



Management's Discussion and Analysis

August 19, 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 six months ended June 30, 2009 and the notes contained therein.

Operating results

Sales revenue	Three months ended June 30			Six months ended June 30		
	2009	2008	Change	2009	2008	Change
(\$ thousand, except %)						
Pressure regulators	\$90	\$566	(\$476)	\$647	\$1,028	(\$381)
Engine management systems	266	152	114	325	192	133
Ignition systems and other parts	42	97	(55)	80	170	(90)
Subtotal product sales	398	815	(417)	1,052	1,390	(338)
Engineering services	259	5	254	268	8	260
Total	\$657	\$820	(\$163)	\$1,320	\$1,398	(\$78)
Gross margin on product sales	51%	44%	7%	44%	45%	(1%)

The major factor in the Company's recording a profit for the second quarter of 2009 was the significant increase in engineering services revenue. Many of the projects that generate such funds are long term in nature, and the revenue is not recorded until the project milestones are completed. In addition, an increase was also seen in the sales of engine management systems as vehicle production in India ramped up after the downturn in Q4 of 2008 and Q1 of 2009. Pressure regulator sales in the second quarter were much reduced compared to those recorded in the prior year, due to the previously announced cessation of production of the vehicle in Europe that used the Company's pressure regulators.

Gross margin on product sales improved during the quarter, as the mix of goods sold moved more toward higher margin system sales and away from pressure regulators, which generally bring a lower margin.

Historical summary financial information for the prior 8 quarters:

(\$ thousand, except per share amounts)	2009		2008				2007	
	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3
Gross revenue	659	666	1,253	1,251	828	584	523	378
Net income (loss)	149	(107)	200	277	37	(20)	(96)	(128)
Net income (loss) per share	0.01	(0.01)	0.01	0.02	0.00	(0.00)	(0.01)	(0.01)

The 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. In Q2 of 2009, pressure regulator sales were down significantly compared to those recorded in the same quarter of the prior year. Sales of engine management systems increased to somewhat offset this decline.

Operating and administrative expenses	Three months ended June 30			Six months ended June 30		
	2009	2008	Change	2009	2008	Change
(\$ thousand, except % change)						
Engineering & product development	\$144	\$139	\$5	\$294	\$280	\$14
Administrative & other	105	121	(16)	222	240	(18)
Sales & marketing	51	45	6	101	93	8
Total	\$300	\$305	(\$5)	\$617	\$613	4

For the three months ended June 30, 2009, employee wages and benefits accounted for 82% or \$245,249 (2008-73% or \$223,396) of the total operating and administrative expenses recognized. This slight increase was primarily due to small salary increases issued in the latter part of Q3 of 2008.

For the six months ended June 30, 2009, employee wages and benefits accounted for 80% or \$496,383 (2008-73% or \$448,030) of the total operating and administrative expenses recognized. This slight increase was primarily due to the same factors discussed above.

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

Other expenses

For the three months ended June 30, 2009, stock-based compensation expense was \$13,395 (2008 - \$4,044). For the six months ended June 30, 2009, stock based compensation expense was \$26,791 (2008 - \$8,537). Both these increases are directly attributable to the expense related to stock options granted to the employees in September 2008.

Compensation of Executive and Directors

The following table sets forth all compensation and awards paid by the Company to the executive officers for the six months ended June 30:

Named Executive Officer	June 30	Salary (\$)	Bonus (\$)	Other Compensation (\$)
Jim F. Perry, President and Chief Executive Officer	2009	91,500	NIL	NIL
	2008	89,082	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	14,384	-

⁽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 \$0.162 as at June 30, 2009.

The non-employee 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 second quarter, the four outside directors as a group were paid a total of \$1,400 to attend the year-end results review meeting.

