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

**Management's Discussion and Analysis ("MD&A")**

**Operating results**

Below is Management's discussion and analysis of financial results for the years ended December 31, 2007 and December 31, 2006.

**Sales revenue – Q4 2007 and Q4 2006**
Summary of quarterly results (amounts in thousands of Canadian dollars):

| 2007 | Q1 | Q2 | Q3 | Q4 | Total |
|---|---|---|---|---|---|
| Pressure regulators | $254 | $402 | $216 | $174 | $1,046 |
| Engine management systems | 82 | 25 | 42 | 91 | 240 |
| Ignition systems & other parts | 69 | 54 | 120 | 153 | 396 |
| **Subtotal product sales** | **$405** | **$481** | **$378** | **$418** | **$1,682** |
| Engineering services | 10 | 20 | 18 | 61 | 109 |
| **Total** | **$415** | **$501** | **$396** | **$479** | **$1,791** |

| 2006 | Q1 | Q2 | Q3 | Q4 | Total |
|---|---|---|---|---|---|
| Pressure regulators | $386 | $384 | $600 | $323 | $1,693 |
| Engine management systems | 195 | 64 | 142 | 53 | 454 |
| Ignition systems & other parts | 33 | 62 | 16 | 137 | 248 |
| **Subtotal product sales** | **$614** | **$510** | **$758** | **$513** | **$2,395** |
| Engineering services | 37 | 21 | 4 | 4 | 66 |
| **Total** | **$651** | **$531** | **$762** | **$517** | **$2,461** |

Sales of pressure regulators were negatively impacted in the fourth quarter of 2007 compared to the same period of 2006 by a shutdown in production by the major European automaker that uses the AFS Falcon natural gas pressure regulator in some of its vehicles. The shutdown was caused by factors not involving AFS. In the fourth quarter of 2006, sales of these products were significantly higher, as the customer maintained full production except for the Christmas holidays. Subsequent to the end of 2007, production was again resumed, albeit at a low rate.

Sales of engine management systems in the fourth quarter of 2007 were about 72% higher than those recorded in the same period of 2006 due to a large order from a new customer in South Asia shipping during the period.

Ignition system and other parts sales in the fourth quarter of 2007 were approximately 12% higher than sales of the same products in Q4 of 2006. This increase was primarily the result of a sale to a customer in China, as well as ongoing sales to India.

Engineering services revenue in Q4 of 2007 was more than 15 times higher than the small amount recorded in the same period of 2006. This increase was the result of billing for engineering work, for projects in India, which commenced in the last half of 2007

Quarterly results for the prior 8 quarters (amounts in thousands of Canadian dollars):

| **2007** | **Q1** | **Q2** | **Q3** | **Q4** | **Total** |
|---|---|---|---|---|---|
| Gross revenue | 425 | 513 | 378 | 523 | 1,839 |
| Net (loss) | (126) | (160) | (128) | (168) | (582) |
| Net (loss) per share | (0.01) | (0.01) | (0.01) | (0.01) | (0.03) |

| **2006** | **Q1** | **Q2** | **Q3** | **Q4** | **Total** |
|---|---|---|---|---|---|
| Gross revenue | 663 | 544 | 773 | 531 | 2,511 |
| Net (loss) income | 14 | (80) | 74 | (108) | (100) |
| Net (loss) income per share | 0.01 | (0.01) | 0.01 | (0.01) | (0.01) |

## Year 2007 and Year 2006

**(amounts in narratives that follow are in Canadian dollars, rounded to the nearest thousand)**

Similar to results seen in the fourth quarter, sales of pressure regulators for the 2007 fiscal year were down about 39% compared to sales of the same product in 2006. The Company's largest pressure regulator end user, a vehicle manufacturer in Europe, experienced two shutdowns in production during the period. The first was in Q1, and the second spanned both Q3 and Q4. Both shutdowns were caused by factors unrelated to AFS.

