



Management's Discussion and Analysis

May 05, 2010

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, 2009 and the unaudited interim financial statements for the three months ended March 31, 2010 and the notes contained therein.

Operating results

(\$ thousand, except percentages)	Three months ended	
	March 31	
	2010	2009
Sales revenue		
Engine management systems	\$298	\$59
Pressure regulators	94	557
Fuel injectors	74	25
Ignition systems and other parts	21	13
Subtotal product sales	487	654
Engineering services	48	9
Total	\$535	\$663
Gross margin percentage	41%	40%

Engine management system sales in the first quarter of 2010 were up by five times compared to sales of the same product in Q1 of 2009. These sales reflect the Company's objective of concentrating on the growth of revenue from products supplied to vehicle manufacturers. As vehicle sales are increasing in India as the effects of last year's recession fade, AFS is seeing significant growth in the quantity of engine management systems being sold. In addition, sales of fuel injectors almost tripled in the first quarter of 2010 compared to the corresponding period in 2009. Since fuel injector sales have become a material portion of the Company's business, revenue from this product line has been disclosed separately. This increase is also a result of increased sales in India, as well as sales to an American customer doing vehicle conversions to CNG. The decrease in sales of natural gas pressure regulators in the first three months of 2010 versus sales recorded last year in the same period is due to the previously disclosed halt in production in Europe of the vehicle that used AFS products. The halt occurred early in 2009. Gross margin percentage in Q1 of 2010 was slightly improved over that of the same period last year, as engine management systems generally have a better margin than other products sold by AFS.

Historical summary financial information

(\$ thousand, except per share amounts)	2010	2009				2008		
	Q1	Q4	Q3	Q2	Q1	Q4	Q3	Q2
Gross revenue	541	666	429	659	663	1,253	1,251	828
Net (loss) income	(67)	(107)	(110)	149	(107)	200	277	37
Net (loss) income per share	(0.00)	(0.01)	(0.00)	0.01	(0.01)	0.01	0.02	0.00

The above quarterly revenue results show the effects of the significant sales of natural gas pressure regulators in the third and fourth quarters of 2008, compared to the third and fourth quarters of 2009 and the first quarter of 2010, where regulator sales were much lower.

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	
	2010	2009
Engineering & product development	\$153	\$150
Administrative & other	91	117
Sales & marketing	50	50
Total	\$294	\$317

Employee wages and benefits accounted for 84% or \$248,018 (2009 - 75% or \$237,737) of the total operating and administrative expenses recognized during the first quarter of 2010. The decrease in total operating and administrative of \$23,000 or 7.3 % in Q1 of 2010 over Q1 of 2009 was primarily due to a decrease in consulting fees in Q1 of 2010 of \$14,849, and an approximate \$4,000 decrease in travel expense.

The Company currently has 11 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 three months ended March 31:

Named Executive Officer ⁽¹⁾	March 31	Salary (\$)	Bonus (\$)	Other Compensation (\$)
Jim Perry, President and Chief Executive Officer	2010	45,750	NIL	⁽²⁾
	2009	45,750	NIL	⁽²⁾

- (1) The position of Chief Financial Officer was filled by Mr. Perry during 2010 and 2009.
(2) The value of perquisites and other personal benefits did not exceed the lesser of \$50,000 or 10% of the total annual salary and bonuses of the named Executive Officer.

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 year end (#)		Value of In the Money options at year end (3) (\$)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
J. Perry	-	-	230,800	17,200	17,010	-

(3) 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 \$0.211 at March 31, 2010.

The non-employee directors of the Company 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 these non-employee directors. During the quarter, no amounts were paid, as the meeting to review the 2009 annual results was held in April 2010 and the review of Q1 2010 results was held in May 2010.

Financial Position

The following table outlines the changes in the balance sheet from December 31, 2009 to March 31, 2010. In particular, it should be noted that the significant increase in inventory in the first quarter of 2010 is due to purchases of long lead-time components needed to fulfill anticipated orders later in the year. For engine management systems, a number of electronic components are being quoted as having extended lead times. In addition, there are a number of fuel injector parts that go through multiple processes at different vendors so that considerable time is involved in completing these components.

	Change (\$)	Change (%)	Explanation
Cash and short-term investments	(212,716)	(13%)	See statements of cash flow.
Accounts receivable	47,678	62%	Increase primarily due to increase in GST receivable, corresponding to increase in inventory purchases below.
Prepaid expenses and deposits	16,597	55%	Increase due to the set up of the annual prepaids at the beginning of the quarter, offset by amortization during the quarter.
Inventory	326,225	49%	Increase relates primarily to inventory purchases for electronics and injectors to meet anticipated orders.
Property, plant and equipment	(1,901)	1%	Net decrease due to purchases of production tooling of \$6,975, offset by amortization of \$8,876.
Intangible assets	(115)	7%	Net decrease due solely to quarterly amortization of \$115.
Accounts payable & accrued	199,377	136%	Increase primarily due to the purchase of inventory

liabilities			above.
Advances from customers	30,829	27%	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. Three customers represented 65%, 18% and 16% of these advances respectively.
Capital stock	-	-	No change to report.
Contributed surplus	12,990	2.2%	Change from December 31, 2009 due solely to impact of stock-based compensation expense of \$12,990.
Deficit	(67,428)	9.5%	The increase in the deficit is due to the impact of the Q1 2010 net loss of (\$67,428).

