



Management's Discussion and Analysis

May 8, 2009

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, 2008 and the unaudited interim financial statements for the three months ended March 31, 2009 and the notes contained therein.

Operating results

(\$ thousand, except percentages)	Three months ended	
	March 31	
Sales revenue	2009	2008
Pressure regulators	\$557	\$462
Engine management systems	58	40
Ignition systems and other parts	38	73
Subtotal product sales	653	575
Engineering services	9	3
Total	\$662	\$578
Gross margin percentage	40%	48%

The increase in sales of pressure regulators in the first quarter of 2009 versus those recorded in the same period of 2008 was primarily due to a large shipment that was held over from December 2008 until January of 2009. The customer requested that these regulators not be sent mid-December, since they were concerned about shipment delays caused by the Christmas holidays. The decrease in gross margin percentage was primarily a result of pressure regulator parts cost increases combined with severance and other costs for seven production employees who were laid off in February and March. In the first quarter of 2008, some low cost pressure regulator parts that were purchased in bulk several years ago were being used in production. In the summer of 2008, these parts were exhausted and new parts were purchased thereafter, at a higher price.

Historical summary financial information:

(\$ thousand, except per share amounts)	2009	2008				2007		
	Q1	Q4	Q3	Q2	Q1	Q4	Q3	Q2
Gross revenue	666	1,253	1,251	828	584	523	378	513
Net (loss) income	(107)	200	277	37	(20)	(96)	(128)	(160)
Net (loss) income per share	(.01)	0.01	0.02	0.00	(0.00)	(0.01)	(0.01)	(0.01)

Quarterly variations in gross revenue are primarily the result of change in volumes of natural gas pressure regulator sales as well as variations in sales of engine management systems. Engine management systems are generally built and shipped in large runs in order to save on setup charges and freight costs. Depending on timing of such runs versus the end of fiscal quarters, significant revenue fluctuations may occur.

Operating and administrative expenses

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

(\$ thousand)	Three months ended March 31	
	2009	2008
Engineering & product development	\$150	\$142
Administrative & other	117	119
Sales & marketing	50	48
Total	\$317	\$309

Employee wages and benefits accounted for 75% or \$237,737 (2008 - 73% or \$224,635) of the total operating and administrative expenses recognized during the first quarter of 2009. The increase in total operating and administrative expenses of \$8,000 or 2.9 % in Q1 of 2009 over Q1 of 2008 was primarily due to a small increase in salaries issued in Q3 of 2008.

A major contributor to the loss incurred during the three months period ended March 31, 2009 was a foreign exchange loss of \$28,913. In the first quarter of 2008, a foreign exchange gain of \$25,947 was recorded. In addition, stock based compensation expense increased from \$4,493 in Q1 of 2008 to \$13,396 in the first quarter of 2009 as a result of stock option grants made to employees in September of 2008.

The Company currently has 10 full time employees with consultants, distributors and agents in Europe, Asia and India

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	2009	45,750	NIL	NIL
	2008	44,541	NIL	NIL

In addition to the above, the President and Chief Executive Officer participates 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⁽¹⁾ (\$)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Jim F. Perry	Nil	Nil	266,400	51,600	696	Nil

⁽¹⁾ 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 \$0.105 as at March 31, 2009.

The directors of the corporation receive a payment of \$350 per Board of Directors meeting attended in person, 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 2008 annual results was held in April 2009 and the review of Q1 2009 results was held in May 2009.

Financial Position

The following table outlines the changes in the balance sheet from December 31, 2008 to March 31, 2009:

	Change (\$)	Change (%)	Explanation
Cash and short-term investments	264,570	19%	See statements of cash flow.
Accounts receivable	(358,329)	(74%)	Decreased due to collection of significantly all balances outstanding as at December 31, 2008. Approximately 80% of the Q1 2009 accounts receivable balance related to one major customer, the balance of which was all current and substantially all collected subsequent to quarter end.
Prepaid expenses and deposits	(10,319)	(17%)	Decrease due entirely to the amortization of the prepaid balance during the quarter.
Inventory	(75,590)	(8%)	Decrease due to inventory being consumed in production, combined with decreased new purchases to match decreased production volumes.

Property, plant and equipment	5,875	3%	Net increase due to purchases of production tooling and shop equipment of \$16,689 offset by amortization of \$10,814.
Intangible assets	(5,115)	(28%)	Net decrease due solely to amortization of \$5,115.
Accounts payable & accrued liabilities	(247,085)	(53%)	Decrease due to the payment of Q4 2008 outstanding payables combined with fewer purchases to meet less production demand in Q1 of 2009 versus Q4 of 2008.
Advances from customers	162,096	58%	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. 75% of these advances were from one customer.
Capital stock	Nil	Nil	No change to report.
Contributed surplus	13,396	2%	Change from December 31, 2008 due solely to impact of stock-based compensation expense of \$13,396.
Deficit	107,315	16%	The increase in the deficit is due to the impact of the Q1 2009 net loss of (\$107,315).

