

April 22, 2008

Auditors' Report

To the Shareholders of
Alternative Fuel Systems (2004) Inc.

We have audited the balance sheets of Alternative Fuel Systems (2004) Inc. as at December 31, 2007 and 2006 and the statements of operations, comprehensive loss and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2007 and 2006 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

PricewaterhouseCoopers LLP

Chartered Accountants
Calgary, Alberta

ALTERNATIVE FUEL SYSTEMS (2004) INC.

Balance Sheets

(expressed in Canadian dollars)

	December 31, 2007 \$	December 31, 2006 \$
Assets		
Current assets		
Cash and short-term investments	964,941	1,465,238
Accounts receivable	229,060	270,366
Prepaid expenses and deposits	11,846	32,177
Inventory	705,597	664,611
	1,911,444	2,432,392
Property, plant and equipment (note 5)	179,686	209,015
Intangible assets (note 6)	35,888	55,305
	2,127,018	2,696,712
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	271,765	205,095
Advances from customers	58,369	108,328
Deferred revenue	-	18,108
	330,134	331,531
Shareholders' Equity		
Capital stock (note 7(a))	2,450,181	2,442,621
Warrants (note 7(a))	-	195,450
Settlement warrants (note 7(b))	-	171,000
Contributed surplus (note 7(d))	502,686	129,682
Deficit	(1,155,983)	(573,572)
	1,796,884	2,365,181
	2,127,018	2,696,712

Contingencies and commitments (note 11 and 13)

The accompanying notes form an integral part of these financial statements.

Approved by the Board of Directors

"David Checkel" Director

"Darshan Kailly" Director

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

	For the year ended December 31	
	2007	2006
	\$	\$
Product revenue	1,682,393	2,394,401
Cost of revenue	1,123,160	1,300,374
Gross margin	559,233	1,094,027
Engineering revenue	108,948	65,857
Interest and other income	47,733	50,557
	715,914	1,210,441
Expenses		
Operating and administration		
Engineering and product development	525,194	562,655
Administrative and other	458,715	410,927
Sales and marketing	176,512	173,699
Amortization of property, plant & equipment	49,176	54,264
Amortization of intangible assets	19,933	64,792
Foreign exchange losses	44,582	3,323
Repayment of research funding (note 13(a))	14,299	18,586
Stock-based compensation (note 7 (c))	9,914	22,588
	1,298,325	1,310,834
Loss and comprehensive loss for the year	(582,411)	(100,393)
Deficit - beginning of year	(573,572)	(473,179)
Deficit - end of year	(1,155,983)	(573,572)
Basic and diluted loss per common share	(0.03)	(0.01)

The accompanying notes form an integral part of these financial statements.

ALTERNATIVE FUEL SYSTEMS (2004) INC.

Statements of Cash Flows

(expressed in Canadian dollars)

	For the year ended December 31	
	2007	2006
	\$	\$
Cash provided by (used in)		
Operating activities		
Loss for the year	(582,411)	(100,393)
Items not involving cash:		
Amortization	69,109	119,056
Stock-based compensation	9,914	22,588
Gain on sale of equipment	-	(350)
	(503,388)	40,901
Change in non-cash working capital items (note 8)	19,254	(197,401)
Cash flow from operations	(484,134)	(156,500)
Investing activities		
Purchase of equipment and intangible assets	(20,363)	(48,899)
Proceeds on disposal of office equipment	-	350
	(20,363)	(48,549)
Financing activities		
Proceeds from exercise of stock options	4,200	-
Proceeds from exercise of warrants	-	15,000
	4,200	15,000
Decrease in cash & short-term investments	(500,297)	(190,049)
Cash & short-term investments - beginning of year	1,465,238	1,655,287
Cash & short-term investments - end of year	964,941	1,465,238

The accompanying notes form an integral part of these financial statements.

Alternative Fuel Systems (2004) Inc.

Notes to Financial Statements

December 31, 2007 and 2006

(expressed in Canadian dollars, except share data)

1. Nature of operations

Alternative Fuel Systems (2004) Inc. (“AFS (2004)” or the “Company”) was incorporated on October 19, 2000 under the original name of “H2 Fuel Inc.” The Company was a wholly owned subsidiary of Alternative Fuel Systems Inc. (“AFS”), a public Company in the business of developing and marketing fuel management systems that enabled internal combustion engines to operate on compressed natural gas.

