



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

Below is Management’s discussion and analysis of financial results for the three and six-month periods ended June 30, 2007 and June 30, 2006.

Operating Results

Sales Revenue

Sales for the second quarter were comprised of the following (amounts in thousands of Canadian dollars):

	Three Months Ended June 30		Six Months Ended June 30	
	2007	2006	2007	2006
Pressure regulators	\$403	\$384	\$657	\$770
Engine management systems	25	64	107	258
Ignition systems and other parts	<u>54</u>	<u>62</u>	<u>122</u>	<u>95</u>
Subtotal Product Sales	\$482	\$510	\$886	\$1,123
Engineering services	<u>20</u>	<u>21</u>	<u>30</u>	<u>58</u>
Total	\$502	\$531	\$916	\$1,181

The decrease in revenue in the second quarter of 2007 versus the same period in 2006, and also in the first six months of this year versus last year was primarily due to a decrease in sales of engine management systems. In 2006, significant sales of these systems were made, primarily for use in Southeast Asia. The customer for the majority of these systems chose to order a large number of them at once, to achieve a better price point. Since most of the systems were delivered, the customer has been selling them to end users, but has not yet drawn down his inventory to the point that he might order more units. In addition, in the first six months of 2007, the previously described interruption in vehicle production by a large European customer adversely affected revenue compared to that recognized in the first six months of 2006.

Gross margins

Gross margins realized in the second quarter were \$191,558 (2006-\$227,408) or 39% (2006-45%). A significant amount of pressure regulator parts inventory was purchased at a low cost from the predecessor company during the corporate restructuring that occurred in 2004. This low cost inventory has been gradually consumed in production, and as new inventory is purchased at today’s cost and used, margins are lowered. In addition, fewer sales of higher

margin engine management systems were recorded in the second quarter compared to the same period of 2006. Gross Margins realized for the six months ended June 30, 2007 were \$358,779 (2006-\$537,144) or 40% (2006- 47%). The margin percentage for the six-month period was lower in 2007 primarily due to the same factors that affected the second quarter.

Operating and administrative expenses

Operating and administrative expenses for the three and six month periods ended June 30, 2007 and June 30, 2006 were comprised of the following (amounts in thousands of Canadian dollars):

	Three months ended June 30		Six months ended June 30	
	2007	2006	2007	2006
Engineering & product development	\$137	\$139	\$272	\$290
Administrative & other	177	112	286	214
Sales & marketing	43	40	88	84
Total	\$357	\$291	\$646	\$588

Employee wages and benefits accounted for 59% of the \$357,000 (2006 - 73% of the \$291,000) in total operating and administrative expenses recognized during the second quarter of 2007. The increase in Administrative and other costs in Q2 of 2007 was primarily due to foreign exchange losses of more than \$36,500 due to the rapid strengthening of the Canadian dollar during the period. In addition, mailing costs for the annual meeting of Shareholders, and increased professional fees contributed to the change. For the six months ended June 30, 2007, increased total operating and administrative expense over the same period in 2006 was due to the same factors.

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

Net Loss and Cash Flow

AFS reported a net loss for the quarter ended June 30, 2007 of \$159,919 (\$0.01 per share on a basic and diluted basis). The net loss in the comparable quarter in 2006 was \$79,779 (\$0.00 per share). Cash outflow from operations for the second quarter of 2007 was (\$4,226) versus a cash outflow of (\$6,050) in the second quarter of 2006. The loss in the second quarter of 2007 was offset by increased cash flow from working capital, primarily due to an increase in accounts payable of \$136,616 and a decrease in accounts receivable of \$87,456.

Accounts Receivable

Accounts receivable has decreased to \$205,670 as at June 30, 2007 compared to the December 31, 2006 balance of \$270,366. As previously discussed above, this decrease is primarily due to a production interruption at our largest customer in Europe, to deal with problems not involving AFS.

Prepaid Expenses

Prepaid expenses increased to \$49,404 as at June 30, 2007 compared to the December 31, 2006 balance of \$32,177. The increase is due to the prepayment of insurance premiums for the 2007 fiscal year.

Inventory

Inventory has increased in the second quarter of 2007 to \$706,719 compared to the December 31, 2006 balance of \$664,611, a change of \$42,108. During Q2 inventory buildup for pressure regulator production increased, as the Company's largest customer for this product line resumed production of natural gas fueled vehicles, albeit at a low rate.

Accounts payable and accrued liabilities

The June 30, 2007 accounts payable balance increased to \$307,222 from \$205,095 at December 31, 2006. The increase of \$102,127 was attributed to increased purchases of inventory for both pressure regulators and engine control modules.

Advances from customers

Advances from customers have decreased to \$38,396 at June 30, 2007 from a balance of \$108,328 at December 31, 2006. The decrease is due to customer deposits being applied to second quarter shipments. 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.

Capital Stock

During the second quarter ended June 30, 2007, there were no changes in the authorized or issued capital stock as disclosed in the audited December 31, 2006 financial statements.

Contractual obligations

AFS leases 5,800 square feet of warehouse, shop and office space, which currently houses all of the company's operations. A new two-year lease was entered into effective July 1, 2006, with monthly lease payments of \$4,688 to June 30, 2008.

