



Management's Discussion and Analysis

May 27, 2008

This Management's Discussion and Analysis ("MD&A") for Alternative Fuel Systems (2004) Inc. ("AFS" or the "Company") should be read in conjunction with the audited financial statements & the accompanying MD&A for the year ended December 31, 2007 and the unaudited interim financial statements for the three months ended March 31, 2008 and the notes contained therein.

Operating results

Sales revenue

Sales for the first quarter were comprised of the following:

	Three months ended March 31	
	2008	2007
Pressure regulators	\$462,373	\$253,789
Engine management systems	39,804	82,059
Ignition systems and other parts	72,932	68,831
Subtotal product sales	575,109	404,679
Engineering services	2,879	10,031
Total	\$577,988	\$414,710

The increase in sales revenue of \$163,278 or 39% during the first quarter of 2008 versus the same period in 2007 was primarily due to the company's largest customer for natural gas pressure regulators resuming production of vehicles in Europe. In the first quarter of 2007, production was suspended for a period of time, due to issues unrelated to AFS. The decrease in sales of engine management systems in Q1-08 versus Q1-07 was due to sales to an American customer in the first quarter of 2007 not recurring in the first quarter of 2008. Additional orders for this customer are on the books for delivery later in the year. During the first quarter of 2008, AFS sent its first low volume shipments of engine controllers destined for TATA Motors. It is anticipated that these shipments should increase in size and frequency.

Summary financial information

\$ thousand, except per share amounts	2008	2007				2006		
	Q1	Q4	Q3	Q2	Q1	Q4	Q3	Q2
Gross revenue	584	523	378	513	425	531	773	544
Net (loss) income	(20)	(96)	(128)	(160)	(126)	(108)	74	(80)
Net (loss) income per share	(0.00)	(0.01)	(0.01)	(0.01)	(0.01)	(0.01)	0.01	(0.01)

Quarterly variations in gross revenue are primarily the result of fluctuations in sales of natural gas pressure regulators. In 2007, in both Q1 and Q3, the largest customer for these products suspended production of vehicles due to issues unrelated to AFS. In Q1 of 2008, production was resumed and sales returned to a more normal level.

Gross margin

Gross margin realized in the first quarter was \$277,688 (2007-\$167,221) or 48 % (2007-41%). The increase in gross margin in 2008 was mainly due to higher volumes of pressure regulators being sold.

Operating and administrative expenses

Operating and administrative expenses for the three months ended March 31, were comprised of the following:

	Three months ended March 31	
	2008	2007
Engineering & product development	\$141,541	\$134,826
Administrative & other	119,276	107,277
Sales & marketing	48,326	44,920
Total	\$309,143	\$287,023

Employee wages and benefits accounted for 73% or \$224,635 (2007 - 74% or \$214,889) of the total operating and administrative expenses recognized during the first quarter of 2008.

The increase in total operating and administrative expenses of \$22,120 in Q1 of 2008 was primarily due to a \$12,000 increase in administrative and other, a \$6,715 increase in engineering and product development and a \$3,406 increase in sales and marketing. In terms of percentage of total expenses, these increases are insignificant.

The Company currently has 12 full time employees, with consultants, distributors and agents in Europe, India, Iran and the U.S.

Compensation of Executive and Directors

The following table sets forth all compensation and awards paid by the Company to the executive officers for the quarters ended March 31:

Named Executive Officer	March 31	Salary (\$)	Bonus (\$)	Other Compensation (\$)
Jim F. Perry, President and Chief Executive Officer	2008	44,541	NIL	NIL
	2007	44,519	NIL	NIL
Joyce Berg, Chief Financial Officer ⁽¹⁾	2008	0	NIL	NIL
	2007	22,280	NIL	NIL

⁽¹⁾ The position of Chief Financial Officer was filled by Mr. Perry during the first quarter of 2008.

In addition to the above, the President and Chief Executive Officer and Chief Financial Officer participate in the Company's stock-based compensation plan:

Name	Shares acquired on exercise (#)	Aggregate value realized (\$)	Options at quarter end (#)		Value of In the Money options at quarter end ⁽²⁾ (\$)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Jim F. Perry	Nil	Nil	199,200	32,800	51,194	8,4291

⁽²⁾ Value is calculated based upon the difference between the exercise price of the options and the 10-day average closing price of the Common Shares on the Exchange of \$0.257 as at March 31, 2008.

⁽³⁾ All options granted to the former Chief Financial Officer were forfeited upon her departure from the Company in 2007.

The directors of the corporation receive a payment of \$350 per Board of Directors meeting attended, as well as reimbursement of expenses to attend the meeting. No other cash compensation is paid to the directors. During the quarter, no amounts were paid, as the meeting to review the 2007 results was held on April 22, 2008.

Net loss and cash flow

AFS reported a net loss for the quarter ended March 31, 2008 of \$(19,881) (\$0.00 per share on a basic and diluted basis). The net loss in the comparable quarter in 2007 was \$(125,561) (\$0.01 per share). Added to this net loss was an overall decrease in working capital in the first quarter of 2008 of \$(181,979) versus a decrease in working capital of \$(96,778) in the same quarter of 2007. The decrease in working capital in the first quarter was primarily due to a increase in accounts receivable of \$90,402, an increase in prepaid expenses and deposits of \$88,620, an increase in inventory of \$28,079 and a decrease in advances from customers of \$26,890. This is offset by an increase in accounts payable of \$52,012. These changes are discussed below.

Cash outflow from operations for the first quarter of 2008 was \$(182,218) versus a cash outflow of \$(206,906) in the first quarter of 2007. This is due to the same factors discussed above.

