

WATERFURNACE RENEWABLE ENERGY, INC.

QUARTERLY REPORT



THIRD QUARTER REPORT 2009



Management's Discussion and Analysis

Completed on November 4, 2009

(Thousands of U.S. dollars except share data 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

The Company's third quarter performance for 2009 did not match the third quarter of 2008 when natural gas and gasoline prices were still rising thus providing an excellent environment for homeowners to embrace energy saving concepts. Also in 2008, residential and commercial new construction activity maintained a robust pace relative to the weaker construction activity that has been experienced across North America in Q3 2009.

Sales for the quarter were 9.4% lower than the third quarter of last year. Net income was impacted by the lower sales; however, it was partially offset by continued expense reduction. Although net income was down by 5.7% as compared to Q3 2008, net income as a percent of sales rose from 13.1% to 13.7% in the quarter. Earnings per share for the quarter were \$0.41 per share as compared to \$0.43 per share in the third quarter of 2008.

Cash and short-term investments continue to rise despite slower sales and current economic conditions. Cash and short-term investments equaled \$14.1 million at the end of the third quarter compared with \$8.6 million in 2008. Accounts receivable collections remain strong while bad debts remain in line with historical performance. Inventory at the end of the third quarter was \$6.4 million compared with \$8.1 million for the same period ending last year. Payables and accruals ended the quarter at \$8.2 million compared with \$10.5 million for the same period last year.

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Outlook

The Company is optimistic about the future of the geothermal market. Geothermal product sales continue to outstrip those of conventional systems, especially in the replacement market. While conventional HVAC system sales have fallen over 30% in the past year, geothermal sales nationwide are down in the 15% range. Although total Company sales are down 5.7% year to date, we continue to outperform the geothermal market. Sales have been blunted by the general economic climate, tight credit and high unemployment rates. Nevertheless, the Company expects that sales will continue to grow, especially with the positive impact of the 30% uncapped tax incentives.

While closely managing discretionary expenses and overhead costs, the Company continues to make strategic investments in people, market penetration, product development and innovation and technology. It is the Company's belief that the current economic weakness, coupled with its financial strength, allows it to strengthen its competitive position in the geothermal market and position it for substantial growth as the economy improves.

The Company expects the balance of the year to continue to follow what we have seen during the first half of the year. 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.

The Company continues to be focused on product cost control, maintaining gross margins, and maintaining the current level of general and administrative expenses while sales growth trends at a slower rate than it has in recent history. The Company is also leveraging its competitive advantage in the areas of delivery time, customer service and research and development to ensure it is well positioned for the growth in the geothermal market the Company expects over the next five to ten years.

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Summary of quarterly results (unaudited)

2009 Quarters ended	March 31	June 30	September 30	
Sales	\$ 23,674	\$ 29,772	\$ 36,209	
Net income	830	3,648	4,947	
Basic and diluted earnings per share	0.07	0.30	0.41	

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 \$14.1 million in cash and cash equivalents and short-term investments after paying \$7.1 million in dividends during the first nine 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.

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

	Operating leases	Capital leases	Other	Total
2009	\$ 59	\$ 10	\$ —	\$ 69
2010	39	40	59	138
2011	28	40	—	68
2012	22	40	—	62
2013	14	39	—	53
2014	—	39	—	39
	<u>\$ 162</u>	<u>\$ 208</u>	<u>\$ 59</u>	<u>\$ 429</u>

The Company's minimum contractual obligations consist of agreements to lease certain facilities and operational and administrative equipment and for other services for various periods through 2014.

In addition, the Company has a deferred compensation plan, detailed in Note 10 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 \$2.1 million during the first nine 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 November 4, 2009, there were 12,092,432 common shares issued and outstanding. As of November 4, 2009, no stock options were outstanding.

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

Transactions with related parties

The Company did not have any related party transactions during the first nine 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.

