

ALTERNATIVE FUEL SYSTEMS (2004) INC.

Balance Sheets

(Unaudited)

(expressed in Canadian dollars)

	March 31 2007 \$	December 31, 2006 \$
Assets		
Current assets		
Cash and short-term investments	1,258,332	1,465,238
Accounts receivable	293,126	270,366
Prepaid expenses and deposits	66,927	32,177
Inventory	641,697	664,611
	2,260,082	2,432,392
Property, plant and equipment	203,082	209,015
Intangible assets	50,492	55,305
	2,513,656	2,696,712
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	170,607	205,095
Advances from customers	80,634	108,328
Deferred revenue	18,108	18,108
	269,349	331,531
Shareholders' Equity		
Capital stock	2,442,621	2,442,621
Warrants	195,450	195,450
Settlement warrants	171,000	171,000
Contributed surplus	134,369	129,682
Deficit	(699,133)	(573,572)
	2,244,307	2,365,181
	2,513,656	2,696,712

ALTERNATIVE FUEL SYSTEMS (2004) INC.

Statements of Income (Loss), Comprehensive Income (Loss) and Deficit (Unaudited)

(expressed in Canadian dollars)

	For the three months ended March 31	
	2007	2006
	\$	\$
Product revenue	404,679	614,207
Cost of revenue	237,458	304,471
Gross Margin	167,221	309,736
Engineering revenue	10,031	36,644
Interest and Other Income	10,788	11,718
	188,040	358,098
Expenses		
Operating and administration		
Engineering and product development	134,826	150,550
Administrative and other	109,258	102,046
Sales and marketing	44,920	43,981
Repayment of research funding	3,110	4,865
Depreciation of property, plant & equipment	11,821	13,582
Amortization of intangible assets	4,979	27,439
Stock option compensation	4,687	1,378
	313,601	343,841
Income (Loss) and Comprehensive Income (Loss)	(125,561)	14,257
Deficit - Beginning of period	(573,572)	(473,179)
Deficit - End of period	(699,133)	(458,922)
Basic and diluted income (loss) per common share	(0.01)	0.00

ALTERNATIVE FUEL SYSTEMS (2004) INC.

Statements of Cash Flows

(Unaudited)

(expressed in Canadian dollars)

	For the three months ended March 31	
	2007	2006
	\$	\$
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Cash provided by (used in)		
Operating activities		
Income (loss) for the period	(125,561)	14,257
Items not involving cash		
Depreciation and amortization	16,800	41,021
Stock option compensation	4,687	1,378
	<hr/>	<hr/>
	(104,074)	56,656
Change in non-cash working capital items	<hr/>	<hr/>
	(96,778)	(310,693)
Cash flow from operations	<hr/>	<hr/>
	(200,852)	(254,037)
Investing activities		
Purchase of equipment and intangible assets	(6,054)	(14,411)
Cash flow from investing	<hr/>	<hr/>
	(6,054)	(14,411)
Decrease in cash & short-term investments	<hr/>	<hr/>
	(206,906)	(268,448)
Cash & short-term investments - beginning of period	<hr/>	<hr/>
	1,465,238	1,655,287
Cash & short-term investments - end of period	<hr/>	<hr/>
	1,258,332	1,386,839

NOTES TO THE FINANCIAL STATEMENTS

1. Nature of operations

The interim financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The interim financial statements have been prepared following the same accounting policies and methods of computation as the financial statements for the year ended December 31, 2006, except where noted below. The disclosures provided below are incremental to those included with the financial statements for the year ended December 31, 2006. These interim financial statements should be read in conjunction with the financial statements and notes for the period ended December 31, 2006.

On January 1, 2007, the Company adopted the new CICA Handbook Sections 3855 – Financial Instruments – Recognition and Measurement, and 1530 – Comprehensive Income. The financial instrument standard establishes the recognition and measurement criteria of financial assets, financial liabilities and derivatives. All financial instruments are required to be measured at fair value on initial recognition of the instrument, except for certain related party transactions. Measurement in subsequent periods depends on whether the financial instrument has been classified as held-for-trading, available-for-sale, held-to-maturity, loans and receivables, or other financial liabilities as defined by the standard. The methods used by the Company in determining the fair value of financial instruments are unchanged as a result of implementing the new standard.

