

# ALTERNATIVE FUEL SYSTEMS (2004) INC.

## Balance Sheets

(Unaudited)

(expressed in Canadian dollars)

	March 31 2008 \$	December 31 2007 \$
<b>Assets</b>		
<b>Current assets</b>		
Cash and short-term investments	782,341	964,941
Accounts receivable	319,462	229,060
Prepaid expenses and deposits	100,466	11,846
Inventory	733,676	705,597
	<b>1,935,945</b>	<b>1,911,444</b>
<b>Property, plant and equipment</b>	<b>171,519</b>	<b>179,686</b>
<b>Intangible assets</b>	<b>30,888</b>	<b>35,888</b>
	<b>2,138,352</b>	<b>2,127,018</b>
<b>Liabilities</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities	323,777	271,765
Advances from customers	31,479	58,369
	<b>355,256</b>	<b>330,134</b>
<b>Shareholders' Equity</b>		
Capital stock (note 5 (a))	2,453,006	2,450,181
Contributed surplus (note 5(c))	505,954	502,686
Deficit	(1,175,864)	(1,155,983)
	<b>1,783,096</b>	<b>1,796,884</b>
	<b>2,138,352</b>	<b>2,127,018</b>

### Commitments and contingencies (note 7 and 8)

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

Approved by the Board of Directors

"Darshan Kailly" Director

"David Checkel" Director

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

(expressed in Canadian dollars, except per share data)

	For the three months ended March 31	
	2008	2007
	\$	\$
<b>Product revenue</b>	575,109	404,679
<b>Cost of revenue</b>	297,441	237,458
<b>Gross margin</b>	277,668	167,221
<b>Engineering revenue</b>	2,879	10,031
<b>Interest and other income</b>	6,792	10,788
	<b>287,339</b>	<b>188,040</b>
<b>Expenses</b>		
Operating and administration		
Engineering and product development	141,541	134,826
Administrative and other	119,276	107,277
Sales and marketing	48,326	44,920
Foreign exchange (gain) loss	(25,947)	1,981
Amortization of property, plant & equipment	10,149	11,821
Amortization of intangible assets	5,000	4,979
Stock-based compensation	4,493	4,687
Repayment of research funding	4,382	3,110
	<b>307,220</b>	<b>313,601</b>
<b>Loss and comprehensive loss for the period</b>	<b>(19,881)</b>	<b>(125,561)</b>
<b>Deficit - beginning of period</b>	<b>(1,155,983)</b>	<b>(573,572)</b>
<b>Deficit - end of period</b>	<b>(1,175,864)</b>	<b>(699,133)</b>
<b>Basic and diluted loss per common share</b>	<b>(0.00)</b>	<b>(0.01)</b>

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

# ALTERNATIVE FUEL SYSTEMS (2004) INC.

## Statements of Cash Flows

(Unaudited)

(expressed in Canadian dollars)

	For the three months ended March 31	
	2008	2007
	\$	\$
<b>Cash provided by (used in)</b>		
<b>Operating activities</b>		
Loss for the period	(19,881)	(125,561)
Items not involving cash:		
Amortization	15,149	16,800
Stock-based compensation	4,493	4,687
	(239)	(104,074)
Change in non-cash working capital items	(181,979)	(96,778)
Cash flow from operations	(182,218)	(200,852)
<b>Investing activities</b>		
Purchase of property, plant and equipment	(1,982)	(6,054)
	(1,982)	(6,054)
<b>Financing activities</b>		
Proceeds from exercise of stock options	1,600	-
Decrease in cash & short-term investments	(182,600)	(206,906)
Cash & short-term investments - beginning of period	964,941	1,465,238
Cash & short-term investments - end of period	782,341	1,258,332

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

# **Alternative Fuel Systems (2004) Inc.**

## **Notes to Financial Statements**

### **Unaudited**

**For the three months ended March 31, 2008 and March 31, 2007**

(expressed in Canadian dollars)

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#### **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. Basis of presentation**

The interim financial statements have been prepared in accordance with Canadian generally accepted accounting principles. The interim financial statements have been prepared following the same accounting policies and methods of computation as the annual audited financial statements for the year ended December 31, 2007, except as noted below in Note 3. These interim financial statements do not contain all the disclosures required for annual statements. Accordingly, they should be read in conjunction with the annual audited financial statements and notes thereto for the year ended December 31, 2007.