Sales of engine management systems in 2007 were down by about 47% compared to the prior year. In 2006, the Company's biggest customer for such systems placed large orders to benefit from quantity price discounts. In 2007, their purchases were significantly reduced, as they worked through the inventory purchased in the prior year

Ignition system and parts sales in 2007 were up by about 60% compared to those recorded in 2006, primarily driven by a large order placed by a new customer from Southeast Asia late in the year. Engineering services revenue was up by 65% as described in the fourth quarter summary.

As was outlined in the revenue analysis above, the decrease in gross revenue of $672,000 between 2006 and 2007 was primarily due to a decrease of $647,000 in pressure regulator sales. This significant drop in revenue resulted in losses in all quarters of fiscal 2007. In addition, a write off of $94,000 in inventory was made in Q4, including parts originally purchased for resale to Mexico and other items which in the opinion of management, are no longer required in future production. In 2006, two quarters were profitable as pressure regulator sales combined with engine management system sales lifted revenue above the break-even point.

**Gross margin**

Gross margin realized in the year was $559,000 (2006-$1,094,000) or 33% (2006- 46%). Except for 2006, historical margins for the business have typically been in the range of 35% to 40%. In 2006, gross margins were significantly higher than this historic range reflecting the sale of inventory incorporating some parts with a zero cost base that were acquired from a predecessor company, Alternative Fuel Systems Inc. as part of the corporate reorganizations in 2004. This lost cost inventory has gradually been consumed in production and during 2007 new, higher cost inventory was purchased. Furthermore, as discussed above, the write off of obsolete inventory in the fourth quarter of 2007 decreased the overall margin for the year below what is typical. As a result, margins have decreased in 2007 compared to 2006.

**Operating and administrative expenses**

Operating and administrative expenses for the years ended December 31, 2007 and December 31, 2006 were comprised of the following:

Summary of quarterly results (amounts in thousands of Canadian dollars):

| **2007** | **Q1** | **Q2** | **Q3** | **Q4** | **Total** |
|---|---|---|---|---|---|
| Engineering & product development | $135 | $137 | $128 | $125 | $525 |
| Administrative & other* | 109 | 177 | 106 | 111 | 503 |
| Sales and marketing | 45 | 43 | 44 | 45 | 177 |
| **Total** | **$289** | **$357** | **$278** | **$281** | **$1,205** |

| **2006** | **Q1** | **Q2** | **Q3** | **Q4** | **Total** |
|---|---|---|---|---|---|
| Engineering & product development | $151 | $139 | $143 | $129 | $562 |
| Administrative & other* | 102 | 112 | 97 | 103 | 414 |
| Sales and marketing | 44 | 40 | 42 | 48 | 174 |
| **Total** | **$297** | **$291** | **$282** | **$280** | **$1,150** |

(*Includes foreign exchange)

Expenses in Q4 – 2007 were not materially different from expenses in the same quarter of 2006.

Year over year, the $89,000 increase in 2007 in administrative and other expenses over the same period is 2006 was primarily due to a $41,000 increase in foreign exchange loss due to the rapid strengthening of the Canadian dollar versus the US dollar. In order to limit exposure to the decreasing value of the US dollar, in the fall of 2007 AFS shifted to billing its European distributor in Euros, which is the currency for sales to the large vehicle manufacturer that is the end user of most AFS products sold into that market. Consulting fees also increased $49,000 in 2007 over 2006.

The $37,000 decrease in engineering and product development expenses in 2007 over the same period in 2006 was primarily due to decreased salaries and benefits expense of $26,000 from having one less engineer for approximately half the year.

Sales and marketing increased approximately $3,000 in 2007 versus 2006 primarily due to an increase in wages and benefits in 2007.

Employee wages and benefits accounted for 66% or $819,000 (2006 - 69% or $832,000) of the $1,205,000 ($1,150,000 - 2006) total operating and administrative expenses recognized during the year. The decrease in the current year of 7% or $13,000 (2006 - 1% or $33,000) was a result of having one less engineer for half of the year.

