trust to which the Company may contribute funds to satisfy the liability which can only be used to satisfy the compensation liability. The plan assets consist of flexible premium variable life insurance policies as well as mutual funds whose value is tied to the market performance of the investment options. These assets are recorded at market value and have been netted with the offsetting liability on the basis that the investments are payable to the trust and only available for funding of the plan liability.

Notes to the Consolidated Financial Statements

(Unaudited—Thousands of U.S. dollars unless otherwise noted)

9. Deferred compensation plan (continued)

During the second quarter of 2009, the Company elected to fund the balance of its deferred compensation liability by contributing \$2.6 million into the deferred compensation plan from cash and cash equivalents.

The plan, approved by the Board of Directors, allows participants to choose from a number of selected mutual funds as “notional investments” for their deferrals and Company contributions prior to June 8, 2009. Effective June 8, 2009, the plan was amended by the Board to require that all future Company contributions are to be notionally invested in WaterFurnace Renewable Energy, Inc. stock. The earnings deferred by the participants plus amounts to be contributed by the Company are then tracked by the plan’s financial institution sponsor as if those amounts were actually invested in the “notional” fund options. The liability is adjusted based on changes to the value of the offsetting “notional investments” with the changes in the market value of the calculated liability charged or credited to deferred compensation plan expense. Accordingly, the Company is exposed to the variability of the value of the “notional investments” as these are used to measure the amount of the plan liability.

The plan is a contractual obligation by the Company to pay the plan participants in the future and is comprised primarily of amounts to be paid post employment, but also includes amounts designated by the participants as in-service and education amounts that can be distributed during the participant’s term of employment according to payment terms designated by the participant.

10. Commitments

Minimum lease payments

2009	\$	136
2010		79
2011		68
2012		62
2013		53
2014		36
	\$	<u>434</u>

The Company has entered into agreements to lease certain facilities and operational and administrative equipment and for other services for various periods through 2014.

Notes to the Consolidated Financial Statements

(Unaudited—Thousands of U.S. dollars except share data unless otherwise noted)

11. Contingencies

The Company and its consolidated subsidiaries are defendants in actions brought against them from time to time in connection with their operations. While it is not possible to estimate the outcome of the various proceedings at this time, the Company does not believe that it will incur any significant loss or expense.

12. Share capital

Common shares issued and outstanding

	Six months ended June 30, 2009		Year ended December 31, 2008	
	Number of shares	Amount	Number of shares	Amount
Balance, beginning of period	12,092,432	\$ 14,865	12,087,432	\$ 14,831
Shares issued for cash on exercise of stock options	—	—	5,000	34
Balance, end of period	<u>12,092,432</u>	<u>\$ 14,865</u>	<u>12,092,432</u>	<u>\$ 14,865</u>

Unlimited common shares without par value are authorized.

13. Supplementary cash flow information

Net change in non-cash working capital

	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Receivables	\$ (1,377)	\$ (2,617)	\$ 3,404	\$ (2,475)
Inventory	(51)	614	1,368	(2,019)
Payables and accruals other than deferred compensation	439	941	(3,188)	899
Income taxes payable	(489)	(242)	(1,680)	(97)
Other current assets	(17)	(10)	(21)	72
	<u>\$ (1,495)</u>	<u>\$ (1,314)</u>	<u>\$ (117)</u>	<u>\$ (3,620)</u>

Cash paid for interest and income taxes

Interest paid	<u>\$ 1</u>	<u>\$ 7</u>	<u>\$ 3</u>	<u>\$ 15</u>
Income taxes paid	<u>\$ 2,801</u>	<u>\$ 2,292</u>	<u>\$ 4,619</u>	<u>\$ 3,198</u>

Notes to the Consolidated Financial Statements

(Unaudited—Thousands of U.S. dollars unless otherwise noted)

14. Geographical information

Sales	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
United States	\$ 25,019	\$ 24,881	\$ 44,558	\$ 44,815
Canada	4,626	5,036	7,981	8,134
Other	127	1,413	907	2,194
	<u>\$ 29,772</u>	<u>\$ 31,330</u>	<u>\$ 53,446</u>	<u>\$ 55,143</u>

All capital assets are located in the United States. Sales are attributed based on the location of the customer.

Seasonality also plays a role in quarterly sales and profitability. The first quarter is historically the lowest quarter for sales and profitability due to the decreased ability to install loops in northern climates during that period. Sales and profitability historically have improved in the second quarter and are highest in the third and fourth quarters.