Net loss and cash flow

AFS reported a net loss for the quarter ended March 31, 2009 of (\$107,315) (\$0.01) per share on a basic and diluted basis. The net loss in the comparable quarter in 2008 was (\$19,881) (\$0.00 per share). To offset this net loss, there was an overall increase in working capital in the first quarter of 2009 of \$ 359,249 versus a decrease in working capital of (\$181,979) in the same quarter of 2008. The increase in working capital in the first quarter was primarily due to a decrease in accounts receivable of (\$358,329), a decrease in prepaid expenses and deposits of (\$10,319), a decrease in inventory of (\$75,590) and a decrease in accounts payable and accrued liabilities of (\$247,085). These decreases were offset by an increase in advances from customers of \$162,096.

Cash flow from operations for the first quarter of 2009 was \$281,259 versus a cash outflow of \$(182,218) in the first quarter of 2008.

Capital stock

The following common shares and stock options were outstanding as of March 31, 2009:

	Number	\$
Common shares	16,998,080	\$2,453,006
	Outstanding	Exercisable
Stock options	1,312,500	1,050,900

Contingent liabilities

During the first quarter ended March 31, 2009, there were no material changes in the contractual obligations or contingent liabilities as previously disclosed in the audited December 31, 2008 financial statements.

Liquidity and capital resources

For the three months ended March 31, 2009, there was a total increase in cash of \$264,570 from the December 31, 2008 balance. Excluding non-cash transactions such as amortization and stock-based compensation expense of \$29,325, this increase was primarily due to an increase in working capital of \$359,249 offset by a net loss from operations of (\$107,315) and purchase of equipment of (\$16,689).

At March 31, 2009, the Company's capital resources included total working capital of \$2,026,160. This is comprised of cash and short-term investments of \$1,677,105, inventory of \$831,096, accounts receivable of \$124,387, and prepaid expenses of \$50,833 offset by accounts payable and accrued liabilities of \$215,311 and advances from customers of \$441,950.

The current business environment is very uncertain. Commodity price fluctuations, credit restrictions and capital market volatility have combined to make forecasting very difficult. As a result, the Company is focusing on controlling costs and preserving capital, while working with its customers to bring new projects into production. Currently, the Company has no outstanding debt and had a cash balance of more than \$1.6 million as at March 31, 2009. As part of the Company's management of liquidity and capital resources, discretionary spending and the cash burn rate are monitored to proactively manage the cash and working capital position of the Company. Management anticipates that this level of resources will be sufficient to allow the Company to continue to operate in the coming year.

Future business direction

As announced in a Press Release on January 23, 2009, AFS was informed by its European representative that the major vehicle manufacturer (the "OEM") that was purchasing the bulk of the Company's natural gas pressure regulators planned to discontinue the production of the vehicle that uses those products. The production halt has since occurred. As a result, a significant portion of the Company's revenue stream going forward will be affected. In 2008, pressure regulator sales to this OEM through AFS's European representative amounted to about fifty-five percent of the Company's revenue.

It is expected that this production halt will have material impact on the Company's revenues in the final nine months of 2009. AFS is concentrating on growing the engine management system side of its business to try and compensate for this anticipated decline in regulator sales. 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

volume to the vehicle manufacturers is always a challenge, since the Compressed Natural Gas market is relatively small and not “main line” business for them. As a result, the manufacturers can change production levels at short 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 opportunities for the Company.

It should be noted that the current business environment is very uncertain. Commodity price fluctuations, credit restrictions, capital market volatility and other factors outside the Company’s control have combined to make forecasting very difficult. It is not possible to determine what portion of the anticipated regulator sales decline might be offset by increased sales of other products in the coming year.

Critical accounting estimates

There are no changes to our critical accounting estimates in the three months ended March 31, 2009.

Business Risks

Our risk factors are consistent with the Company’s MD&A for the year ended December 31, 2008

New accounting policies

The CICA has issued the following new Handbook Section that was effective for the Company beginning January 1, 2009. Section 3064, “Goodwill and Intangible Assets,” deals with the accounting treatment of internally developed intangibles and the recognition of such assets. The adoption of this standard did not have a material effect on the Company’s financial statements.

Adoption of International Financial Reporting Standards

In 2006, the CICA Accounting Standards Board (AcSB) adopted a strategic plan for the direction of accounting standards in Canada. As part of that 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 the changeover 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, 2009.

Forward-looking statements

Certain statements in this MD&A including but not limited to (i) statements that may contain words such as "anticipate", "could", "expect", "seek", "may", "might", "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 MD&A specifically 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 as the case may be. Such forward-looking statements are subject to important risks, uncertainties and assumptions 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; market conditions in the countries where the Company operates; 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. Except as required by applicable securities laws, the Company undertakes no intention or obligation to update or revise any forward-looking statements.

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 other documents that the Company files from time to time with securities regulatory authorities. Copies of these documents are available without charge from the Company or electronically on the internet on the Company's SEDAR profile at www.sedar.com.

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