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

**Net loss and cash flow**

AFS reported a net loss for the year ended December 31, 2007 of $(582,000) ($0.03 per share on a basic and diluted basis). The net loss for the year ended December 31, 2006 was $(100,000) ($0.01 per share).

In 2007, the Company recorded an increase in working capital for the year of $ 20,000 compared to a decrease in working capital of $(197,000) in 2006. The increase in working capital during the year was primarily due to a decrease in advances from customers of $(50,000), a decrease in deferred revenue of $(18,000), a decrease in accounts receivable of $(41,000), and a decrease in prepaid expenses and deposits of $(20,000). This is offset by an increase in inventory of $41,000 and an increase in accounts payable and accrued liabilities of $67,000.

Cash outflow from operations for the year was $(484,000) versus a cash outflow of $(157,000) for the year ended December 31, 2006. This change is due to the factors discussed above.

**Annual information**

Summary of the last three year's annual information (in thousands of Canadian dollars, except per share data):

| | **2007** | **2006** | **2005** |
|---|---|---|---|
| Total revenue | $1,839 | $2,511 | $2,319 |
| Net loss | $(582) | $(100) | $(194) |

| | | | |
|---|---|---|---|
| Basic and diluted loss per share | (0.03) | (0.01) | (0.01) |
| Total assets | $2,127 | $2,697 | $2,930 |

The decrease in revenue in 2007 compared to the prior two years was due to the regulator customer production shutdowns previously discussed.

The increase in net loss over the last three years is also primarily a result of the regulator revenue decrease while engineering expenses remained at a high level for work on India projects.

The decrease of $(803,000) in total assets over the last three year is primarily due to a decrease in cash of approximately $(691,000), a $(134,000) decrease in prepaid expenses and deposits, a $(118,000) decrease in property, plant and equipment and intangible assets, and a $(78,000) decrease in accounts receivable offset by a $219,000 increase in inventory.

**Accounts receivable**
As at December 31, 2007 accounts receivable has decreased to $229,000 compared to the December 31, 2006 balance of $270,000. This decrease of $41,000 was primarily due to decreased sales in the fourth quarter of 2007 compared to 2006 as well as more timely account collection in 2007.

**Prepaid expenses**
As at December 31, 2007 prepaid expenses decreased to $12,000 compared to the December 31, 2006 balance of $32,000. The decrease of $20,000 was primarily due to a performance bond deposit of $19,000, which expired February 28, 2007, and was taken into income in that year.

**Inventory**
As at December 31, 2007 the inventory balance was $706,000 compared to the December 31, 2006 balance of $665,000. The inventory carried has increased throughout the year to accommodate a buildup for increased production of pressure regulators, as the Company's largest customer for this product line resumed production of natural gas fueled vehicles during the year. In addition, in the last quarter of 2007, inventory purchases were made in anticipation of commencement of production of engine management systems for TATA Motors of India in the first half of 2008. Finally, as previously mentioned, a write off of about $94,000 in inventory was taken in Q4 of 2007 to reflect items no longer required for production.

**Accounts payable and accrued liabilities**
As at December 31, 2007 the accounts payable and accrued liabilities balance increased to $272,000 from $205,000 at December 31, 2006. The increase of $67,000 was attributed to increased purchases of inventory for both pressure regulators and engine control modules.

**Advances from customers**
As at December 31, 2007 advances from customers have decreased to $58,000 from a balance of $108,000 at December 31, 2006. The decrease of $(50,000) is due to customer advances being applied to outstanding invoices and shipments. In order to mitigate the risk inherent in providing

customized engineering and product development work, the Company generally requires a deposit for new large orders before work commences.

**Capital stock**

a) **Authorized**
Unlimited common voting shares without nominal or par value

b) **Issued**
As At December 31, 2007, the Company had 16,982,080 (2006- 16,940,080) shares outstanding. The issued capital stock increased during the year by 42,000 shares due to the exercise of 42,000 stock options in the fourth quarter of 2007.

