



ALTERNATIVE FUEL SYSTEMS (2004) INC.

Interim Financial Statements For the third quarter ended September 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)

	September 30 2008 \$	December 31 2007 \$
Assets		
Current assets		
Cash and short-term investments	1,267,202	964,941
Accounts receivable	529,730	229,060
Prepaid expenses and deposits	22,111	11,846
Inventory	800,771	705,597
	2,619,814	1,911,444
Property, plant and equipment	185,302	179,686
Intangible assets	22,383	35,888
	2,827,499	2,127,018
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	375,153	271,765
Advances from customers	330,926	58,369
	706,079	330,134
Shareholders' Equity		
Capital stock (note 5 (a))	2,453,006	2,450,181
Contributed surplus (note 5(c))	530,350	502,686
Deficit	(861,936)	(1,155,983)
	2,121,420	1,796,884
	2,827,499	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 nine months	
	September 30		ended September 30	
	2008	2007	2008	2007
	\$	\$	\$	\$
Product revenue	1,128,536	378,417	2,518,620	1,264,394
Cost of revenue	602,760	239,785	1,358,270	766,983
Gross margin	525,776	138,632	1,160,350	497,411
Engineering revenue	116,110	17,821	123,895	48,315
Interest and other income	6,348	9,932	20,944	32,344
	648,234	166,385	1,305,189	578,070
Expenses				
Operating and administration				
Engineering and product development	138,267	127,599	418,688	399,355
Administrative and other	113,569	104,706	354,046	356,353
Sales and marketing	49,287	43,900	142,554	132,071
Foreign exchange loss	24,125	1,367	372	35,840
Amortization of property, plant & equipment	11,031	12,452	31,666	36,724
Amortization of intangible assets	5,040	4,987	15,080	14,945
Stock-based compensation	20,352	(4,695)	28,889	5,473
Repayment of research funding	9,297	3,965	19,847	10,685
	370,968	294,281	1,011,142	991,446
Income (loss) and comprehensive income (loss) for the period	277,266	(127,896)	294,047	(413,376)
Deficit - beginning of period	(1,139,202)	(859,052)	(1,155,983)	(573,572)
Deficit - end of period	(861,936)	(986,948)	(861,936)	(986,948)
Basic and diluted income (loss) per common share	0.02	(0.01)	0.02	(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		For the nine months ended	
	September 30		September 30	
	2008	2007	2008	2007
	\$	\$	\$	\$
Cash provided by (used in)				
Operating activities				
Income (loss) for the period	277,266	(127,896)	294,047	(413,376)
Items not involving cash:				
Amortization	16,071	17,439	46,746	51,669
Stock-based compensation	20,352	(4,695)	28,889	5,473
	313,689	(115,152)	369,682	(356,234)
Change in non-cash working capital items	52,505	(71,869)	(30,164)	(35,865)
Cash flow from operations	366,194	(187,021)	339,518	(392,099)
Investing activities				
Purchase of property, plant, equipment and intangible assets	(21,792)	(350)	(38,857)	(20,362)
Financing activities				
Proceeds from exercise of stock options	-	-	1,600	-
Increase (decrease) in cash and short-term investments	344,402	(187,371)	302,261	(412,461)
Cash and short-term investments - beginning of period	922,800	1,240,148	964,941	1,465,238
Cash and short-term investments - end of period	1,267,202	1,052,777	1,267,202	1,052,777

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

Alternative Fuel Systems (2004) Inc.

Notes to Financial Statements

Unaudited

For the nine months ended September 30, 2008 and September 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.

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 disclosure requirements and leaves unchanged its presentation requirements. These new sections place increased emphasis on disclosures about the nature and extent of

Alternative Fuel Systems (2004) Inc.

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Unaudited

For the nine months ended September 30, 2008 and September 30, 2007

(expressed in Canadian dollars)

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

The weighted average number of shares outstanding as at September 30, 2008 was 16,995,102.

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 September 30, 2008, the company has outstanding 1,318,500 stock options, of which 834,100 are exercisable.

Alternative Fuel Systems (2004) Inc.

Notes to Financial Statements

Unaudited

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(expressed in Canadian dollars)

During the quarter the Company issued 422,000 stock options to the employee group. 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 the stock options granted. Significant assumptions used in this model were as follows:

Valuation assumptions:

Option term	5 years
Expected volatility	100%
Expected dividend yield	NIL
Risk-free interest rate	2.89%
Calculated fair value of options granted	\$0.22

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

The Company recognized a \$20,352 expense for stock-based compensation in the statement of operations related to the options during the quarter ended September 30, 2008 (2007 - \$ (4,695)). The stock-based compensation expense for the nine months ended September 30, 2008 was \$28,889 (2007 - \$5,473).

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 nine months ended September 30, 2008	28,889
Balance - September 30, 2008	<u>\$530,350</u>

Alternative Fuel Systems (2004) Inc.

Notes to Financial Statements

Unaudited

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(expressed in Canadian dollars)

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:

a) Geographic information

Revenues by region (including product and engineering revenue):

(\$ thousands)	For the three months ended September 30		For the nine months ended September 30	
	2008	2007	2008	2007
Europe	639	152	1,618	770
India	261	101	430	187
China	31	14	89	14
U.S.A.	182	107	243	209
Asia	38	13	110	93
Canada and other	94	9	153	40
	1,245	396	2,643	1,313

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

b) Major customers

For the quarter ended September 30, 2008, two individual customers accounted for 51% and 21% of revenue respectively. For the quarter ended September 30, 2007 three individual customers accounted for 35%, 25% and 17% of revenue respectively.

As at September 30, 2008, one individual customer accounted for 79% of the accounts receivable. As at September 30, 2007, one individual customer accounted for 41% 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.

Alternative Fuel Systems (2004) Inc.

Notes to Financial Statements

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(expressed in Canadian dollars)

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 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 September 30, 2008, the Company repaid an additional \$9,298 (2007 - \$3,965) to the NRC in respect of this government funding bringing the total repayments to date to approximately \$189,974 (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 September 30, 2008, capital stock 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 no formal debt to equity ratio has been established by the Company, the ratio of debt to equity has not exceeded 10%.

Alternative Fuel Systems (2004) Inc.

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(expressed in Canadian dollars)

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:

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. When deemed appropriate, the company requires that deposits be provided in advance of any work or shipments.

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 September 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

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(expressed in Canadian dollars)

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 September 30, 2008, the amount in cash and short-term investments was \$1,267,202.

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

The Company did not incur any fees in the third quarter to a law firm in which a director of the Company is a partner. The total fees paid to that firm for the nine months ended September 30, 2008 were not material.

12. Comparative information

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