



ALTERNATIVE FUEL SYSTEMS (2004) INC.

Interim Financial Statements For the second quarter ended June 30, 2008

NOTICE OF NO AUDITOR REVIEW OF INTERIM FINANCIAL STATEMENTS

The accompanying unaudited interim financial statements of the Company have been prepared by and are the responsibility of the Company's management. The Company's independent auditor has not performed a review of these financial statements in accordance with standards established by the Canadian Institute of Chartered Accountants for review of interim financial statements by an entity's auditor.

ALTERNATIVE FUEL SYSTEMS (2004) INC.

Balance Sheets

(Unaudited)

(expressed in Canadian dollars)

	June 30 2008 \$	December 31 2007 \$
Assets		
Current assets		
Cash and short-term investments	922,800	964,941
Accounts receivable	404,310	229,060
Prepaid expenses and deposits	44,241	11,846
Inventory	726,168	705,597
	2,097,519	1,911,444
Property, plant and equipment	174,541	179,686
Intangible assets	27,423	35,888
	2,299,483	2,127,018
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	301,742	271,765
Advances from customers	173,939	58,369
	475,681	330,134
Shareholders' Equity		
Capital stock (note 5 (a))	2,453,006	2,450,181
Contributed surplus (note 5(c))	509,998	502,686
Deficit	(1,139,202)	(1,155,983)
	1,823,802	1,796,884
	2,299,483	2,127,018

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 Income (Loss), Comprehensive Income (Loss) and Deficit

(Unaudited)

(expressed in Canadian dollars, except per share data)

	For the three months ended		For the six months ended	
	June 30		June 30	
	2008	2007	2008	2007
	\$	\$	\$	\$
Product revenue	814,975	481,298	1,390,084	885,977
Cost of revenue	458,069	289,740	755,510	527,198
Gross margin	356,906	191,558	634,574	358,779
Engineering revenue	4,906	20,463	7,785	30,494
Interest and other income	7,804	11,624	14,596	22,412
	369,616	223,645	656,955	411,685
Expenses				
Operating and administration				
Engineering and product development	138,880	136,930	280,421	271,756
Administrative and other	121,201	140,236	240,477	251,647
Sales and marketing	44,941	43,251	93,267	88,171
Foreign exchange loss (gain)	2,194	36,626	(23,753)	34,473
Amortization of property, plant & equipment	10,486	12,451	20,635	24,272
Amortization of intangible assets	5,040	4,979	10,040	9,958
Stock-based compensation	4,044	5,481	8,537	10,168
Repayment of research funding	6,168	3,610	10,550	6,720
	332,954	383,564	640,174	697,165
Income (loss) and comprehensive income (loss) for the period	36,662	(159,919)	16,781	(285,480)
Deficit - beginning of period	(1,175,864)	(699,133)	(1,155,983)	(573,572)
Deficit - end of period	(1,139,202)	(859,052)	(1,139,202)	(859,052)
Basic and diluted income (loss) per common share	0.00	(0.01)	0.00	(0.02)

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 June 30		For the six months ended June 30	
	2008	2007	2008	2007
	\$	\$	\$	\$
Cash provided by (used in)				
Operating activities				
Income (loss) for the period	36,662	(159,919)	16,781	(285,480)
Items not involving cash:				
Amortization	15,526	17,430	30,675	34,230
Stock-based compensation	4,044	5,481	8,537	10,168
	56,232	(137,008)	55,993	(241,082)
Change in non-cash working capital items	99,310	(132,782)	(82,669)	36,004
Cash flow from operations	155,542	(4,226)	(26,676)	(205,078)
Investing activities				
Purchase of property, plant, equipment and intangible assets	(15,083)	(13,958)	(17,065)	(20,012)
Financing activities				
Proceeds from exercise of stock options	-	-	1,600	-
Increase (decrease) in cash and short-term investments	140,459	(18,184)	(42,141)	(225,090)
Cash and short-term investments - beginning of period	782,341	1,258,332	964,941	1,465,238
Cash and short-term investments - end of period	922,800	1,240,148	922,800	1,240,148

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

Alternative Fuel Systems (2004) Inc.

