



ALTERNATIVE FUEL SYSTEMS (2004) INC.

Interim Financial Statements

**For the quarter ended
September 30, 2009**

NOTICE OF NO AUDITOR REVIEW OF INTERIM FINANCIAL STATEMENTS

Under National Instruments 51-102, Part 4, subsection 4.3(3) (a), if an auditor has not performed a review of the interim financial statements they must be accompanied by a notice indicating that the financial statements have not been reviewed by an auditor. The accompanying unaudited interim financial statements of the Company have been prepared by and are the responsibility of the management of the company. The company's independent auditor has not performed a review of these financial statements in accordance with the standards established by the Canadian Institute of Chartered Accountants for a review of interim financial statements by an entity's auditor.

ALTERNATIVE FUEL SYSTEMS (2004) INC.

Balance Sheets

(Unaudited)

(expressed in Canadian dollars)

	September 30 2009 \$	December 31 2008 \$
Assets		
Current assets		
Cash and short-term investments	1,549,475	1,412,535
Accounts receivable	148,380	482,716
Prepaid expenses and deposits	30,409	61,152
Inventory	824,760	906,686
	2,553,024	2,863,089
Property, plant and equipment	172,891	190,169
Intangible assets	2,699	18,045
	2,728,614	3,071,303
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	224,658	462,396
Advances from customers	203,303	279,854
	427,961	742,250
Shareholders' Equity		
Capital stock (note 5 (a))	2,453,006	2,453,006
Contributed surplus (note 5(c))	577,495	537,714
Deficit	(729,848)	(661,667)
	2,300,653	2,329,053
	2,728,614	3,071,303

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

"Harvie Andre" Director

ALTERNATIVE FUEL SYSTEMS (2004) INC.

Statements of (Loss) Income, Comprehensive (Loss) Income and Deficit (Unaudited)

(expressed in Canadian dollars, except per share data)

	For the three months ended		For the nine months ended	
	September 30		September 30	
	2009	2008	2009	2008
	\$	\$	\$	\$
Product revenue	387,890	1,128,536	1,439,342	2,518,620
Cost of revenue	223,016	602,760	810,828	1,358,270
Gross margin	164,874	525,776	628,514	1,160,350
Engineering revenue	40,989	116,110	309,198	123,895
Interest and other income	631	6,348	5,509	20,944
	206,494	648,234	943,221	1,305,189
Expenses				
Operating and administration				
Engineering and product development	144,078	138,267	437,726	418,688
Administrative and other	94,530	113,569	316,486	354,046
Sales and marketing	46,321	49,287	147,809	142,554
Foreign exchange (gain) loss	(343)	24,125	8,706	372
Amortization of property, plant & equipment	10,734	11,031	32,362	31,666
Amortization of intangible assets	5,116	5,040	15,346	15,080
Stock-based compensation	12,990	20,352	39,781	28,889
Repayment of research funding	3,217	9,297	13,186	19,847
	316,643	370,968	1,011,402	1,011,142
(Loss) income and comprehensive (loss) income for the period	(110,149)	277,266	(68,181)	294,047
Deficit - beginning of period	(619,699)	(1,139,202)	(661,667)	(1,155,983)
Deficit - end of period	(729,848)	(861,936)	(729,848)	(861,936)
Basic and diluted income per common share	0.00	0.02	0.00	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	
	2009	2008	2009	2008
	\$	\$	\$	\$
Cash provided by (used in)				
Operating activities				
(Loss) income for the period	(110,149)	277,266	(68,181)	294,047
Items not involving cash:				
Amortization	15,850	16,071	47,708	46,746
Stock-based compensation	12,990	20,352	39,781	28,889
	(81,309)	313,689	19,308	369,682
Change in non-cash working capital items	95,262	52,505	132,716	(30,164)
Cash flow from operations	13,953	366,194	152,024	339,518
Investing activities				
Purchase of equipment and intangible assets	-	(21,792)	(15,084)	(38,857)
Financing activities				
Proceeds from exercise of stock options	-	-	-	1,600
Increase in cash and short-term investments	13,953	344,402	136,940	302,261
Cash and short-term investments - beginning of period	1,535,522	922,800	1,412,535	964,941
Cash and short-term investments - end of period	1,549,475	1,267,202	1,549,475	1,267,202

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, 2009 and September 30, 2008

(expressed in Canadian dollars)

1. Nature of operations

Alternative Fuel Systems (2004) Inc. (“AFS” or the “Company”) was incorporated on October 19, 2000 under the original name of “H2 Fuel Inc.” The 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, 2008. 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, 2008

3. Adoption of New Accounting Standards

The CICA has issued the following new Handbook Section that became effective for the Company 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 financial statements of the Company.