As a result of a corporate restructuring effective June 30, 2004, H2Fuel Inc. was renamed AFS (2004) which continues to carry on the business of the former AFS. On August 4, 2004 AFS (2004) was listed for trading on the Canadian Venture Exchange under the symbol “AFX”

The financial viability of AFS (2004) going forward will be dependant on the Company’s ability to generate cash from operating activities and/or raising funds in the equity markets.

2. Accounting policies

a) Basis of accounting principles

These financial statements have been prepared in accordance with Canadian generally accepted accounting principles.

b) Revenue recognition

Revenues from the sale of electronic fuel management systems, natural gas pressure regulators and related components are recognized at the time these items are shipped. Other revenues are recognized at the time services are rendered.

c) Cash and short-term investments

Cash and short-term investments consist of cash and term deposits with initial maturities of three months or less.

d) Inventory

Inventory, which is primarily electronic fuel management systems, natural gas pressure regulators and related components, is valued at the lower of cost, determined on a weighted average basis, and net realizable value.

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e) Property, plant and equipment

Property, plant and equipment are recorded at cost, less accumulated amortization. The amortization expense and related accumulated amortization is computed by the declining balance method as follows:

Machine and equipment	20% per annum
Computer hardware and software	33% per annum
Furniture, fixtures and office equipment	20% per annum
Vehicles	20% per annum

f) Intangible assets

Research and development expenditures (with the exception of those which are capital in nature) are expensed as incurred unless a development project meets the criteria for deferral under Canadian generally accepted accounting principles.

Patents and trademarks are amortized on a straight-line basis over five years.

g) Future income taxes

The Company uses the liability method of accounting for future incomes taxes. Under this method of tax allocation, future income tax liabilities and assets are recognized for the estimated tax consequences attributable to differences between the amounts reported in the financial statements and their respective tax bases, using substantively enacted tax rates and laws that are expected to be in effect in the periods in which the future income tax assets or liabilities are expected to be settled or realized. The effect of a change in income tax rates on future income tax liabilities and assets is recognized in income in the period that the change occurs. Future income tax assets are recognized to the extent that they are considered more likely than not to be realized.

h) Stock-based compensation

Stock options are expensed on the statement of operations using the fair value based method of accounting. For purposes of calculating the compensation costs associated with the fair value of granted options, the Company employs the straight-line method whereby compensation costs are calculated in even quarterly amounts over the Company's two year vesting period. Cumulative compensation costs at any date must be at least equal to the compensation costs associated with total options vested at that date.

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i) Loss per share

The loss per share is calculated using the weighted average number of shares outstanding of 16,943,647 (2006 - 16,918,094).

The Company follows the treasury stock method of accounting for diluted loss per common share. The treasury stock method computes the number of incremental shares by assuming the outstanding stock options exercisable at exercise prices below the average market price for the applicable fiscal year are exercised and then that number of incremental shares is reduced by the number of shares that could have been repurchased from the issuance proceeds, using the average market price of the Company's shares for the applicable fiscal year. The effects of any potential dilutive instruments on loss per share related to the outstanding stock options and warrants are anti-dilutive, and therefore have been excluded from calculations of diluted loss per share.

j) Product warranty cost

The Company accrues product warranty costs relating to sales of fuel management systems, natural gas pressure regulators and related components. This warranty estimate, which is calculated as a percentage of sales, is adjusted periodically to reflect actual product return rates.

k) Foreign currency translation

Foreign currency transactions are initially translated into Canadian currency at the rate of exchange at the date of the transaction. At the balance sheet date, monetary items denominated in foreign currencies are translated to Canadian currency at closing rates of exchange at that date. Resulting exchange gains or losses are recognized as income or expense during the year.

l) Impairment of long-lived assets

Property, plant and equipment and definite life intangible assets are reviewed for impairment on a regular basis or whenever events or changes in circumstances suggest that the carrying amount of an asset may not be recoverable. Impairment is recognized when the carrying amount of an asset to be held and used exceeds the undiscounted projected future net cash flows expected from its use and disposal and is measured as the amount by which the carrying amount of the asset exceeds its fair value.

Alternative Fuel Systems (2004) Inc.

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m) Use of estimates

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The most significant estimates relate to valuation of inventory and assessment of net realizable value, determining the liability relating to product warranty costs, recoverability of the carrying values of property, plant and equipment and intangible assets, valuation of the settlement warrants and valuation of options to compute stock-based compensation expense. Actual results could differ materially from these estimates.