As of April 22, 2008, the number of shares outstanding is unchanged from the December 31, 2007 balance.

**Contractual obligations**

AFS leases 5,800 square feet of warehouse, shop and office space, which currently houses all of the company's operations. A new two-year lease was entered into effective July 1, 2006, with monthly lease payments of just less than $5,000 to June 30, 2008.

**Contingent liabilities**

For the year ended December 31, 2007, there were no material changes in the contingent liabilities of the company.

**Liquidity and capital resources**

For the twelve months ended December 31, 2007, there was a total decrease in cash of $(500,000) from the December 31, 2006 balance. Excluding non-cash transactions such as amortization and stock-based compensation expense of $79,000, this decrease was primarily due to the net loss from operations of $(582,000) and purchase of equipment of $(20,000), offset by a positive change in working capital of $19,000 and stock option exercise proceeds of $4,000. Although the Company's balance of cash and short term investments decreased in 2007, much of this change was due to expenses related to pursuit of new business opportunities such as those announced for TATA Motors of India. These expenses were a major factor in the net loss from operations. The end-2007 balance of about $965,000 in cash and short term investments is anticipated to provide sufficient resources for the company in the coming year.

**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.

**Significant accounting policies**

a) **Revenue recognition**

Revenues from the sale of electronic fuel management systems, natural gas pressure regulators and related components are recognized at the time these items are shipped. Other revenues are recognized at the time services are rendered.

b) **Inventory**

Inventory, which is primarily electronic fuel management systems, natural gas pressure regulators and related components, is valued at the lower of cost determined on a weighted average basis, and net realizable value.

c) **Property, plant and equipment**

Property, plant and equipment are recorded at cost, less accumulated amortization. The amortization expense and related accumulated amortization is computed by the declining balance method as follows:

| | |
|---|---|
| Machine and equipment | 20% per annum |
| Computer hardware and software | 33% per annum |
| Furniture, fixtures and office equipment | 20% per annum |
| Vehicles | 20% per annum |

d) **Intangible assets**

Research and development expenditures (with the exception of those which are capital in nature) are expensed as incurred unless a development project meets the criteria for deferral under Canadian generally accepted accounting principles. Patents and trademarks are amortized on a straight-line basis over five years.

e) **Product warranty cost**

The Company accrues product warranty costs relating to sales of fuel management systems, natural gas pressure regulators and related components. This warranty estimate, which is calculated as a percentage of sales, is adjusted periodically to reflect actual product return rates.

**Critical accounting estimates**

The preparation of financial statements in conformity with Canadian generally accepted accounting principles requires management to makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The most significant estimates relate to valuation of inventory and assessment of net realizable value, determining the liability relating to product warranty costs, recoverability of the carrying values of property, plant and equipment and intangible assets, valuation of the settlement warrants and valuation of options to compute stock-based compensation expense. Actual results could differ materially from these estimates.

**Changes in Accounting Policies**

On January 1, 2007, the Company adopted the new CICA Handbook sections 3855 - Financial Instruments – Recognition and Measurement and 1530 – Comprehensive Income. The financial instruments standard establishes the recognition and measurement criteria of financial assets, financial liabilities and derivatives. All financial instruments are required to be measured at fair value on initial recognition of the instrument, except for certain related party transactions. Measurement in subsequent periods depends on whether the financial instrument has been classified as held-for-trading, available-for-sale, held-to-maturity, loans and receivables, or other financial liabilities as defined by the standard.

Financial assets and financial liabilities held-for-trading are measured at fair value with changes in those fair values recognized in net earnings (loss). Financial assets available-for-sale are measured at fair value, with changes in those fair values recognized in other comprehensive income (loss). Financial assets held-to-maturity, loans and receivables and other financial liabilities are measured at amortized cost using the effective interest method of amortization.