Accounts receivable

Accounts receivable has increased to \$319,462 as at March 31, 2008 compared to the December 31, 2007 balance of \$229,060. This increase of \$ 90,402 or 39% was primarily due to a 42% increase in sales to a major European customer in Q1 of 2008 compared to Q1 of 2007.

Prepaid expenses

Prepaid expenses increased to \$100,466 as at March 31, 2008 compared to the December 31, 2007 balance of \$11,846. The increase of \$88,620 is primarily due to annual expenses such as insurance that were prepaid in the first quarter of 2008. These expenses will be amortized over the next 3 quarters.

Inventory

Inventory has increased in the first quarter of 2008 to \$733,676 compared to the December 31, 2007 balance of \$705,597 a change of \$28,079 or 4%. This slight increase is primarily due to purchase of inventory related to production of electronic engine controllers for TATA Motors of India.

Accounts payable and accrued liabilities

The March 31, 2008 accounts payable balance increased to \$323,777 from \$271,765 at December 31, 2007. The increase of \$52,012 or 19% was attributed to increased purchases of inventory for both pressure regulators and engine control modules.

Advances from customers

Advances from customers have decreased to \$31,479 at March 31, 2008 from a balance of \$58,369 at December 31, 2007. The decrease of \$26,890 is due to customer deposits being applied to first quarter shipments. In order to mitigate the risk inherent in providing customized engineering and product development work, the Company generally requires a deposit on all new large orders before work commences.

Capital stock

The following common shares and stock options were outstanding as of May 27, 2008

	Number	\$
Common shares	16,998,080	\$2,453,006
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	Outstanding	Exercisable
Stock options	966,500	748,900
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Contractual obligations and contingent liabilities

During the first quarter ended March 31, 2008, there were no material changes in the contractual obligations or contingent liabilities as previously disclosed in the audited December 31, 2007 financial statements.

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.

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 March 31, 2008 there was a total decrease in cash of \$(182,218) from the December 31, 2007 balance. This is primarily due to a decrease in working capital of \$(181,979) as discussed above.

At March 31, 2008, our capital resources included total working capital of \$1,580,689. This is comprised of cash and short-term investments of \$782,341, \$733,676 of inventory, accounts receivable of \$319,462 and prepaid expenses of \$100,466 offset by accounts payable and accrued liabilities and advances from customers of \$355,256.

At present, the company has 748,900 vested options outstanding, exercisable at any time at an exercise price of \$0.10 per option. These options expire on various dates from 2009 through 2011. Should all of these options be exercised, it would result in gross proceeds of \$74,890 to the company.

Currently, the company has no outstanding debt and believes that it has the resources to meet operating requirements.

Critical accounting estimates

There are no changes to our critical accounting estimates in the three months ended March 31, 2008.

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:

- a) "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.

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.

- b) "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.

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

- c) "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.

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

Business Risks

Our risk factors are consistent with the Company's MD&A for the year ended December 31, 2007

Future business direction

AFS is concentrating on increasing its business with vehicle manufacturers, and is de-emphasizing the retrofit market where older diesel engines are being converted to run on natural gas. The vehicle manufacturers are customers that order large volumes of product

and who are generally reluctant to change suppliers once a relationship has been established. Although these customers can be very demanding and price conscious, in the opinion of AFS management, they offer the best opportunity for growth of AFS revenues. Forecasting sales from the vehicle manufacturers is always a challenge, since the CNG market is relatively small and not “main line” business for them. As a result, the manufacturers can change production forecasts at short notice depending on market demand and vehicle performance in the field. However, the significant regulatory changes being enacted in many countries in order to address pollution and greenhouse gas emissions are expected to lead to increased use of alternative fuels. These changes could lead to significantly higher volumes of natural gas fuelled vehicles being manufactured, and could provide increased business for the Company.

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.

Disclosure controls update

The company is required to comply with Multilateral Instrument 52-109 “Certification of Disclosure in Issuer’s Annual and Interim Filings”. This instrument requires that the Company disclose in the interim MD&A any changes in the Company’s internal control over financial reporting that occurred during the most recent interim period that has materially affected or is reasonably likely to materially affect, the Company’s internal control over financial reporting. The Company confirms that no such changes occurred during the three months ended March 31, 2008.

Forward-looking statements

Certain statements in this news release including (i) statements that may contain words such as "anticipate", "could", "expect", "seek", "may" "intend", "will", "believe", "should", "project", "forecast", "plan" and similar expressions, including the negatives thereof, (ii) statements that are based on current expectations and estimates about the markets in which the Company operates and (iii) statements of belief, intentions and expectations about developments, results and events that will or may occur in the future, constitute "forward-looking statements" and are based on certain assumptions and analysis made by the Company. Forward-looking statements in this news release include, but are not limited to, statements with respect to future business opportunities, nature and timing thereof; business strategy; expansion and growth of the Company’s business and operations and other such matters. Such forward-looking statements are subject to important risks and uncertainties, which are difficult to predict and that may affect the Company’s operations, including, but not limited to: the impact of general economic conditions; industry conditions; customer base changes; financial market conditions; government and regulatory

developments; oil and natural gas product supply, demand and pricing; foreign exchange rates; competition; and the Company's ability to attract and retain qualified personnel. The Company's actual results, performance or achievements could differ materially from those expressed in, or implied by, these forward-looking statements and, accordingly, no assurance can be given that any of the events anticipated by the forward-looking statements will transpire or occur, or if any of them do transpire or occur, what benefits or disadvantage the Company may derive therefrom. Subject to applicable law, the Company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

All forward-looking statements contained in this document are expressly qualified by this cautionary statement. Further information about the factors affecting forward-looking statements is available in the Company's current financial statements and associated documents, which are available on www.sedar.com