Future adoption of International Financial Reporting Standards (IFRS)

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. The Company's first IFRS compliant financial statements will be for the first quarter of 2011. Management is assessing and evaluating the effects and any changes required of IFRS implementation upon its operations, internal controls and financial reporting. The Company commissioned a scoping of convergence to IFRS which has now been completed. The study identified additional data, new information and areas where specialized accounting principles will be required to comply with IFRS. It also summarized relevant IFRS initial adoption requirements and options and strategy for its application. Currently, management is putting together a detailed plan for adoption and application of the new reporting standards.

Consolidated Statements of Income & Retained Earnings

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

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Sales	\$ 36,209	\$ 39,964	\$ 89,655	\$ 95,107
Cost of sales	22,962	25,230	58,416	62,544
Gross profit	13,247	14,734	31,239	32,563
Operating expenses	4,865	5,741	15,115	15,249
Research and development expenses (Note 18)	507	490	1,722	1,434
Income before interest and income taxes	7,875	8,503	14,402	15,880
Interest income	29	35	37	128
Interest expense	(7)	(12)	(15)	(30)
Income before income taxes	7,897	8,526	14,424	15,978
Income taxes (Note 19)	2,950	3,278	4,999	5,723
Net income	\$ 4,947	\$ 5,248	\$ 9,425	\$ 10,255
Earnings per share (Note 20)				
Basic and diluted	\$ 0.41	\$ 0.43	\$ 0.78	\$ 0.85
Weighted average number of shares (Note 20)				
Basic	12,092,432	12,092,432	12,092,432	12,089,950
Diluted	12,092,432	12,092,432	12,092,432	12,091,403
Retained earnings, beginning of period	\$ 11,610	\$ 6,057	\$ 11,842	\$ 5,504
Net income	4,947	5,248	9,425	10,255
Dividends (Note 21)	(2,418)	(2,291)	(7,128)	(6,745)
Retained earnings, end of period	\$ 14,139	\$ 9,014	\$ 14,139	\$ 9,014

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

Consolidated Balance Sheets

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

	September 30, 2009	December 31, 2008
Assets		
Current assets		
Cash and cash equivalents	\$ 3,761	\$ 6,029
Short-term investments	10,368	5,316
Receivables (Note 2)	16,823	18,797
Inventory (Note 4)	6,360	8,714
Other current assets (Note 5)	2,709	2,433
Total current assets	40,021	41,289
Capital assets (Note 6)	4,854	4,643
Other assets (Note 7)	2,727	2,080
Total Assets	\$ 47,602	\$ 48,012
Liabilities		
Current liabilities		
Payables and accruals	\$ 8,178	\$ 10,542
Income taxes payable	272	2,027
Provision for warranty claims - current portion (Note 9)	2,138	1,824
Total current liabilities	10,588	14,393
Capital leases (Note 8)	150	—
Deferred compensation (Note 10)	261	1,085
Provision for warranty claims (Note 9)	7,599	5,827
Total Liabilities	18,598	21,305
Shareholders' Equity		
Share capital (Note 13)	14,865	14,865
Retained earnings	14,139	11,842
Total Shareholders' Equity	29,004	26,707
Total Liabilities & Shareholders' Equity	\$ 47,602	\$ 48,012

Commitments and contingencies, respectively (Notes 11 and 12)