3. Changes in Accounting Policies

On January 1, 2007, the Company adopted the new CICA Handbook sections 3855 - Financial Instruments – Recognition and Measurement and 1530 – Comprehensive Income. 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 (loss). Financial assets available-for-sale are measured at fair value, with changes in those fair values recognized in other comprehensive income (loss). Financial assets held-to-maturity, loans and receivables and other financial liabilities are measured at amortized cost using the effective interest method of amortization.

The Company has implemented the following classifications:

- a) The Company's cash and short term investments 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.

- b) Accounts receivable are designated as loans and receivables. For the Company, the measured amount usually corresponds to cost due to their short-term maturity.

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c) Accounts payable and accrued liabilities and advances from customers are designated as other liabilities. For the Company, the fair value of the short term liabilities corresponds to cost as a result of their short-term maturity.

Section 1530 – Comprehensive Income introduces a new measurement of results – comprehensive income – which is a change in equity of an enterprise during a period from transactions from non-owner sources. On adoption of this standard, the Company recognized no accumulated other comprehensive income.

4. Future Accounting Changes

The CICA issued four new accounting standards, section 1535 “Capital Disclosures”, Section 3031 “Inventories”, section 3862 “Financial Instruments - Disclosures”, and section 3863 “Financial Instruments - Presentation”. These standards become effective for AFS in the first quarter of 2008.

Section 1535 requires disclosure of the company’s objectives, policies and processes for managing capital. This includes qualitative information regarding AFS’s objectives, policies and processes for managing capital and quantitative data about what AFS manages as capital. These disclosures are based on information that is provided internally by AFS’s key management.

Section 3031 provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to the net realizable value, and on the cost formulas that are used to assign costs to inventories. The adoption of these recommendations is not expected to have a material impact in the earnings or assets of the Company. These recommendations are effective for the Company beginning January 1, 2008.

Section 3862 and 3863 replace section 3861 “Financial Instruments – Disclosures and Presentation” which revises and enhances financial instruments disclosure requirements and leaves unchanged its presentation requirements. These new sections place increased emphasis on disclosures about the nature and extent of risks arising from financial instruments and how AFS manages those risks.

The Accounting Standards Board of the CICA (“AcSB”) has adopted a strategy to apply International Financial Reporting Standards (“IFRS”) to publicly accountable enterprises in the future. In May 2007, the AcSB published an updated version of its “Implementation Plan for Incorporating International Financial Reporting Standards into Canadian GAAP”. This plan includes an outline of the key decisions that the AcSB will need to make as it implements the Strategic Plan for publicly accountable enterprises. One step in the implementation plan is for the AcSB to conduct a Progress Review to determine if the changeover date to IFRS for fiscal years beginning on or after January 1, 2011 continues to be appropriate. The AcSB has

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commenced these activities and in July 2007 published its initial plan, "Progress Review - Steps to IFRS Incorporation into Canadian GAAP". The AcSB presented a final report in February 2008 confirming the transition date of January 1, 2011 that will require the Company to restate, for comparative purposes, amounts reported for the year ended December 31, 2010. The Company is still investigating the impact of the adoption of IFRS on the financial statements of the Company.

5. Property, plant and equipment

	2007		
	Cost	Accumulated depreciation	Net book value
Machinery and equipment	\$189,321	\$81,623	\$107,698
Computer hardware and software	102,259	61,806	40,453
Furniture, fixtures and office equipment	40,182	15,812	24,370
Vehicles	14,730	7,565	7,165
	\$346,492	\$166,806	\$179,686

	2006		
	Cost	Accumulated depreciation	Net book value
Machinery and equipment	\$179,583	\$56,058	\$123,525
Computer hardware and software	92,151	44,951	47,200
Furniture, fixtures and office equipment	40,182	10,849	29,333
Vehicles	14,730	5,773	8,957
	\$326,646	\$117,631	\$209,015

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6. Intangible assets

	2007		
	Cost	Accumulated depreciation	Net book value
Patents and trademarks	\$100,009	\$64,121	\$35,888
	2006		
	Cost	Accumulated depreciation	Net book value
Patents and trademarks	\$99,493	\$44,188	\$55,305

7. 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
Shares issued on exercise of warrants	75,000	19,050
Balance – December 31, 2006	16,940,080	2,442,621
Shares issued on exercise of stock options	42,000	4,200
Option value transferred to share capital upon exercise of options	-	3,360
Balance – December 31, 2007	16,982,080	\$2,450,181

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. The expiry date of the share purchase warrants associated with the 8 million units was extended an additional 12 months to April 15, 2007.