Contingent liabilities

During the second quarter ended June 30, 2007, there were no material changes in the contingent liabilities as disclosed in the audited December 31, 2006 financial statements.

Liquidity and Capital Resources

In April 2005 the Company closed a series of equity financings which raised gross proceeds of \$1.5 million. As a result of these financings, AFS remains well capitalized to pursue potential business opportunities and increase its sustainability period. Through June 30, 2007 there was a total decrease in cash of \$225,090 from the December 31, 2006 balance. Included in this decrease was \$69,932 of customer deposits that were applied to items shipped and \$20,012 that was invested in capital equipment.

Critical accounting estimates

The Company's June 30, 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 has evaluated the effectiveness of the company's internal control over financial reporting as of June 30, 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 June 30, 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 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. Accounts receivable and accounts payable and accrued liabilities are measured at cost, which due to the short-term nature of these items is estimated to equal their fair values.

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. Fluctuations in foreign currency valuations may result in exchange losses or gains that would affect net income.

Major Competitors – AFS has a number of competitors that are much larger in size and 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.

ALTERNATIVE FUEL SYSTEMS (2004) INC.

Balance Sheets

(Unaudited)

(expressed in Canadian dollars)

	As at June 30, 2007 \$	As at December 31, 2006 \$
Assets		
Current assets		
Cash and short-term investments	1,240,148	1,465,238
Accounts receivable	205,670	270,366
Prepaid expenses and deposits	49,404	32,177
Inventory	706,719	664,611
	2,201,941	2,432,392
Property, plant and equipment	204,589	209,015
Intangible assets	45,513	55,305
	2,452,043	2,696,712
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	307,222	205,095
Advances from customers	38,396	108,328
Deferred revenue	16,556	18,108
	362,174	331,531
Shareholders' Equity		
Capital stock	2,442,621	2,442,621
Warrants	-	195,450
Settlement warrants	171,000	171,000
Contributed surplus	335,300	129,682
Deficit	(859,052)	(573,572)
	2,089,869	2,365,181
	2,452,043	2,696,712

ALTERNATIVE FUEL SYSTEMS (2004) INC.
Statement of Operations, Comprehensive (Loss) and Deficit
(Unaudited)
(expressed in Canadian dollars)

	For the three months ended June 30		For the six months ended June 30	
	2007	2006	2007	2006
	\$	\$	\$	\$
Product revenue	481,298	509,468	885,977	1,123,675
Cost of revenue	289,740	282,060	527,198	586,531
Gross Margin	191,558	227,408	358,779	537,144
Engineering revenue	20,463	21,141	30,494	57,785
Interest and Other Income	11,624	13,237	22,412	24,955
	223,645	261,786	411,685	619,884
Expenses				
Operating and administration				
Engineering and product development	136,930	139,420	271,756	289,970
Administrative and other	176,862	111,608	286,120	213,654
Sales and marketing	43,251	40,199	88,171	84,180
Repayment of research funding	3,610	3,969	6,720	8,834
Depreciation of property, plant & equipment	12,451	13,805	24,272	27,387
Amortization of intangible assets	4,979	27,450	9,958	54,889
Stock-based compensation	5,481	5,114	10,168	6,492
	383,564	341,565	697,165	685,406
Loss and Comprehensive Loss for the period	(159,919)	(79,779)	(285,480)	(65,522)
Deficit - Beginning of period	(699,133)	(458,922)	(573,572)	(473,179)
Deficit - End of period	(859,052)	(538,701)	(859,052)	(538,701)
Basic and diluted loss per common share	(0.01)	(0.00)	(0.02)	(0.00)

ALTERNATIVE FUEL SYSTEMS (2004) INC.

Statements of Cash Flows

(Unaudited)

(expressed in Canadian dollars)

	For the three months ended June 30		For the six months ended June 30	
	2007	2006	2007	2006
	\$	\$	\$	\$
Cash provided by (used in)				
Operating activities				
Loss for the period	(159,919)	(79,779)	(285,480)	(65,522)
Items not involving cash:				
Depreciation and amortization	17,430	41,255	34,230	82,276
Stock-based compensation	5,481	5,114	10,168	6,492
	(137,008)	(33,410)	(241,082)	23,246
Change in non-cash working capital items	132,782	27,360	36,004	(283,333)
Cash flow from operations	(4,226)	(6,050)	(205,078)	(260,087)
Financing activities				
Proceeds from exercise of warrants	-	15,000	-	15,000
Investing activities				
Purchase of equipment and intangible assets	(13,958)	(9,227)	(20,012)	(23,638)
Decrease in cash & short-term investments	(18,184)	(277)	(225,090)	(268,725)
Cash & short-term investments - beginning of period	1,258,332	1,386,839	1,465,238	1,655,287
Cash & short-term investments - end of period	1,240,148	1,386,562	1,240,148	1,386,562

Alternative Fuel Systems (2004) Inc.