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 September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Operating				
Net income	\$ 4,947	\$ 5,248	\$ 9,425	\$ 10,255
Add back non-cash items:				
Depreciation (Note 6)	178	133	513	417
Gain on disposal of capital assets	—	(1)	(18)	(1)
Change in provision for warranty claims	686	402	2,086	1,530
Change in deferred compensation	76	242	1,305	499
Change in future income taxes	(84)	(265)	(985)	(867)
Net cash before working capital adjustments	5,803	5,759	12,326	11,833
Net change in non-cash working capital (Note 14)	866	(868)	749	(4,488)
	<u>6,669</u>	<u>4,891</u>	<u>13,075</u>	<u>7,345</u>
Financing				
Funding of deferred compensation plan	—	—	(2,630)	—
Principal payments for capital leases	(31)	—	(31)	—
Repayment of long-term debt	—	—	—	(65)
Issue of capital stock	—	—	—	34
Payment of dividends	(2,418)	(2,291)	(7,128)	(6,745)
	<u>(2,449)</u>	<u>(2,291)</u>	<u>(9,789)</u>	<u>(6,776)</u>
Investing				
Change in short-term investments	(4,000)	2,890	(5,052)	6,410
Purchase of capital assets	(271)	(290)	(564)	(381)
Proceeds on disposal of capital assets	—	—	52	1
Change in other assets	4	3	10	9
	<u>(4,267)</u>	<u>2,603</u>	<u>(5,554)</u>	<u>6,039</u>
Net increase (decrease) in cash and cash equivalents	(47)	5,203	(2,268)	6,608
Cash and cash equivalents, beginning of period	3,808	3,426	6,029	2,021
Cash and cash equivalents, end of period	<u>\$ 3,761</u>	<u>\$ 8,629</u>	<u>\$ 3,761</u>	<u>\$ 8,629</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 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 and equipment under capital lease 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 in accordance with Section 3064 of the CICA Handbook.

(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. The Company's first IFRS compliant financial statements will be for the first quarter of 2011. Management is assessing and evaluating the effects and any changes required of IFRS implementation upon its operations, internal controls and financial reporting. The Company commissioned a scoping of convergence to IFRS which has now been completed. The study identified additional data, new information and areas where specialized accounting principles will be required to comply with IFRS. It also summarized relevant IFRS initial adoption requirements and options and strategy for its application. Currently, management is putting together a detailed plan for adoption and application of the new reporting standards.

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 September 30, 2009, the Company had \$3.8 million (\$6.0 million at December 31, 2008) in cash and cash equivalents and \$10.4 million (\$5.3 million at December 31, 2008) in short-term investments remaining after paying \$7.1 million in dividends during the first nine 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

	September 30, 2009	December 31, 2008
Trade receivables - current	\$ 14,378	\$ 12,258
Trade receivables - 1 to 89 days past current	1,938	6,352
Trade receivables - 90 plus days past current	546	617
Other receivables	247	34
Allowance for doubtful accounts	(286)	(464)
	<u>\$ 16,823</u>	<u>\$ 18,797</u>

Allowance for doubtful accounts

	Three months ended September 30, 2009	Nine months ended September 30, 2009	Year ended December 31, 2008
Balance, beginning of period	\$ 301	\$ 464	\$ 220
Increase in provision	24	18	252
Net adjustment for finance charges, write-offs and recoveries	(39)	(196)	(8)
Balance, end of period	<u>\$ 286</u>	<u>\$ 286</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 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 a net gain of \$7 thousand and net loss of \$2 thousand for the three months ended September 30, 2009 and 2008, respectively. Foreign currency adjustments resulted in a net loss of \$23 thousand and a net loss of zero for the nine months ended September 30, 2009 and 2008, respectively.

3. Capital disclosures

Capital includes shareholders' equity. At September 30, 2009, the Company had no bank loans or long-term debt other than \$208 thousand under capital leases. 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 six to one at September 30, 2009.

4. Inventory

	September 30, 2009	December 31, 2008
Raw material	\$ 4,125	\$ 6,423
Finished goods	2,235	2,291
	<u>\$ 6,360</u>	<u>\$ 8,714</u>

5. Other current assets

	September 30, 2009	December 31, 2008
Future income taxes	\$ 2,536	\$ 2,213
Prepays and deposits	173	220
	<u>\$ 2,709</u>	<u>\$ 2,433</u>

Notes to the Consolidated Financial Statements

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

6. Capital assets

Cost

	September 30, 2009	December 31, 2008
Land	\$ 450	\$ 450
Building and improvements	3,924	3,886
Equipment	5,461	4,836
Equipment under capital lease	221	—
Construction in progress	375	627
	<u>10,431</u>	<u>9,799</u>