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As at December 31, 2007 none of the share purchase warrants were exercised and have expired on April 15, 2007. For accounting purposes, the Company has recorded the expiration of these share purchase warrants as a \$195,450 increase to contributed surplus.

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 Inc., formerly AFS (“AFS Energy”) and 2,954,847 settlement warrants of AFS (2004) were issued to these employees as part of the Plan of Arrangement (the “Plan”) after emerging from re-organization of debt and equity under the Canadian Companies Creditors Arrangement Act (“CCAA”) protection. All of the settlement warrants expired on July 27, 2007. For accounting purposes, the Company has recorded the expiration of these settlement warrants as a \$171,000 increase to contributed surplus.

c) Stock-based compensation

Under the stock option plan, the number of options granted at any time cannot exceed 10% of the issued and outstanding common shares on a non-diluted basis at time of granting. The options granted under the option plan shall not result at any time in:

- a) The number of common shares reserved for issuance pursuant to options granted to insiders exceeding 10% of the issued and outstanding common shares;
- b) The grant to insiders within a twelve-month period, of a number of options exceeding 10% of the outstanding common shares; or
- c) The grant to any one (1) optionee within a twelve-month period, of a number of options exceeding 5% of the issued and outstanding common shares.

The option period is determined by the Board of Directors and is not to exceed the maximum period permitted by the Exchange, which maximum period is five (5) years from the date the option is granted based on the Company being a Tier II issuer. Subject to Exchange Policies, the Board of Directors may, in its sole discretion, determine the timing during which an option shall vest and the method of vesting, or that no vesting restriction shall exist. Subject to Exchange Policies and any limitations imposed by any other regulatory authority having jurisdiction over the Company, the exercise price of an option granted under the Option Plan shall be as determined by the Board of Directors when such option is granted and shall be an amount at least equal to the allowable discounted market price of the common shares.

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Summary of the Company's stock-based compensation plan as at December 31, 2007 and 2006 and the changes for the years then ended, is presented below:

	2007		2006	
	Number of options	Weighted average exercise price	Number of options	Weighted average exercise price
Outstanding - beginning of year	1,020,000	\$0.12	732,500	\$0.34
Granted during the year	54,000	0.10	368,500	0.10
Exercised during the year	(42,000)	(0.10)	-	-
Forfeited during the year	(107,000)	(0.10)	(79,000)	(0.10)
Expired carry-over options	(500)	70.20	(2,000)	(70.20)
Outstanding - end of year	924,500	0.10	1,020,000	0.12
Options exercisable - end of year	751,900	\$0.10	591,800	\$0.13

As part of the June 30, 2004 Plan of Arrangement of AFS, AFS (2004) inherited 5,000 "Carry Over Options". The adjusted exercise price was \$70.20 per option. Half of these carry-over options expired during April 2005, 2,000 expired during 2006 and the remaining 500 expired January 2007.

As at December 31, 2007:

Exercise price	Options outstanding			Options exercisable		
	Options outstanding	Weighted average remaining term (in years)	Weighted average exercise price	Options exercisable	Weighted average exercise price	
\$0.10	265,500	2.00	\$0.10	265,500	\$0.10	
0.10	281,500	3.00	0.10	281,500	0.10	
0.10	323,500	4.00	0.10	194,100	0.10	
\$0.10	54,000	4.50	\$0.10	10,800	\$0.10	
	924,500	3.15	\$0.10	751,900	\$0.10	

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These options have a five year term, vest at 20% on the date of grant and 20% every six months thereafter (with full vesting after two years) and are each exercisable into one common share.