Financial Position

The following table outlines the changes in the balance sheet from December 31, 2008 to June 30, 2009:

	Change (\$)	Change (%)	Explanation
Cash and short-term investments	122,987	8.7	See statements of cash flow.
Accounts receivable	(221,915)	(46.0)	Decreased due to collection of all balances outstanding as at December 31, 2008, offset by new receivables related to current revenue. Approximately 87% of the Q2 2009 accounts receivable balance related to one major customer, the balance of which was substantially all current.
Prepaid expenses and deposits	(25,638)	(41.9)	Decrease due to the monthly amortization of the prepaid balance.
Inventory	(100,122)	(11.0)	Decrease due to inventory being consumed in production, combined with decreased new purchases to match decreased regulator production volumes.
Property, plant and equipment	(6,544)	(3.4)	Net decrease due to purchases of production tooling and shop equipment of \$15,085 offset by amortization of \$21,628.
Intangible assets	(10,230)	(56.7)	Net decrease due to amortization of \$10,230.
Accounts payable & accrued liabilities	(270,272)	(58.5)	Decrease due to the payment of Q4 2008 outstanding payables combined with significantly fewer purchases for inventory to meet less production demand in Q2 of 2009 versus Q4 of 2008.
Advances from customers	(39,949)	(14.3)	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. In Q2, 85% of these advances were from one customer.
Capital stock	-	-	No change to report.
Contributed surplus	26,791	5.0	Change from December 31, 2008 due solely to impact of stock-based compensation expense of \$26,791.
Deficit	(41,968)	(6.3)	The decrease in the deficit is due to the impact of the Q2 2009 year to date net income of \$41,968.

Net income and cash flow

AFS reported net income for the quarter ended June 30, 2009 of \$149,283 or \$0.01 per share on a basic and diluted basis. The net income in the comparable quarter in 2008 was \$36,662 or \$0.00 per share. Offsetting this net income was an overall decrease in working capital in the second quarter of 2009 of (\$321,795) versus an increase in working capital of \$99,310 in the same quarter of 2008. The decrease in working capital in the second quarter of 2009 was primarily due to an increase in accounts receivable of \$136,414, a decrease in accounts payable of \$23,187, and a decrease in advances from customers of \$202,045. These were offset by a decrease in prepaid expenses and deposits of \$15,319 and a decrease in inventory of \$24,532.

Cash flow from operations for the second quarter of 2009 was (\$143,188) versus a cash flow of \$155,542 in the second quarter of 2008. Excluding non-cash items such as amortization and stock-based compensation expense, this change of (\$298,730) was due to the change in working capital during the three months of (\$421,105) offset by an \$112,621 increase in net income in the second quarter of 2009 versus the second quarter of 2008.

Capital stock

The following common shares and stock options were outstanding as of June 30, 2009:

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

Commitments and contingent liabilities

During the second quarter ended June 30, 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 June 30, 2009 there was a total decrease in cash of (\$141,583). Excluding non-cash transactions such as amortization of \$15,929 and stock-based compensation expense of \$13,395 this three month decrease was primarily due to income from operations of \$149,283 offset by a decrease in working capital of (\$321,795).

For the six months ended June 30, 2009 there was a total increase in cash of \$122,987 from the December 31, 2008 balance. Excluding non-cash transactions such as amortization of \$31,858 and stock-based compensation expense of \$26,791, this six month increase was primarily due to income from operations of \$41,968 and an increase in working capital of \$37,454, offset by purchases of equipment totaling \$15,084.

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, had a cash balance of more than \$1.5 million at the end of the quarter and as at June 30, 2009, the Company's capital resources included total working capital of \$2,206,372. 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 for at least the next twelve months.

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, sales of pressure regulators are down significantly compared to prior periods

AFS is concentrating on growing the engine management system side of its business to try and compensate for the decline in regulator sales. This growth has already been seen in the results for the second quarter of 2009. Much of the increase has been from customers in India, where the world economic downturn adversely affected car and truck sales in the last quarter of 2008 and the first quarter of 2009. However, it appears that sales in the light commercial vehicle market segment, where most AFS engine controllers are sold, have rebounded in the second quarter of 2009. If this pattern continues, growth in engine controller revenues could result.

Critical accounting estimates

There are no changes to our critical accounting estimates in the three months ended June 30, 2009.

Business Risks

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

Adoption of New Accounting Standards

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 June 30, 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 there from. 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.