Notes to Financial Statements

For the three and six months ended June 30, 2007 and June 30, 2006

(expressed in Canadian dollars)

1. Nature of operations

These interim unaudited financial statements of Alternative Fuel Systems (2004) Inc. (“AFS or the company”) do not include all of the disclosures required by Canadian generally accepted accounting principles for annual financial statements and, accordingly, should be read in conjunction with the December 31, 2006 audited financial statements and notes thereto. The accompanying financial statements include all normally recurring adjustments, which in the opinion of management are necessary to present fairly the Company’s financial position as at June 30, 2007 and the results of operations and comprehensive loss, deficit and cash flows for the three-month periods ended June 30, 2007 and June 30, 2006.

On January 1, 2007, the Company adopted the new CICA Handbook Sections 3855 – Financial Instruments – Recognition and Measurement, 1530 – Comprehensive Income, and 3865. 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. 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. Accounts receivable and accounts payable and accrued liabilities are measured at cost, which due to the short-term nature of these items is estimated to equal their fair values.

AFS trades on the Canadian TSX Venture Exchange under the symbol “AFX”.

2. Capital stock

a) **Authorized**

Unlimited common voting shares without nominal or par value.

Alternative Fuel Systems (2004) Inc.

Notes to Financial Statements

For the three and six months ended June 30, 2007 and June 30, 2006

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>19,500</u>
Balance, December 31, 2006 and June 30, 2007	16,940,080	2,442,621

On April 15, 2005, the Company issued 10 million units at a price of \$0.15 per unit, with each unit comprised of one common share of the Company and one half share purchase warrant. Each whole share purchase warrant is exchangeable into an additional common share at an exercise price of \$0.20.

A total of 2 million units (or 20% of the offering) were issued pursuant to private placements. These subscribers had a four-month hold period on their common shares and share purchase warrants and the warrants were exercisable for a term of eighteen (18) months. Subscribers to the remaining 8 million units were not subject to a hold period and the related share purchase warrants will be exercisable for a term of twelve months. Subsequently, the expiry date of the share purchase warrants associated with the 8 million units was extended an additional twelve (12) months to April 15, 2007. As of June 30, 2007, none of the share purchase warrants were exercised and all have expired.

b) Settlement warrants

As part of the corporate restructuring of Alternative Fuel Systems Inc. ("Former AFS"), a severance liability arose when various senior employees of that company 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 were issued to these employees as part of the Plan. Issuance of these warrants was approved by the shareholders and creditors of Former AFS, as well as the Court of Queen's Bench of Alberta. The estimated value of this severance liability was based on the estimated values of the related settlement warrants that were issued. The portion of the severance liability related to the issue of AFS warrants, estimated at \$171,000, was transferred from Former AFS to AFS as part of the sale of business assets and liabilities between the two entities.

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 (such exercise price as determined under the Plan).

Alternative Fuel Systems (2004) Inc.

Notes to Financial Statements

For the three and six months ended June 30, 2007 and June 30, 2006

- The term of the warrants is for three years commencing July 27, 2004. By the time financial statements will be published these warrants will expire.
- All of the warrants were initially escrowed. Over the three-year warrant term, the warrants will be 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
Four months	10%
Six months	15%
Twelve months	15%
Eighteen months	15%
Twenty-four months	15%
Thirty months	15%
Thirty-six months	<u>15%</u>
	<u>100%</u>

- Subsequent to period end, these warrants have expired.

c) Stock-based compensation

The company's stock option plan is described in Note 5 c) to the audited December 31, 2006 financial statements. From commencement of operations on June 30, 2004 to the current period ended June 30, 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 as at December 31, 2006 and 2005 and the changes for the years then ended, 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 \$5,481 of compensation expense in the statement of operations related to the vested options during the quarter ended June 30, 2007 (2006 - \$ 5,114). The stock option compensations expense for the six months ended June 30, 2007 was \$ 10,168 (2006- \$6,492).

Alternative Fuel Systems (2004) Inc.

Notes to Financial Statements

For the three and six months ended June 30, 2007 and June 30, 2006

d) Contributed Surplus

The balance of contributed surplus is comprised of the following:

	\$
Balance December 31, 2006	129,682
Share purchase warrants expired April 15, 2007	195,450
Stock option compensation for the six months ended June 30, 2007	<u>10,168</u>
Balance June 30, 2007	335,300

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 thousands of CDN \$)	Three months ended June 30, 2007	Three months ended June 30, 2006	Six months ended June 30, 2007	Six months ended June 30, 2006
Europe	386	382	618	740
U.S.A.	21	93	102	315
Asia	-	54	80	65
India	68	—	86	-
Canada and Other	11	1	14	14
Mexico	<u>16</u>	<u>1</u>	<u>16</u>	<u>47</u>
Total	502	531	916	1,181

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

b) Major customers

For the three months ended June 30, 2007, two individual customers accounted for 71% and 13% of revenue respectively. For the three months ended June 30, 2006 three individual customers accounted for 71%, 15% and 13% of revenue respectively.

Alternative Fuel Systems (2004) Inc.

Notes to Financial Statements

For the three and six months ended June 30, 2007 and June 30, 2006

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 will be required to pay a royalty to the licensor for each regulator sold.

b) AFS has leased 5,800 square feet of warehouse, shop and office space which currently houses 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.