The Company has implemented the following classifications:

a) The Company's cash and short term investments are designated as held-for-trading and are measured at carrying value, which approximates fair value due to the short-term nature of these instruments.

b) Accounts receivable are designated as loans and receivables. For the Company, the measured amount usually corresponds to cost due to their short-term maturity.

c) Accounts payable and accrued liabilities and advances from customers are designated as other liabilities. For the Company, the fair value of the short-term liabilities corresponds to cost as a result of their short-term maturity.

Section 1530 – Comprehensive Income introduces a new measurement of results – comprehensive income – which is a change in equity of an enterprise during a period from transactions from non-owner sources. On adoption of this standard, the Company recognized no accumulated other comprehensive income.

**Future Accounting Changes**

The CICA issued three new accounting standards, section 1535 "Capital Disclosures", section 3031 "Inventories", section 3862 "Financial Instruments - Disclosures", and section 3863 “Financial Instruments - Presentation”. These standards become effective for AFS in the first quarter of 2008.

Section 1535 requires disclosure of the company’s objectives, policies and processes for managing 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. 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. The adoption of these recommendations is not expected to have a material impact in the earnings or assets of the Company. These recommendations are effective for the Company beginning January 1, 2008.

Section 3862 and 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 Accounting Standards Board of the CICA (“AcSB”) has adopted a strategy to apply International Financial Reporting Standards (“IFRS”) to publicly accountable enterprises in the future. In May 2007, the AcSB published an updated version of its "Implementation Plan for Incorporating International Financial Reporting Standards into Canadian GAAP". This plan includes an outline of the key decisions that the AcSB will need to make as it implements the Strategic Plan for publicly accountable enterprises. One step in the implementation plan is for the AcSB to conduct a Progress Review to determine if the changeover date to IFRS for fiscal years beginning on or after January 1, 2011 continues to be appropriate. The AcSB has commenced these activities and in July 2007 published its initial plan, “Progress Review - Steps to IFRS Incorporation into Canadian GAAP”. The AcSB presented a final report in February 2008 confirming the transition date of January 1, 2011 that will require the Company to restate, for comparative purposes, amounts reported for the year ended December 31, 2010. The Company is still investigating the impact of the adoption of IFRS on the financial statements of the Company.

**Key Business Risks and Uncertainties**

a) Small Customer Base – AFS has a small number of customers, some of which are major contributors to the Company’s revenue stream. If one of these major customers were to cease to use AFS products, a significant impact on sales volume would occur.

b) Financial Resources – The Company has limited financial resources compared to those of its larger competitors, some of which are major multinational corporations. Although AFS has raised funds in the equity markets in times past, there is no guarantee that the Company will be able to access such markets in future if additional resources are required.

c) Foreign Exchange Rate Risk - Almost all of AFS's invoicing to customers is due and payable in Euros or US dollars. AFS is exposed to Euro to CDN and USD to Canadian dollar exchange rate risk. Fluctuations in foreign currency valuations may result in exchange losses or gains that would affect net income.

d) Major Competitors – AFS has a number of competitors that are much larger in size and have considerably more resources than the Company. Although AFS has been successful in gaining business through quality products and customer service, other players in the market may develop competing technologies.

e) Government Regulations – sales of AFS products in a number of jurisdictions such as India and other Southeast Asian markets are driven in part by local government regulations on vehicle emissions. If these regulations are changed so that vehicles no longer have to meet such emissions restrictions, a significant negative change in AFS sales might follow.

f) Fuel Pricing and Infrastructure – Growth in the Company's primary markets is dependent on a number of factors, including having a favorable price differential between conventional fuels and natural gas, and having sufficient fueling stations to make natural gas vehicles attractive to customers. There can be no assurance that either or both of these factors will continue to be present in any particular market.

g) Dependence Upon Key Personnel – AFS depends on its senior management and its technical staff. If the Company is unable to attract and retain key personnel, it may have a material adverse effect on the business.

**Forward-looking statements**

Certain statements in this document including (i) statements that my 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**