



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

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

### Operating Results

#### Sales revenue

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

	Three Months Ended September 30		Nine Months Ended September 30	
	2007	2006	2007	2006
Pressure regulators	\$216	\$600	\$873	\$1,370
Engine management systems	42	142	165	400
Ignition systems and other parts	<u>120</u>	<u>16</u>	<u>227</u>	<u>111</u>
<b>Subtotal Product Sales</b>	<b>\$378</b>	<b>\$758</b>	<b>\$1,264</b>	<b>\$1,881</b>
Engineering services	<u>18</u>	<u>4</u>	<u>48</u>	<u>62</u>
<b>Total</b>	<b>\$396</b>	<b>\$762</b>	<b>\$1,313</b>	<b>\$1,943</b>

The decrease in sales revenue in the third quarter of 2007 versus the same period in 2006 was primarily due to a large European customer’s interruptions in production of vehicles using AFS pressure regulators. The decrease in sales revenue during the first nine months of this year versus last year was primarily due to the same factor. In addition, in 2006, significant sales of engine control systems were made, primarily for use in Southeast Asia. The customer for the majority of these systems chose to order a large number of regulators 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 more units are required.

#### Gross margin

Gross margin realized in the third quarter was \$138,632 (2006-\$368,256) or 36 % (2006- 49%). 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 third quarter compared to the same period of 2006.

Gross margin realized for the nine months ended September 30, 2007 was \$497,411 (2006- \$905,400) or 39% (2006- 48%). The margin percentage for the nine-month period was lower in 2007 primarily due to the same factors that affected the third quarter.

### **Operating and administrative expenses**

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

	<b>Three months ended September 30</b>		<b>Nine months ended September 30</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Engineering & product development	<b>\$128</b>	<b>\$143</b>	<b>\$399</b>	<b>\$433</b>
Administrative & other	<b>106</b>	<b>97</b>	<b>392</b>	<b>310</b>
Sales & marketing	<b>44</b>	<b>42</b>	<b>132</b>	<b>126</b>
<b>Total</b>	<b>\$278</b>	<b>\$282</b>	<b>\$923</b>	<b>\$869</b>

Employee wages and benefits accounted for 69% of the \$278,000 (2006 - 74% of the \$282,000) in total operating and administrative expenses recognized during the third quarter of 2007. The decrease in Administrative and other costs in Q3 of 2007 was primarily due to a decrease in Engineering and product development of \$15,000, offset by an increase in Administrative and other expenses of \$9,000. For the nine months ended September 30, 2007, increased total operating and administrative expense over the same period in 2006 was primarily due to foreign exchange losses of more than \$19,000 due to the rapid strengthening of the Canadian dollar during the period and increased professional fees of \$48,000.

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 September 30, 2007 of \$(127,896) (\$0.01 per share on a basic and diluted basis). The net income in the comparable quarter in 2006 was \$74,438 (\$0.00 per share). Added to this net loss was an overall decrease in working capital in the third quarter of 2007 of \$(71,869) versus an increase in working capital of \$44,288 in the same quarter of 2006. The decrease in working capital in the third quarter was primarily due to a decrease in accounts payable of \$93,000, an increase in accounts receivable of \$25,000 and an increase in inventory of \$15,000 during the quarter, offset by an increase in advances from customers of \$32,000 and a decrease in prepaid expenses of \$29,000.

Cash outflow from operations for the third quarter of 2007 was \$(187,021) versus a cash flow of \$141,023 in the third quarter of 2006. This is due to the factors discussed above.

**Accounts receivable**

Accounts receivable has decreased to \$230,779 as at September 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 decreased to \$20,238 as at September 30, 2007 compared to the December 31, 2006 balance of \$32,177. The decrease of \$11,939 is primarily due to a performance bond deposit, which has now been taken into income as the requirement of the contract has been fulfilled.

**Inventory**

Inventory has increased in the third quarter of 2007 to \$720,527 compared to the December 31, 2006 balance of \$664,611, a change of \$55,916. During the third quarter, 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 very low rate.

**Accounts payable and accrued liabilities**

The September 30, 2007 accounts payable balance increased to \$214,437 from \$205,095 at December 31, 2006. The increase of \$9,342 was attributed to increased purchases of inventory for both pressure regulators and engine control modules.

**Advances from customers**

Advances from customers have decreased to \$70,204 at September 30, 2007 from a balance of \$108,328 at December 31, 2006. The decrease of \$38,124 is due to customer deposits being applied to third quarter shipments. In order to mitigate the risk inherent in providing customized engineering and product development work, the Company generally requires that, a deposit guarantee all new large orders, before work commences.

**Capital stock**

During the third quarter ended September 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 September 30, 2008.

**Contingent liabilities**

During the third quarter ended September 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 September 30, 2007 there was a total decrease in cash of \$412,461 from the December 31, 2006 balance. This is primarily due to the net loss from operations of \$(413,376).

**Critical accounting estimates**

The Company's September 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 September 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 September 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.