15. 401(k) pension plan

	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
401(k) pension plan expenses	<u>\$ 100</u>	<u>\$ 101</u>	<u>\$ 242</u>	<u>\$ 198</u>

The Company provides a 401(k) pension plan for employees. Employees can elect to contribute up to 80% of their gross earnings. Starting January 1, 2008, the Company matched, and continues to match, 100% of the first 4% of compensation contributed by employees. All Company matches vest immediately.

16. Stock-based compensation plan

The Company has issued stock options in the past, but did not grant any in the first six months of 2009 or the year 2008. At June 30, 2009, no options were outstanding.

Notes to the Consolidated Financial Statements

(Unaudited—Thousands of U.S. dollars unless otherwise noted)

17. Research and development expenses

	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Research and development expenses	\$ 600	\$ 608	\$ 1,317	\$ 1,025
Research tax credits	(48)	(33)	(102)	(81)
	<u>\$ 552</u>	<u>\$ 575</u>	<u>\$ 1,215</u>	<u>\$ 944</u>

18. Income taxes

Income tax provision

	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Current	\$ 2,316	\$ 2,044	\$ 2,950	\$ 3,047
Future	(425)	(198)	(901)	(602)
	<u>\$ 1,891</u>	<u>\$ 1,846</u>	<u>\$ 2,049</u>	<u>\$ 2,445</u>

Future income tax assets

	June 30, 2009	December 31, 2008
Warranty	\$ 3,596	\$ 3,040
Deferred compensation and other compensation amounts	1,988	1,629
Inventory reserve	(332)	(325)
Tax value of assets in excess of book value	57	55
Book value of assets in excess of tax value	(248)	(255)
Other	115	131
	<u>\$ 5,176</u>	<u>\$ 4,275</u>
Future income taxes in "Other current assets"	\$ 2,610	\$ 2,213
Future income taxes in "Other assets"	2,566	2,062
	<u>\$ 5,176</u>	<u>\$ 4,275</u>

Notes to the Consolidated Financial Statements

(Unaudited—Thousands of U.S. dollars except share data unless otherwise noted)

19. Earnings per share

	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Shares outstanding at beginning of period	12,092,432	12,087,432	12,092,432	12,087,432
Weighted average dilution for exercised options	—	2,527	—	1,264
Basic weighted average shares outstanding	12,092,432	12,089,959	12,092,432	12,088,696
Weighted average dilution for unexercised options	—	1,750	—	2,186
Diluted weighted average shares outstanding	12,092,432	12,091,709	12,092,432	12,090,882
Net income	\$ 3,648	\$ 3,425	\$ 4,478	\$ 5,007
Basic and diluted earnings per share	\$ 0.30	\$ 0.28	\$ 0.37	\$ 0.41

As of June 30, 2009, there was no dilution and no stock options were outstanding.

20. Dividends

Dividends paid per share (U.S.\$)

Date of payment	Date of record	Six months ended June 30,	
		2009	2008
March 2 (March 3)	February 20 (February 20)	\$ 0.18	\$ 0.17
June 1 (June 2)	May 15 (May 21)	0.19	0.18
		\$ 0.37	\$ 0.35

Total dividend

	Three months ended June 30,		Six months ended June 30,	
	2009	2008	2009	2008
Dividend payment to shareholders	\$ 2,297	\$ 2,176	\$ 4,474	\$ 4,231
Withholding tax payment to the IRS on intercorporate dividend	122	115	236	223
	\$ 2,419	\$ 2,291	\$ 4,710	\$ 4,454

WaterFurnace Renewable Energy, Inc.

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For quarter and annual reports by mail go to
www.computershare.com/maillinglist

Trading Information

CUSIP 9415EQ108
ISIN CA9415EQ1089
Toronto Stock Exchange
WFI for trading in Canadian dollars
WFI.U for trading in U.S. dollars

Directors

Thomas F. Huntington
President and CEO
WaterFurnace Renewable Energy, Inc.

James R. Shields¹
Chairman Emeritus
WaterFurnace Renewable Energy, Inc.

Timothy E. Shields¹
Chairman
WaterFurnace Renewable Energy, Inc.

Thomas C. Dawson, CA^{1,2}
Corporate Director

J. David Day, LLB^{1,3,4}
Corporate Director

Charles R. Diltz^{2,3,4}
Sr. Vice President
Comfort Systems USA

Dr. Geoffrey W.J. Pottow^{2,3,4}
President and CEO
The Becker Milk Co. Ltd.

1 Member of the Executive Committee

2 Member of the Audit Committee

3 Member of the Compensation Committee

4 Member of the Governance Committee

Officers

Thomas F. Huntington
President and
Chief Executive Officer

Timothy E. Shields
Chairman

Fred Andriano
Secretary, Treasurer and
Chief Financial Officer