The Black-Scholes model was used to calculate the fair value of stock options granted. Significant assumptions used in this model were as follows:

	<u>2007</u>	<u>2006</u>
Valuation assumptions:		
Option term (years)	5	5
Expected volatility	100%	100%
Expected dividend yield	Nil	Nil
Risk-free interest rate	4.6%	3.9%
Calculated fair value of options granted	\$0.06	\$0.07

d) Contributed surplus

The balance of contributed surplus is comprised of the following:

Balance - December 31, 2005	\$36,394
Stock-based compensation expense for the year ended December 31, 2006	22,588
Warrants expired during 2006	<u>70,700</u>
Balance - December 31, 2006	129,682
Expiry of share purchase warrants April 15, 2007	195,450
Expiry of settlement warrants July 27, 2007	171,000
Benefit on options exercised charged to share capital	(3,360)
Stock-based compensation expense for the year ended December 31, 2007	<u>9,914</u>
Balance - December 31, 2007	<u>\$502,686</u>

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8. Change in non-cash working capital items

	<u>2007</u>	<u>2006</u>
Accounts receivable	\$41,306	\$36,986
Prepaid expenses and deposits	20,331	113,727
Inventory	(40,986)	(177,670)
Accounts payable and accrued liabilities	66,670	(66,115)
Advances from customers	(49,959)	(104,335)
Deferred revenue	(18,108)	6
	<u>\$19,254</u>	<u>\$(197,401)</u>

9. Income Taxes

a) Future income taxes

Future income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The components of the Company's future tax assets are as follows:

	<u>2007</u>	<u>2006</u>
Future income tax assets		
Non-capital losses	\$279,125	155,583
Capital assets	21,250	4,529
Warranty	10,540	16,507
Share issue costs	27,349	39,972
	<u>338,264</u>	<u>216,591</u>
Total future income tax assets	338,264	216,591
Less: valuation allowance	(\$338,264)	(\$216,591)
	<u>-</u>	<u>-</u>

A full valuation allowance has been recorded against the Company's net future tax asset until such time as it is more likely than not that the Company will realize its future tax assets. Realization of the future tax benefits is dependent upon many factors, including the Company's ability to generate taxable income in the future.

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b) Income tax rate reconciliation

	2007 \$	2006 \$
Loss for the year	582,411	100,393
Statutory income tax rate	32.12%	32.50%
Expected income tax recovery at statutory rate	187,070	32,628
Stock option compensation and other non-deductible items	(3,741)	(7,478)
Effect of change in tax rate and other	(61,382)	(37,761)
Income tax (recovery) expense not recognized	(121,947)	12,611
Income tax	-	-

As of December 31, 2007, the Company has non-capital loss carryforwards of approximately \$1,116,500 (2006-\$545,905) available to be applied against future taxable income. These losses expire as to \$248,541 in 2014, \$49,793 in 2015, \$247,571 in 2026 and \$570,595 in 2027.

10. 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 (including product and engineering revenue):

	2007	2006
Europe	\$837,547	\$1,627,078
India	388,885	77,632
U.S.A.	236,544	477,921
Asia	163,827	30,827
China	102,937	128,585
Mexico	40,978	65,643
Canada and other	11,569	15,960
Iran	9,054	36,612
	\$1,791,341	\$2,460,258

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

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b) Major customers

For the year ended December 31, 2007, two individual customers accounted for 44% and 22% of revenue respectively. For the year ended December 31, 2006 two individual customers accounted for 65% and 17% of revenue respectively.

As at December 31, 2007, one individual customer accounted for 79% of accounts receivable. As at December 31, 2006, one individual customer accounted for 30% of accounts receivable and an additional three individual customers accounted for 20% each of accounts receivable.

11. Commitments

- a) In November 2005, the Company entered into a license agreement effective July 1, 2006 to June 30, 2011. Under the terms of this license the Company is 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.

12. Credit and foreign exchange risk

Since substantially all of the Company's trade accounts receivable are denominated in Euros or U.S. dollars but operating expenses and payables are denominated primarily in Canadian dollars, there is exposure in the value of these receivables due to the fluctuating currency exchange rate. The Company currently purchases insurance for a significant portion of accounts receivable through the Export Development Company of Canada ("EDC").

13. Contingent liabilities

- a) Included in the package of assets and liabilities acquired from AFS Energy 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 Energy. The original funding amount was \$310,000, of which approximately \$114,000 had been repaid to June 30, 2004. The net amount remaining of \$200,000 is repayable by AFS (2004) 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%.

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During the year ended December 31, 2007, the Company repaid an additional \$14,299 (2006 - \$18,586) to the NRC in respect of this government funding bringing the total repayments to date to approximately \$170,127 (2006 - \$155,828).

- b) AFS (2004) 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 cost of sales. 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.

14. Comparative information

Certain prior year amounts have been reclassified to conform to the current year's presentation.