

ALTERNATIVE FUEL SYSTEMS (2004) INC.**Balance Sheets****(Unaudited)**

(expressed in Canadian dollars, except per share data)

	As at September 30, 2007 \$	As at December 31, 2006 \$
Assets		
Current assets		
Cash and short-term investments	1,052,777	1,465,238
Accounts receivable	230,779	270,366
Prepaid expenses and deposits	20,238	32,177
Inventory	720,527	664,611
	<u>2,024,321</u>	<u>2,432,392</u>
Property, plant and equipment	192,137	209,015
Intangible assets	40,876	55,305
	<u>2,257,334</u>	<u>2,696,712</u>
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	214,437	205,095
Advances from customers	70,204	108,328
Deferred revenue	15,415	18,108
	<u>300,056</u>	<u>331,531</u>
Shareholders' Equity		
Capital stock (note 2)	2,442,621	2,442,621
Warrants	-	195,450
Settlement warrants	-	171,000
Contributed surplus (note 2)	501,605	129,682
Deficit	(986,948)	(573,572)
	<u>1,957,278</u>	<u>2,365,181</u>
	<u>2,257,334</u>	<u>2,696,712</u>
Commitments (note 4)		
Contingencies (note 5)		
See accompanying notes to the financial statements.		

ALTERNATIVE FUEL SYSTEMS (2004) INC.**Statements of Operations, Comprehensive Income (Loss) and Deficit****(Unaudited)**

(expressed in Canadian dollars, except per share data)

	For the three months ended		For the nine months ended	
	September 30		September 30	
	2007	2006	2007	2006
	\$	\$	\$	\$
Product revenue	378,417	757,557	1,264,394	1,881,232
Cost of revenue	239,785	389,301	766,983	975,832
Gross margin	138,632	368,256	497,411	905,400
Engineering revenue	17,821	4,557	48,315	62,342
Interest and Other Income	9,932	11,330	32,344	36,285
	166,385	384,143	578,070	1,004,027
Expenses				
Operating and administration				
Engineering and product development	127,599	143,398	399,355	433,368
Administrative and other	106,073	96,701	392,193	310,355
Sales and marketing	43,900	41,593	132,071	125,773
Repayment of research funding	3,965	5,716	10,685	14,550
Depreciation of property, plant & equipment	12,452	13,262	36,724	40,649
Amortization of intangible assets	4,987	4,951	14,945	59,840
Stock-based compensation	(4,695)	4,084	5,473	10,576
	294,281	309,705	991,446	995,111
(Loss) Income and Comprehensive (Loss) Income for the period	(127,896)	74,438	(413,376)	8,916
Deficit - Beginning of period	(859,052)	(538,701)	(573,572)	(473,179)
Deficit - End of period	(986,948)	(464,263)	(986,948)	(464,263)
Basic and diluted (loss) earnings per common share	(0.01)	0.00	(0.02)	0.00

See accompanying notes to the financial statements.

ALTERNATIVE FUEL SYSTEMS (2004) INC.**Statements of Cash Flows****(Unaudited)**

(expressed in Canadian dollars, except per share data)

	For the three months ended September 30		For the nine months ended September 30	
	2007	2006	2007	2006
	\$	\$	\$	\$
Cash provided by (used in)				
Operating activities				
(Loss) income for the period	(127,896)	74,438	(413,376)	8,916
Items not involving cash:				
Depreciation and amortization	17,439	18,213	51,669	100,489
Stock-based compensation	(4,695)	4,084	5,473	10,576
	(115,152)	96,735	(356,234)	119,981
Change in non-cash working capital items	(71,869)	44,288	(35,865)	(239,046)
Cash flow from operations	(187,021)	141,023	(392,099)	(119,065)
Investing activities				
Purchase of equipment and intangible assets	(350)	(13,569)	(20,362)	(37,206)
Financing activities				
Proceeds from exercise of warrants	-	-	-	15,000
(Decrease) increase in cash & short-term investments	(187,371)	127,454	(412,461)	(141,271)
Cash & short-term investments - beginning of period	1,240,148	1,386,562	1,465,238	1,655,287
Cash & short-term investments - end of period	1,052,777	1,514,016	1,052,777	1,514,016

See accompanying notes to the financial statements.

Alternative Fuel Systems (2004) Inc.