Net loss and cash flow

AFS reported a net loss for the quarter ended March 31, 2010 of (\$67,428) (\$0.00) per share on a basic and diluted basis. The net loss in the comparable quarter in 2009 was (\$107,315) (\$0.01) per share. In addition to this net loss, there was an overall decrease in working capital in the first quarter of 2010 of \$(160,294) versus an increase in working capital of \$359,249 in the same quarter of 2009. The decrease in working capital in the first quarter of 2010 was primarily due to: an increase in inventory of \$326,225, an increase in accounts receivable of \$47,678, an increase in prepaid expenses and deposits of \$16,597, offset by an increase in accounts payable and accrued liabilities of \$199,377 and an increase in advances from customers of \$30,829.

Cash outflow from operations for the first quarter of 2010 was (\$205,741) versus a cash inflow of \$281,259 in the first quarter of 2009. Excluding the change in non-cash items such as amortization and stock-based compensation expense of \$7,344, this change of (\$487,000) was due to the change in working capital during the three months of (\$519,543), offset by a \$39,887 decrease in net loss in the first quarter of 2010 over the first quarter of 2009.

Capital stock

The following common shares and stock options were outstanding as of March 31, 2010:

	Number	\$
Common shares	17,486,580	2,512,301
	Outstanding	Exercisable
Stock options	824,000	740,400

Commitments and contingent liabilities

AFS has renewed its lease for 5,800 square feet of warehouse, shop and office space, which currently house all of its operations. The lease is for a two-year period from July 1, 2010 to June 30, 2012 with monthly lease payments of \$5,800.

Liquidity and capital resources

For the three months ended March 31, 2010, there was a total decrease in cash of (\$212,716) from the December 31, 2009 balance. Excluding non-cash transactions such as amortization and stock-based compensation expense of \$21,981, this decrease was primarily due to an decrease in working capital of (\$160,294) combined with a net loss from operations of (\$67,428) and purchase of equipment of (\$6,975).

At March 31, 2010, the Company's capital resources included total working capital of \$2,162,622. This is comprised of cash and short-term investments of \$1,483,399, inventory of \$998,680, accounts receivable of \$124,371, and prepaid expenses of \$46,813 offset by accounts payable and accrued liabilities of \$345,777 and advances from customers of \$144,865.

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 \$1.4 million as at March 31, 2010. 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 without having to finance or incur debt.

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 occurred shortly thereafter. 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 third and fourth quarters of 2009, and in Q1 of 2010. Although vehicle sales in India declined dramatically during the economic downturn in late 2008 and early 2009, sales in the light commercial vehicle market segment, where most AFS engine controllers are sold, rebounded in the third and fourth quarters of 2009, and reached new highs in the first quarter of 2010. If this pattern continues, growth in engine controller revenues should result.

Critical accounting estimates

There are no changes to our critical accounting estimates in the three months ended March 31, 2010.

Business Risks

Our risk factors are consistent with the Company's MD&A for the year ended December 31, 2009.

Adoption of International Financial Reporting Standards

In February 2008, the Canadian Accounting Standards Board ("AcSB") confirmed that International Financial Reporting Standards ("IFRS") will replace Canadian GAAP in 2011 for profit-oriented Canadian publicly accountable enterprises. AFS will transition to IFRS effective January 1, 2011 and intends to issue its first interim financial statements using these standards for the period ending March 31, 2011. The Company has developed a project plan for the transition to IFRS which includes the following three phases:

Diagnostic phase, which includes the identification of significant differences between IFRS and Canadian GAAP at a high level as relevant to the Company;

Detailed assessment and design phase which includes the identification, evaluation and selection of accounting policies necessary for the Company to transition to IFRS: the assessment of IFRS 1, *First-Time Adoption of IFRS*, elections; the identification of any business impacts resulting from the identified accounting differences; and training analysis and information systems analysis.

Implementation phase, which includes implementing all of the required changes necessary for IFRS compliance.

Diagnostic Phase

During the fourth quarter of 2009, the Company completed its initial diagnostic phase to identify differences between IFRS and Canadian GAAP. This diagnostic indicated that the areas of accounting difference of the highest potential impact to the Company include property, plant and equipment, impairment of assets, the requirements of IFRS 1 dealing with first time adoption choices and presentations and disclosures. There are other areas of IFRS that will impact the Company but to a lesser extent.

Under IFRS 1, the Company will have the option to value the property, plant and equipment assets at their deemed cost, that being the Canadian GAAP net book value assigned to these assets at the date of transition, providing that all assets are tested for impairment on adoption. AFS expects that it will use this option.

Detailed Assessment and Design Phase

The Company has begun the second phase, which is expected to be completed by the end of the second quarter of 2010. The Company is currently analyzing accounting policy alternatives for the areas of greatest potential impact to the Company's financial statements. At this time the Company does not anticipate that the transition to IFRS will have a significant impact on its information systems or internal controls.

The Company also intends to conduct a detailed review of the net book values assigned to property, plant and equipment and test for any impairment. Any necessary componentization will also be identified during this review. It is expected that this detailed review will have little impact to the Company, other than presentation and disclosure.

Implementation Phase

The Company anticipates the implementation phase will be conducted during the fourth quarter of 2010.

The Company is monitoring the IASB's active projects and any changes to IFRS prior to January 1, 2011 will be addressed as required. At this time, the impact of the transition to IFRS on the Company's financial statements cannot be reasonably determined.

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**](http://www.sedar.com).

For further information please contact Jim Perry, President and CEO Phone: (403) 516-6632
E-mail jperry@afsglobal.com.

Visit our website at: www.afsglobal.com