These financial statements have not been reviewed by the Company’s auditors.

#### **3. New accounting policies and practices**

As disclosed in the December 31, 2007 annual audited financial statements, on January 1, 2008, the Company adopted the following CICA’s handbook sections:

“Capital Disclosures”, Section 1535 requires disclosure of the company’s objectives, policies and processes for managing its 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. See note 9.

“Inventories”, 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.

## Alternative Fuel Systems (2004) Inc.

### Notes to Financial Statements

#### Unaudited

For the three months ended March 31, 2008 and March 31, 2007

(expressed in Canadian dollars)

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There is no impact on our financial position or results of operations as a result of the adoption of this standard.

“Financial Instruments - Disclosures”, Section 3862 and “Financial Instruments - Presentation”, Section 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. See note 10.

#### 4. Recent accounting pronouncements

In January 2006, the CICA Accounting Standards Board (“AcSB”) adopted a strategic plan for the direction of accounting standards in Canada. As part of the plan, the AcSB confirmed in February 2008 that International Financial Reporting Standards (“IFRS”) will replace Canadian GAAP in 2011 for profit-orientated Canadian publicly accountable enterprises. As the Company will be required to report its results in accordance with IFRS starting in 2011, the Company is assessing the potential impacts of this transition and developing a plan accordingly.

#### 5. Capital stock

##### a) Authorized

Unlimited common voting shares without nominal or par value

##### Issued

	Number of shares	Amount
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
Shares issued on exercise of stock options	16,000	1,600
Option value transferred to share capital upon exercise of options	-	1,225
Balance – March 31, 2008	16,998,080	\$2,453,006

## Alternative Fuel Systems (2004) Inc.

### Notes to Financial Statements

#### Unaudited

For the three months ended March 31, 2008 and March 31, 2007

(expressed in Canadian dollars)

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#### b) Stock-based compensation

The company's stock option plan is described in Note 7 c) to the audited December 31, 2007 financial statements. From commencement of operations on June 30, 2004 to the current period ended March 31, 2008, the company has outstanding 966,500 stock options, of which 748,900 are exercisable.

During the quarter ended March 31, 2008, 16,000 stock options were exercised at an exercise price of \$0.10.

The Company recognized a \$4,493 expense for stock-based compensation in the statement of operations related to the options during the quarter ended March 31, 2008 (2007 - \$ 4,687).

#### c) Contributed surplus

The balance of contributed surplus is comprised of the following:

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	502,686
Benefit on options exercised charged to share capital	(1,225)
Stock-based compensation expense for the quarter ended March 31, 2008	<u>4,493</u>
Balance - March 31, 2008	<u>\$505,954</u>

#### 6. 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 months ended March 31, 2008 and March 31, 2007

(expressed in Canadian dollars)

#### a) Geographic information

Revenues by region (including product and engineering revenue):

	<b>Three months ended March 31, 2008</b>	<b>Three months ended March 31, 2007</b>
Europe	\$462,411	\$233,125
India	40,552	18,389
China	36,421	60,318
U.S.A.	20,540	80,431
Asia	14,870	19,209
Canada and other	3,194	2,844
	<u>\$577,988</u>	<u>\$414,710</u>

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

#### b) Major customers

For the quarter ended March 31, 2008, one individual customer accounted for 75% of revenue. For the quarter ended March 31, 2007 two individual customers accounted for 52% and 15% of revenue respectively.

As at March 31, 2008, one individual customer accounted for substantially all accounts receivable. As at March 31, 2007, two individual customers accounted for 58% and 28% of the accounts receivable respectively.

## 7. Commitments

Since the release of the annual audited financial statements, there has been no change in the existence, likelihood or amount of commitments of the company.