Notes to Financial Statements

Unaudited

For the six months ended June 30, 2008 and June 30, 2007

(expressed in Canadian dollars)

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.

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.

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

Alternative Fuel Systems (2004) Inc.

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(expressed in Canadian dollars)

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 – June 30, 2008	16,998,080	\$2,453,006

b) Stock-based compensation

The company’s stock option plan is described in Note 7c) to the audited December 31, 2007 financial statements. From commencement of operations on June 30, 2004 to the current period ended June 30, 2008, the company has outstanding 896,500 stock options, of which 738,900 are exercisable.

Alternative Fuel Systems (2004) Inc.

Notes to Financial Statements

Unaudited

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(expressed in Canadian dollars)

During the quarter ended June 30, 2008, no stock options were exercised.

The Company recognized a \$4,044 expense for stock-based compensation in the statement of operations related to the options during the quarter ended June 30, 2008 (2007 - \$ 5,481). The stock-based compensation expense for the six months ended June 30, 2007 was \$8,537 (2007 - \$10,168).

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	9,914
Balance - December 31, 2007	<u>502,686</u>
Benefit on options exercised charged to share capital	(1,225)
Stock-based compensation expense for the six months ended June 30, 2008	8,537
Balance - June 30, 2008	<u>\$509,998</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 six months ended June 30, 2008 and June 30, 2007

(expressed in Canadian dollars)

a) Geographic information

Revenues by region (including product and engineering revenue):

(\$ thousands)	For the three months ended June 30		For the six months ended June 30	
	2008	2007	2008	2007
Europe	\$517	\$386	\$979	\$618
India	128	68	169	86
China	22	-	58	-
U.S.A.	40	21	61	102
Asia	57	-	72	80
Canada and other	56	27	59	30
	\$820	\$502	\$1,398	\$916

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

b) Major customers

For the quarter ended June 30, 2008, two individual customers accounted for 60% and 15% of revenue respectively. For the quarter ended June 30, 2007 two individual customers accounted for 71% and 13% of revenue respectively.

As at June 30, 2008, one individual customer accounted for 70% of the accounts receivable. As at June 30, 2007, one individual customer accounted for 88% of the accounts receivable.

7. Commitments

AFS 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, 2008 to June 30, 2010 with monthly lease payments of \$6,283.

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 \$196,000 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

Alternative Fuel Systems (2004) Inc.

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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%.

During the quarter ended June 30, 2008, the Company repaid an additional \$6,168 (2007 - \$3,610) to the NRC in respect of this government funding bringing the total repayments to date to approximately \$181,277 (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's objectives when managing capital are to safeguard the Company's ability to continue as a going concern and maintain an optimal structure to reduce the cost of capital and to facilitate the growth strategy of the Company.

The Company monitors its capital management through analysis of near-term and mid-term cash flow expectations to ensure an adequate amount of liquidity and through the monthly review of financial results and business expectations. The Company considers the shareholders' equity to be the capital of the Company. As at June 30, 2008, shareholder's equity totaled \$2,453,006.

Based upon the dynamic nature of the technology markets that the Company engages in, and the low level of tangible assets required, the capital strategy is to carry a very low level of debt (including capital leases and notes payable). Although a formal debt to equity ratio has not been established by the Company, the ratio of debt to equity has not exceeded 10%.

Where considered appropriate by Management and/or the Board of Directors, the Company may incur and carry long-term debt from time to time as a result of expansion activities or cash flow expectations.

10. Financial instruments

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

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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 June 30, 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.

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(expressed in Canadian dollars)

Maturity dates for investments are established to ensure cash availability for operating expenses as they come due. As at June 30, 2008, the amount in cash and short-term investments was \$922,800.

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.

11. Related party transaction

In the second quarter of 2008, the Company incurred fees payable to a law firm in which a director of the Company is a partner. The total fees paid for the six months ended June 30, 2008 were not material.

12. Comparative information

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