Accumulated depreciation

Building and improvements	1,927	1,844
Equipment	3,623	3,312
Equipment under capital lease	27	—
	<u>5,577</u>	<u>5,156</u>

Net book value

Land	450	450
Building and improvements	1,997	2,042
Equipment	1,838	1,524
Equipment under capital lease	194	—
Construction in progress	375	627
	<u>\$ 4,854</u>	<u>\$ 4,643</u>

Depreciation

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Depreciation in cost of sales	\$ 96	\$ 77	\$ 263	\$ 259
Depreciation in operating expenses	82	56	250	158
Total depreciation	<u>\$ 178</u>	<u>\$ 133</u>	<u>\$ 513</u>	<u>\$ 417</u>

Notes to the Consolidated Financial Statements

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

7. Other assets

	September 30, 2009	December 31, 2008
Future income taxes	\$ 2,725	\$ 2,062
Licensing costs	—	5
Deposits and other	2	13
	<u>\$ 2,727</u>	<u>\$ 2,080</u>

8. Capital leases

The Company leases certain equipment under capital leases.

	September 30, 2009	December 31, 2008
Current portion in "Payables and accruals"	\$ 40	\$ —
Long-term portion as a separate line item	150	—
	<u>\$ 190</u>	<u>\$ —</u>

Minimum lease payments due under capital leases

2009	\$ 10
2010	40
2011	40
2012	40
2013	39
2014	39
Total minimum lease payments	<u>208</u>
Less: interest	<u>(18)</u>
Total minimum principal lease payments	<u>\$ 190</u>

9. Warranty reserve

	September 30, 2009	December 31, 2008
Current portion	\$ 2,138	\$ 1,824
Long-term portion	7,599	5,827
	<u>\$ 9,737</u>	<u>\$ 7,651</u>

Notes to the Consolidated Financial Statements

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

10. Deferred compensation plan

	September 30, 2009	December 31, 2008
Plan assets		
Life insurance policies	\$ 1,338	\$ 1,096
Mutual funds	2,461	—
	<u>3,799</u>	<u>1,096</u>
Plan liabilities	<u>(4,060)</u>	<u>(2,682)</u>
Plan net liability	<u>\$ (261)</u>	<u>\$ (1,586)</u>
Current portion in “Payables and accruals”	\$ —	\$ 501
Long-term portion as a separate line item	<u>261</u>	<u>1,085</u>
Plan net liability	<u>\$ 261</u>	<u>\$ 1,586</u>
Unvested additional awards balances not reflected in plan liabilities	<u>\$ 981</u>	<u>\$ 391</u>

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Deferred compensation plan expenses	<u>\$ 64</u>	<u>\$ 216</u>	<u>\$ 573</u>	<u>\$ 302</u>
Deferred compensation awarded during the period	<u>\$ 18</u>	<u>\$ 9</u>	<u>\$ 1,280</u>	<u>\$ 221</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.

During the second quarter of 2009, the Company elected to fund the balance at that time of its deferred compensation liability by contributing \$2.6 million into the deferred compensation plan.

Notes to the Consolidated Financial Statements

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

10. Deferred compensation plan (continued)

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.

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.

11. Commitments

Contractual obligations due

2009	\$	59
2010		98
2011		28
2012		22
2013		14
	\$	<u>221</u>

The Company has entered into agreements to lease certain facilities and operational and administrative equipment and for other services for various periods through 2013.

12. 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.

Notes to the Consolidated Financial Statements

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

13. Share capital

Common shares issued and outstanding

	Nine months ended September 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.

