



Management’s Discussion and Analysis (“MD&A”)

Below is Management’s discussion and analysis of financial results for the three-month periods ended March 31, 2007 and March 31, 2006.

Sales Revenue

Sales for the first quarter were comprised of the following:

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006
Pressure regulators	\$253,789	\$386,306
Ignition systems and other parts	82,059	194,739
Engine management systems	68,831	36,644
Engineering revenue	<u>10,031</u>	<u>33,162</u>
Total	\$414,710	\$650,851

Gross margins

Gross margins realized in the first quarter were \$167,221 or 41% compared to 50 % for the same quarter in 2006. This percentage is lower in 2007 as previous inventories of zero cost items have been used up and new inventory is now being purchased at market prices.

Operating and administrative expenses

Operating and administrative expenses for the three-month periods ended March 31, 2007 and March 31, 2006 were comprised of the following:

	Three months ended March 31, 2007	Three months ended March 31, 2006
Engineering & product development	\$134,826	\$150,550
Administrative & other	109,258	102,046
Sales & marketing	<u>44,920</u>	<u>43,981</u>
Total	\$289,004	\$296,577

Employee wages and benefits accounted for 74% or \$214,889 (72% of the \$296,577 - 2006) in total operating and administrative expenses recognized during the first quarter of 2007. Generally all departments' expenses are higher overall compared to the same quarter in 2006 due to salary and wage increases incurred in order to remain competitive in the Calgary market. The engineering and product development expenses dropped due to a vacant position.

The Company currently has 11 full time employees, with consultants, distributors and agents in Europe, India, Iran and the U.S.

Net Loss

AFS reported a net loss for the quarter ended March 31, 2007 of \$125,561 (\$0.01 per share) on a basic and diluted basis. There was a profit of \$14,257 in the comparable quarter in 2006 (\$0.01 per share).

Prepaid expenses and deposits

Prepaid expenses are increased to \$66,927 as at March 31, 2007 compared to the December 31, 2006 balance of \$32,177. The increase is due to the prepaid of the insurance premiums for the 2007 fiscal year.

Accounts payable and accrued liabilities

The March 31, 2007 balance for accounts payables decreased to \$170,607 from the \$205,095 balance at December 31, 2006. The decrease is due to the annual audit invoicing drawing down the accrual balance.

Advances from customers

Advances from customers has decreased to \$80,634 at March 31, 2007 from a balance of \$108,328 at December 31, 2006. The decrease is due to deposits being applied to shipments made in the first quarter. In order to mitigate the risk inherent in providing customized engineering and product development work, the Company generally requires that all new large orders be guaranteed by a deposit before work commences.

Contractual obligations

AFS (2004) had the following contractual obligation at March 31, 2007:

AFS (2004) leases 5,800 square feet of warehouse, shop and office space, which currently house all of the company's operations. A two-year lease was entered into effective July 1, 2006 with monthly payments of \$4,688 to June 2008.

Contingent liabilities

During the first quarter ended March 31, 2007, there were no material changes in the contingent liabilities as disclosed in the audited December 31, 2006 financial statements.

Liquidity and cash flow from operations

On April 15, 2005, the Company closed a series of equity financings (as announced in the press release on April 18, 2005) which raised gross proceeds of \$1.5 million. As a result of these

financings, AFS (2004) remains well capitalized to pursue potential business opportunities and increase its sustainability period. During the first quarter ended March 31, 2007 there was a total decrease in cash of \$206,906 from the December 31, 2006 balance. \$6,054 was invested in capital equipment. A net loss of \$125,562, the result of slow sales in the first quarter accounted for a large portion of the decrease as well. The balance of the cash decrease was due the decrease in accounts payable and advances from customers.

Critical accounting estimates

The Company's March 31, 2007 period end financial statements contain significant accounting estimates made by management, including ongoing valuation of inventory and assessment of its net realizable value, determination of the liability related to product warranty costs, and recoverability of the carrying values of property, plant and equipment and intangible assets. There is no guarantee that such estimates are accurate.

Disclosure Controls and Procedures

The Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the Company's internal control over financial reporting as of March 31, 2007, pursuant to the requirements of Multilateral Instrument 52-109 of the Canadian Securities Administrators.

Internal control over financial reporting

There were no changes in the Company's internal controls over financial reporting that occurred during the three months ended March 31, 2007. A full discussion of the internal controls over financial reporting is included in the Company's MD&A for the year ended December 31, 2006.

Financial Instruments

On January 1, 2007, the Company adopted the new CICA Handbook Sections 3855 – Financial Instruments – Recognition and Measurement, 1530 – Comprehensive Income, and 3865 – Hedges. The financial instruments 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. Financial assets and financial liabilities held-for-trading are measured at fair value with changes in those fair values recognized in net earnings. Financial assets available-for-sale is measured at fair value, with changes in those fair values recognized in other comprehensive income. The method 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. Accounts receivable and accounts payable and accrued liabilities are measured at cost.

Business Risks

Key Business Risks and Uncertainties

Small Customer Base – AFS has a small number of customers, some of which are major contributors to the Company’s revenue stream. If one of these major customers ceases to use AFS products, a significant impact on sales volume would occur.

Foreign Exchange Rate Risk - Almost all of Alternative Fuel Systems invoicing to customers is due and payable in US dollars. AFS is exposed to USD to CDN dollar exchange rate risk. There is potential for exchange loss and gains affecting net income due to fluctuations in foreign currency valuations.

Major Competitors – AFS has a number of competitors that are much larger in size and which have considerably more resources than the Company. Although AFS has been successful in gaining business through quality products and customer service, other players in the market may develop competing technologies.

Fuel Pricing and Infrastructure – growth in the Company’s primary markets is dependent on a number of factors, including having a favorable price differential between conventional fuels and natural gas, and having sufficient fueling stations to make natural gas vehicles attractive to customers. There can be no assurance that either or both of these factors will continue to be present in any particular market.

Dependence Upon Key Personnel – AFS depends on its senior management and its technical staff. If the Company is unable to attract and retain key personnel, it may have a material adverse effect on the business.