Notes to Financial Statements

(Unaudited)

For the three and nine months ended September 30, 2007

(expressed in Canadian dollars, except per share data)

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 September 30, 2007 and the results of operations and comprehensive income (loss), deficit and cash flows for the three-month periods ended September 30, 2007 and September 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 instruments, 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”.

Alternative Fuel Systems (2004) Inc.

Notes to Financial Statements

(Unaudited)

For the three and nine months ended September 30, 2007

(expressed in Canadian dollars, except per share data)

2. 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>19,500</u>
Balance, December 31, 2006 and September 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 was exchangeable into an additional common share at an exercise price of \$0.20.

As of September 30, 2007, none of the remaining 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. As of September 30, 2007, none of the share purchase warrants were exercised and all 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 September 30, 2007, the company has outstanding 966,500 stock options, of which 672,900 are exercisable. During the quarter, the company issued 54,000 stock options.

Alternative Fuel Systems (2004) Inc.

Notes to Financial Statements

(Unaudited)

For the three and nine months ended September 30, 2007

(expressed in Canadian dollars, except per share data)

The Company recognized a \$(4,695) recovery for stock-based compensation expense in the statement of operations related to the options during the quarter ended September 30, 2007 (2006 - \$ 4,084). The stock option compensations expense for the nine months ended September 30, 2007 was \$ 5,473 (2006- \$10,576). As a result of the grant of options during the reporting period, the amount of stock-based compensation increased, however, the stock-based compensation for the three-month reporting period was offset by the effect of options forfeited by a former employee. As a result, a stock option compensation recovery was realized in the quarter.

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
Settlement warrants expired July 27, 2007	171,000
Stock option compensation for the nine months ended September 30, 2007	<u>5,473</u>
Balance September 30, 2007	501,605

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:

Alternative Fuel Systems (2004) Inc.

Notes to Financial Statements

(Unaudited)

For the three and nine months ended September 30, 2007

(expressed in Canadian dollars, except per share data)

a) Geographic information - revenues by region

(amounts in thousands of CDN \$)	Three months ended September 30, 2007	Three months ended September 30, 2006	Nine months ended September 30, 2007	Nine months ended September 30, 2006
Europe	152	587	770	1,327
U.S.A.	107	119	209	434
Asia	13	54	93	119
India	101	—	187	-
Canada and Other	15	1	30	16
Mexico	8	1	24	48
Total	396	762	1,313	1,944

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

b) Major customers

For the three months ended September 30, 2007, three individual customers accounted for 35%, 25% and 17% of revenue respectively. For the three months ended September 30, 2006 two individual customers accounted for 76% and 15% of revenue respectively.

For the nine-month period ended September 30, 2007, two customers accounted for 55% and 15% of revenue respectively. For the nine-month period ended September 30, 2006, two individual customers accounted for 67% and 21% of revenue respectively.

For the nine months ended September 30, 2007, one (2006 - one) individual customer accounted for 41% (2006 - 76%) of the accounts receivable balance, and an additional two (2006 - one) customers accounted for 28% and 25% respectively (2006 - 12%).

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.

Alternative Fuel Systems (2004) Inc.

Notes to Financial Statements

(Unaudited)

For the three and nine months ended September 30, 2007

(expressed in Canadian dollars, except per share data)

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

5. Contingent liabilities

- a) Included in the package of business assets and liabilities acquired from AFS was a contingent liability to repay certain government funding from the National Research Council of Canada (the "NRC") that had been previously received by AFS. The original funding amount received was \$310,000, of which approximately \$114,000 had been repaid to June 30, 2004. The net amount remaining of approximately \$200,000 is repayable by AFS on a quarterly basis at a rate of 0.75% of gross sales recognized in the related period. The company will continue to make repayments to the NRC until the earlier of the full repayment or December 31, 2011. The repayment rate of 0.75% is subject to periodic review by the NRC, which has the discretion to increase the rate to 1.5%.

The Company recognized \$3,965 (2006- \$5,716) expense relating to the NRC repayment in the statement of operations during the quarter ended September 30, 2007 (2006 - \$ 5,716). The repayment to the NRC for the nine months ended September 30, 2007 was \$10,685 (2006- \$14,550).

- b) AFS provides warranty on the electronic fuel management systems, natural gas pressure regulators, and related components that it sells. Warranty costs are accrued as a percentage of sales and recognized as a cost of sales. The warranty cost is adjusted periodically to reflect actual product returns rates. The warranty provision is an estimate and the impact of future costs associated with repairs of products under warranty could have a material effect on these financial statements.