



Management's Discussion and Analysis

November 24, 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 nine months ended September 30, 2008 and the notes contained therein.

Operating Results

Sales revenue (\$ thousand, except % change)	Three months ended September 30			Nine months ended September 30		
	2008	2007	% Change	2008	2007	% Change
Pressure regulators	735	216	240%	1,763	873	102%
Engine management systems	278	42	562%	470	165	185%
Ignition systems and other parts	116	120	(3%)	286	227	26%
Subtotal product sales	1,129	378	199%	2,519	1,265	99%
Engineering services	116	18	544%	124	48	158%
Total	1,245	396	214%	2,643	1,313	101%
Gross margin percentage	47%	36%	30%	46%	39%	18%

The increase in pressure regulator sales revenue of 240% during the third quarter of 2008 versus the same period in 2007 was due to significant ramp up of sales in Europe, combined with sales to a new Canadian customer that is doing alternative fuel conversions in the northwestern USA. Engine management systems sales were dramatically increased as a US based customer, very active in the Southeast Asian market, placed large orders. Shipments to India, primarily for Tata Motors projects, were also increased during the quarter. Engineering services revenue was up significantly during Q3 of 2008 due to billing of development work primarily for customers in India.

The increase in sales revenue of 101% for the nine months ended September 30, 2008 versus the same nine months of 2007 was primarily due to the factors discussed above, combined with the effects of production slowdowns by the Company's largest European customer for pressure regulators, which were experienced in Q1 and Q3 of 2007.

Gross margins for the three-month period ended September 30, 2008 were improved as a result of higher volumes of product shipments, combined with changes in product mix toward items with higher margin. The same factors apply to the improvement in margins for the nine-month period of 2008 compared to the margins recorded for the same nine months of 2007.

Historical summary financial information

(\$ thousand, except per share amounts)	2008				2007			2006
	Q3	Q2	Q1	Q4	Q3	Q2	Q1	Q4
Gross revenue	1,251	828	584	523	378	513	425	531
Net income (loss)	277	37	(20)	(96)	(128)	(160)	(126)	(108)
Net income (loss) per share	0.02	0.00	(0.00)	(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 both Q1 and Q3 of 2007, the largest customer for natural gas pressure regulators, suspended production of vehicles due to issues unrelated to AFS. In 2008, sales of pressure regulators have increased each quarter as this customer has ramped up production.

Operating and administrative expenses	Three months ended September 30			Nine months ended September 30		
	2008	2007	% Change	2008	2007	% Change
Engineering & product development	138	128	7.8%	419	399	5.0%
Administrative & other	114	105	7.5%	354	356	0.6%
Sales & marketing	49	44	11.4%	143	132	8.3%
Total	301	277	8.7%	916	887	3.3%

Engineering and product development expenses were up slightly compared to the prior year as an additional technician has been added to staff during the quarter. Sales and marketing expenses increased primarily as a result of a marketing trip to India during the quarter.

For the three months ended September 30, 2008, employee wages and benefits accounted for 78% or \$235,666 (2007 - 69% or \$194,491) of the total operating and administrative expenses recognized. This 13% increase during Q3 of 2008 versus the same period of 2007 was primarily due to a net increase of 3 full time employees joining the company at various times during the third quarter of 2008. The increased staff was required to handle the growth in volume of both pressure regulator and engine controller sales. As well, the Company had 2 summer students employed during July and August to assist in meeting production demands.

For the nine months ended September 30, 2008, employee wages and benefits accounted for 74% or \$683,697 (2007 – 70% or \$621,071) of the total operating and administrative expenses recognized. The 6% increase during the first nine months of the year versus the same period of 2007 was primarily due to the same factors discussed above.

The Company currently has 16 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 nine months ended September 30:

Named Executive Officer	September 30	Salary (\$)	Bonus (\$)	Other Compensation (\$)
Jim F. Perry, President and Chief Executive Officer	2008	132,000	NIL	1,558
	2007	132,000	NIL	1,558
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 three quarters 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	232,800	85,200	36,297	3,909

⁽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. 267 at September 30, 2008.

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

During the quarter, no cash or other compensation was paid to the directors of the Company.