4. 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.

Alternative Fuel Systems (2004) Inc.

Notes to Financial Statements

Unaudited

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(expressed in Canadian dollars)

5. Capital stock

a) Authorized

Unlimited common voting shares without nominal or par value

	Number of shares	Amount
Balance – September 30, 2009 and December 31, 2008	16,998,080	\$2,453,006

b) Stock-based compensation

The Company's stock option plan is described in Note 7 b) to the audited December 31, 2008 financial statements. From commencement of operations on September 30, 2004 to the current period ended September 30, 2009, the Company has outstanding 1,312,500 stock options, of which 1,145,300 are exercisable.

During the quarter ended September 30, 2009, no stock options were exercised.

The Company recognized a \$12,990 expense for stock-based compensation in the statement of operations related to the options during the quarter ended September 30, 2009 (2008 - \$ 20,352).

c) Contributed surplus

The balance of contributed surplus is comprised of the following:

Balance - December 31, 2007	\$502,686
Benefit on options exercised charged to share capital	(1,225)
Stock-based compensation expense for the year ended December 31, 2007	<u>36,253</u>
Balance - December 31, 2008	537,714
Stock-based compensation expense for the nine months ended September 30, 2009	<u>39,781</u>
Balance – September 30, 2009	<u>\$577,495</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	
	2009	2008	2009	2008
Europe	53	639	671	1,618
India	311	261	765	430
China	1	31	13	89
U.S.A.	43	182	244	243
Asia	21	38	47	110
Canada and other	0	94	9	153
	429	1,245	1,749	2,643

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

b) Major customers

For the quarter ended September 30, 2009, two individual customers accounted for 72% and 10% of the revenue. For the quarter ended September 30, 2008 two individual customers accounted for 51% and 21% of revenue respectively.

As at September 30, 2009, one individual customer accounted for approximately 82% of the accounts receivable. As at September 30, 2008, one individual customer accounted for 79% of the accounts receivable.

7. Commitments

Since the release of the annual audited financial statements, there has been no change in the existence, likelihood or amount of commitments of the Company.

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

Alternative Fuel Systems (2004) Inc.

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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. During the quarter ended September 30, 2009, the Company repaid an additional \$3,217 (2008 - \$9,297) to the NRC in respect of this government funding bringing the total repayments to date to approximately \$212,422 (balance at end of 2008 - \$199,236).

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%.

- 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 adequate amount of liquidity and through the monthly review of financial results and business expectations. The Company considers the shareholder's equity to be the capital of the Company. As at September 30, 2009, the Company's 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%.

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.

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(expressed in Canadian dollars)

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. The Company evaluates 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. The Company's objective is to have no credit losses.

The 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, 2009, 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. 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. Financial liabilities arose primarily from the purchase of inventory to meet production demand. As at September 30, 2009, the Company has met all of the obligations associated with its financial liabilities.

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. The Company evaluates market risk on an ongoing basis and assesses the impact of variability in identified market risks on our medium-term cash requirements. Late in 2007, the Company 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.

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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. Our cash balances are currently invested in money market instruments with major Canadian banks in the form of term deposits. As at September 30, 2009, the amount in cash and short-term deposits was \$1,549,475. The Company does not expect any investment losses based on these investments.

b) Accounts receivable

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. Therefore, the Company estimates the risk of credit loss as low.

As at September 30, 2009, one individual customer accounted for approximately 82% of the accounts receivable.

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. Liquidity and capital resources

For the nine months ended September 30, 2009 there was a total increase in cash of \$136,940 from the December 31, 2008 balance. Excluding non-cash transactions such as amortization of \$47,708 and stock-based compensation expense of \$39,781, this increase was primarily due to an increase in working capital of \$132,716 offset

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by purchases of equipment totaling (\$15,084) and a loss from operations of (\$68,181).

The current business environment is very uncertain. Commodity price fluctuations, credit restrictions and capital market volatility have combined to make forecasting a challenge. 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, had a cash balance of more than \$1.5 million at the end of the quarter and as at September 30, 2009, the Company's capital resources included total working capital of about \$2.1 million. 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 grow the business without having to finance or incur debt.