14. Supplementary cash flow information

Net change in non-cash working capital

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Receivables	\$ (1,430)	\$ (4,409)	\$ 1,974	\$ (6,884)
Inventory	986	(1,199)	2,354	(3,218)
Other current assets	69	115	48	187
Payables and accruals other than deferred compensation and capital lease liabilities	1,316	2,964	(1,872)	3,863
Income taxes payable	(75)	1,661	(1,755)	1,564
	<u>\$ 866</u>	<u>\$ (868)</u>	<u>\$ 749</u>	<u>\$ (4,488)</u>

Cash paid for interest and income taxes

Interest paid	<u>\$ 1</u>	<u>\$ 5</u>	<u>\$ 4</u>	<u>\$ 20</u>
Income taxes paid	<u>\$ 3,109</u>	<u>\$ 1,867</u>	<u>\$ 7,728</u>	<u>\$ 5,065</u>

Non-cash transactions

Equipment acquired under capital lease	<u>\$ 221</u>	<u>\$ —</u>	<u>\$ 221</u>	<u>\$ —</u>
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Notes to the Consolidated Financial Statements

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

15. Geographical information

Sales	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
United States	\$ 30,305	\$ 32,316	\$ 74,863	\$ 77,131
Canada	5,521	7,261	13,502	15,395
Other	383	387	1,290	2,581
	<u>\$ 36,209</u>	<u>\$ 39,964</u>	<u>\$ 89,655</u>	<u>\$ 95,107</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.

16. 401(k) pension plan

401(k) pension plan expenses	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
	<u>\$ 105</u>	<u>\$ 99</u>	<u>\$ 347</u>	<u>\$ 297</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.

17. Stock-based compensation plan

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

18. Research and development expenses

Research and development expenses	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Research and development expenses	\$ 555	\$ 552	\$ 1,872	\$ 1,577
Research tax credits	(48)	(62)	(150)	(143)
	<u>\$ 507</u>	<u>\$ 490</u>	<u>\$ 1,722</u>	<u>\$ 1,434</u>

Notes to the Consolidated Financial Statements

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

19. Income taxes

Income tax provision

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Current	\$ 3,034	\$ 3,543	\$ 5,984	\$ 6,590
Future	(84)	(265)	(985)	(867)
	<u>\$ 2,950</u>	<u>\$ 3,278</u>	<u>\$ 4,999</u>	<u>\$ 5,723</u>

Future income tax assets

	September 30, 2009	December 31, 2008
Warranty	\$ 3,772	\$ 3,040
Deferred compensation and other compensation amounts	1,913	1,629
Inventory reserve	(325)	(325)
Tax value of assets in excess of book value	41	55
Book value of assets in excess of tax value	(241)	(255)
Other	101	131
	<u>\$ 5,261</u>	<u>\$ 4,275</u>
Future income taxes in "Other current assets"	\$ 2,536	\$ 2,213
Future income taxes in "Other assets"	2,725	2,062
	<u>\$ 5,261</u>	<u>\$ 4,275</u>

Notes to the Consolidated Financial Statements

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

20. Earnings per share

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Shares outstanding at beginning of period	12,092,432	12,092,432	12,092,432	12,087,432
Weighted average dilution for exercised options	—	—	—	2,518
Basic weighted average shares outstanding	12,092,432	12,092,432	12,092,432	12,089,950
Weighted average dilution for unexercised options	—	—	—	1,453
Diluted weighted average shares outstanding	12,092,432	12,092,432	12,092,432	12,091,403
Net income	\$ 4,947	\$ 5,248	\$ 9,425	\$ 10,255
Basic and diluted earnings per share	\$ 0.41	\$ 0.43	\$ 0.78	\$ 0.85

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

21. Dividends

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

Date of payment	Date of record	Nine months ended September 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
September 1 (September 2)	August 19 (August 22)	0.19	0.18
		\$ 0.56	\$ 0.53

Total dividend

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Dividend payment to shareholders	\$ 2,298	\$ 2,177	\$ 6,772	\$ 6,408
Withholding tax payment to the IRS on intercorporate dividend	120	114	356	337
	\$ 2,418	\$ 2,291	\$ 7,128	\$ 6,745

WaterFurnace Renewable Energy, Inc.

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Toll-free number for shareholder inquiries
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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