Financial Position

The following table outlines the changes in the balance sheet from December 31, 2007 to September 30, 2008:

	Change (\$)	Change (%)	Explanation
Cash and short-term investments	302,261	31%	See statements of cash flow.
Accounts receivable	300,670	131%	Increase due to an increase in operating activity levels in Q3 of 2008 versus Q4 of 2007. Approximately 79% of the accounts receivable related to one major customer, of which the balance is current.
Prepaid expenses and deposits	10,265	87%	Increase due to prepayment of annual expenses such as insurance at the beginning of Q1 which will be fully amortized by the end of the 4 th quarter.
Inventory	95,174	13%	Increase due to purchases to meet higher sales volumes and orders.
Property, plant and equipment	5,616	3%	Net increase due to purchases of production tooling equipment of \$37,282 offset by amortization of \$31,666.
Intangible assets	(13,505)	38%	Net decrease due to amortization of \$15,080 partially offset by purchases of \$1,575.
Accounts payable & accrued liabilities	103,388	38%	Increase primarily due to a \$101,595 increase in trade accounts payable as a result of increased operating activity levels in Q3 of 2008 versus Q4 of 2007.
Advances from customers	272,557	467%	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. 70% of these advances are from one customer.
Capital stock	\$2,825	.1%	Increase due to exercise, in Q1, of 16,000 employee stock options at \$0.10 per share, plus \$1,225. fair value of those options exercised charged to share capital.
Contributed surplus	\$27,664	6%	Change from December 31, 2007 due to impact of stock-based compensation expense of \$28,889 offset by fair value of stock options of \$1,225 exercised in Q1.
Deficit	\$294,047	25%	The decrease in the deficit is due to the impact of net income of \$294,047 for the nine months ended September 30, 2008.

Net income (loss) and cash flow

AFS reported net income for the quarter ended September 30, 2008 of \$277,266 (\$0.02 per share on a basic and diluted basis). The net loss in the comparable quarter in 2007 was \$(127,896) (\$0.01 per share). Added to net income was an overall increase in working capital in the third quarter of 2008 of \$52,505 versus a decrease in working capital of \$(71,869) in the same quarter of 2007. The increase in working capital in the third quarter was primarily due to a increase in accounts receivable of \$125,420, and an increase in inventory of \$74,603, offset by a decrease in prepaid expenses of \$22,130, an increase in accounts payable and accrued liabilities of \$73,411, and a increase in advances from customers of \$156,987.

Cash flow from operations for the third quarter of 2008 was \$366,194 versus a cash outflow of \$(187,021) in the third quarter of 2007. This is due to the same factors discussed above.

Capital stock

The following common shares and stock options were outstanding as of November 20, 2008:

	Number	\$
Common shares	16,998,080	\$2,453,006
	Outstanding	Exercisable
Stock options	1,318,500	834,100

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:

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

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).

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

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 September 30, 2010 with monthly lease payments of \$6,283.

Contingent liabilities

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 September 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 - \$3,695) 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).

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.

Related party transaction

The Company did not incur any fees during 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.

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 September 30, 2008 there was a total increase in cash of \$302,261 from the December 31, 2007 balance. This is primarily due to an increase in cash flow from operations of \$339,518 as discussed above.

At September 30, 2008, our capital resources included total working capital of \$1,913,735. This is comprised of cash and short-term investments of \$1,267,202, \$800,771 of inventory, accounts receivable of \$529,730 and prepaid expenses of \$22,111 offset by accounts payable and accrued liabilities of \$375,153 and advances from customers of \$330,926.

At present, the company has 834,100 vested options outstanding. 84,400 are exercisable at any time at an exercise price of \$0.25 per option and 749,700 are exercisable any time at an exercise price of \$0.10 per option. These options expire on various dates from 2009 through 2013. Should all of these options be exercised, it would result in gross proceeds of \$96,070 to the company.

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

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 September 30, 2008, shareholder's equity was \$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. 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 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.

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 Company is also striving increase the diversity of its customer base, since a large portion of sales revenue comes from only a few end users. 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. AFS competes with a number of large multinational companies for such business, and vehicle manufacturers can switch suppliers quickly and with little notice. 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. Initial assessment suggests that the conversion from Canadian GAAP to IFRS will have minimal impact on AFS.

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