## 8. 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

## **Alternative Fuel Systems (2004) Inc.**

### **Notes to Financial Statements**

#### **Unaudited**

**For the three months ended March 31, 2008 and March 31, 2007**

(expressed in Canadian dollars)

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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%.

During the quarter ended March 31, 2008, the Company repaid an additional \$4,382 (2007 - \$3,110) to the NRC in respect of this government funding bringing the total repayments to date to approximately \$175,109 (balance at end of 2007 - \$170,127).

- 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.

#### **9. Capital management strategy**

The Company considers its capital structure to include only shareholder's equity. The Company had no debt or lines of credit. As at March 31, 2008, shareholder's equity totaled \$2,453,006.

#### **10. Financial instruments**

The Company considers its risk in relation to financial instruments in the following categories:

##### **Credit risk**

Credit risk is the risk that counterparty to a financial instrument will not discharge its obligations, resulting in a financial loss to the company. The company has policies and procedures in place that govern the credit risk it will assume. We evaluate credit risks on an ongoing basis including an evaluation of counterparty credit rating and counterparty concentrations measured by amount and percentage.

Our primary sources of credit risk for the company arise from the following financial assets: cash and short-term investments and accounts receivable. The Company has not had any material credit losses in the past and the risk of financial loss is considered to be low. As at March 31, 2008, the company has no financial assets that are impaired due to credit risk related defaults.

##### **Liquidity risk**

Liquidity risk is the risk that the Company will not be able to meet its obligations associated with financial liabilities. Our financial liabilities are primarily comprised of accounts payable and accrued liabilities. The Company frequently assesses its

## **Alternative Fuel Systems (2004) Inc.**

### **Notes to Financial Statements**

#### **Unaudited**

**For the three months ended March 31, 2008 and March 31, 2007**

(expressed in Canadian dollars)

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liquidity position and obligations under its financial liabilities. The Company mitigates liquidity risk by maintaining a sufficient cash balance as well as a sufficient current and projected liquidity cushion to meet expected future payments. Our financial liabilities arose primarily from the purchase of inventory to meet production demand.

#### **Market risk**

Market risk is the risk the fair value (for assets and liabilities considered to be held for trading and available for sale) or future cash flows (for assets and liabilities considered to be held-to-maturity, other financial liabilities and receivables) of a financial instrument will fluctuate because of changes in market prices. We evaluate market risk on an ongoing basis. We assess the impact of variability in identified market risks on our medium-term cash requirements. Late in 2007, we changed to Euros for billing to our largest European customer to mitigate the risk of significant changes in the US dollar to Canadian dollar exchange rate. Prior to this change, billing to this large customer was in US dollars.

The following sections describe these risks in relation to the company's key financial instruments:

a) **Cash and short-term investments**

The Company has cash deposits with Canadian banks and has money market investments. The Company's Treasury Policy requires that cash not required for short-term needs be invested in instruments issued and backed by a major Canadian chartered bank.

Maturity dates for investments are established to ensure cash availability for operating expenses as they come due. As at March 31, 2008, the amount in cash and short-term investments was \$782,341.

b) **Accounts receivable**

Our accounts receivable primarily consists of amounts due from our primary customers, as well as amounts due from Canada Revenue Agency in respect of GST. The Company's credit risk in regards to accounts receivable therefore relates primarily to the risk of default by our customers. The company has purchased insurance from the Export Development Corporation in the amount of \$150,000 to partially mitigate this credit risk.

c) **Accounts payable and accrued liabilities**

Accounts payable and accrued liabilities are comprised primarily of amounts payable for inventory purchased and for typical operating expenses. Payment terms on these amounts are typically 30 to 60 days from receipt of invoice but do

# **Alternative Fuel Systems (2004) Inc.**

## **Notes to Financial Statements**

### **Unaudited**

**For the three months ended March 31, 2008 and March 31, 2007**

(expressed in Canadian dollars)

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not bear interest. The Company has met all its obligations in respect of these liabilities.

#### **11. Related party transaction**

In the first quarter of 2008, the Company incurred fees of \$935 payable to a law firm in which a director of the Company is a partner.

#### **12. Comparative information**

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