The Company has no financial instruments or activities that give rise to other comprehensive income. The Company's cash and cash equivalents are designated as held-for-trading and are measured at carrying value, which approximates fair value due to the short-term nature of these instruments.

AFS (2004) trades on the Canadian TSX Venture Exchange under the symbol "AFX".

1. Capital stock

a. Authorized

Unlimited common voting shares without nominal or par value

Issued

	Number of shares	Amount \$
Balance – December 31, 2005	16,865,080	2,423,571
April 15, 2006 financing unit warrants exercised	<u>75,000</u>	<u>19,050</u>
Balance – December 31, 2006 and March 31, 2007	16,940,080	2,442,621

a) **Stock-based compensation**

From commencement of operations on June 30, 2004 to the current period ended March 31, 2007, the company has issued 1,020,000 stock options, of which 591,800 are exercisable. A summary of the Company's stock option plan is presented in Note 5 c) to the audited December 31, 2006 financial statements. There have been no new issues subsequent to December 31, 2006.

The Company recognized \$4,687 of compensation expense in the statement of operations related to the vested options during the quarter ended March 31, 2007 (\$1,378 during the quarter ended March 31, 2006).

b) **Settlement warrants**

As part of the corporate restructuring of AFS, a severance liability arose when various senior employees of AFS were terminated on June 30, 2004. To extinguish that liability, 1,362,956 settlement warrants of AFS Energy and 2,954,847 settlement warrants of AFS (2004) were issued to these employees as part of the Plan.

The settlement warrants issued by AFS (2004) have the following basic terms:

- Each warrant entitles the holder to acquire one common share of the Company at the exercise price of \$0.105 (the exercise price as approved under the Plan of Arrangement).
- The term of the warrants is for three years commencing July 27, 2004.
- All of the warrants were initially escrowed. Over the three-year warrant term, the warrants are eligible for release from escrow (and become exercisable in the hands of the warrant holder) according to the following release schedule:

Date of release (# of months after July 27, 2004)	% eligible for release
4 months	10%
6 months	15%
12 months	15%
18 months	15%
24 months	15%
30 months	15%
36 months	<u>15%</u>
	<u>100%</u>

There are now 2,511,620 warrants eligible for release from escrow.

c) Stock-based compensation

From commencement of operations on June 30, 2004 to the current period ended March 31, 2007, the company has issued 1,020,000 stock options, of which 591,800 are exercisable. A summary of the Company's stock option plan is presented in Note 5 c) to the audited December 31, 2006 financial statements. There have been no new issues subsequent to December 31, 2006.

The Company recognized \$4,687 of compensation expense in the statement of operations related to the vested options during the quarter ended March 31, 2007 (\$1,378) during the quarter ended March 31, 2006.

3. Segmented Information

The company operates in a single business segment which is the development and marketing of fuel management systems and related components that enable internal combustion engines to operate on compressed natural gas.

Enterprise wide disclosures as follows:

a) **Geographic information - Revenues by region**

(amounts in CDN \$)	Three months ended March 31, 2007	Three months ended March 31, 2006
Europe	233,125	358,585
U.S.A.	81,142	222,234
Asia	68,945	7,837
India	29,592	2,889
Canada and Other	1,906	13,607
Mexico	-	45,699
Total	414,710	650,851

All of the company's assets are located in Canada.

b) **Major customers**

For the three months ended March 31, 2007, two individual customers accounted for 52% and 15% of revenue respectively. For the three months ended March 31, 2006 two individual customers accounted for 55% and 32% of revenue respectively. At March 31, 2007 four (March 31, 2006 - two) individual customers accounted for 56%, 27%, 25% and 15% (March 31, 2006 - 55% and 42%).

4 Commitments

a) In November 2005, a new regulator royalty agreement was signed which became effective July 1, 2006 and expires June 30, 2011. Under the terms of this license agreement, AFS (2004) will be required to pay a royalty to the licensor for each regulator sold.

b) AFS (2004) has leased 5,800 square feet of warehouse, shop and office space which currently house all of its operations. The lease agreement is for a two-year period from July 1, 2006 to June 30, 2008 with monthly lease payments of \$4,688.