



Management's Discussion and Analysis

August 12, 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 six months ended June 30, 2010 and the notes contained therein.

Operating Results

Sales revenue	Three months ended June 30			Six months ended June 30		
	2010	2009	Change	2010	2009	Change
(\$ thousand, except %)						
Engine management systems	\$527	\$266	\$261	\$825	\$325	\$500
Pressure regulators	147	90	57	241	647	(406)
Ignition systems and other parts	15	21	(6)	36	44	(8)
Fuel injectors	126	21	105	200	35	165
Subtotal product sales	815	398	417	1,302	1,051	251
Engineering services	9	259	(250)	57	268	(211)
Total	\$824	\$657	\$167	\$1,359	\$1,319	\$40
Gross margin on product sales	40%	51%	(11%)	40%	44%	(4%)

Engine management system sales in the second quarter of 2010 were double the sales of the same product in Q1 of 2009. Vehicle manufacturers in India have continued to grow their sales of compressed natural gas ("CNG") fuelled light commercial vehicles. That market segment is where AFS engine controllers are used. Sales of AFS fuel injectors were more than five times higher than in the second quarter of 2009, as customers in both India and the USA increased their purchases. Revenue from sales of natural gas pressure regulators increased in the three month period ended June 30, 2010 compared to the same quarter of 2009, primarily due to growth in sales to a customer based in the USA that is converting city delivery trucks, school buses and other vehicles to run on CNG. Margin on product sales during the quarter was lower than in the same quarter of 2009, primarily due to the increase in the Canadian dollar versus US dollar and Euro exchange rate. Engineering services revenue during the second quarter of 2010 was significantly lower than recorded in the same period of 2009. Engineering revenue is generally recognized when project milestones are reached.

In the second quarter of 2009, several large projects reached milestones, while in the second quarter of 2010, the number of large projects was lower and timing was such that no major milestones occurred during the period.

The decrease of (\$406) in sales of natural gas pressure regulators in the first six months of 2010 versus the same period last year is due to the previously disclosed 2009 halt in production in Europe of a vehicle that used AFS products.

Historical summary financial information:

(\$ thousand, except per share amounts)	2010		2009				2008	
	Q2	Q1	Q4	Q3	Q2	Q1	Q4	Q3
Gross revenue	827	541	666	429	659	663	1,253	1,251
Net income (loss)	30	(67)	21	(110)	149	(107)	200	277
Net income (loss) per share	0.00	(0.00)	0.00	(0.00)	0.01	(0.01)	0.01	0.02

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 two quarters of 2010, where regulator sales were much lower due to the previously announced cessation of production of a European vehicle that used AFS pressure regulators.

Operating and administrative expenses

Operating and administrative expenses for the three and six months ended June 30, 2010, were comprised of the following:

Operating and administrative expenses (\$ thousand, except % change)	Three months ended June 30			Six months ended June 30		
	2010	2009	Change	2010	2009	Change
Engineering & product development	\$144	\$144	-	\$297	\$294	\$3
Administrative & other	81	105	(24)	172	222	(50)
Sales & marketing	48	51	(3)	97	101	(4)
Total	\$273	\$300	(\$27)	\$566	\$617	(\$51)

For the three months ended June 30, 2010, employee wages and benefits accounted for 88% or \$240,563 (2009 - 82% or \$245,249) of the total operating and administrative expenses recognized. For the six months ended June 30, 2010, employee wages and benefits accounted for 86% or \$488,581 (2009 – 80% or \$496,383) of the total operating and administrative expenses recognized.

The Company currently has 11 full time employees with consultants, distributors and agents in Europe, Asia and India.

The decrease in total operating and administrative expense of (\$27,000) or 9.0 % in Q2 of 2010 over Q2 of 2009 was primarily due to a decrease in consulting fees in 2010 of (\$14,849), a (\$4,000) decrease in travel expense, and a small decrease in insurance.

The decrease in total operating and administrative expense of (\$51,000) or 8.2% for the six months ended June 30, 2010 was primarily due to a decrease in consulting fees of (\$21,554), a decrease in travel expense of (\$10,031), and a decrease in insurance expense of (\$6,587).

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 ⁽¹⁾	June 30	Salary (\$)	Bonus (\$)	Other Compensation (\$)
Jim Perry, President and Chief Executive Officer	2010	91,500	NIL	(2)
	2009	91,500	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 quarter end (#)		Value of In the Money options at quarter end (3) (\$)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
J. Perry	-	-	230,800	17,200	\$15,390	-

(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 \$0.193 at June 30, 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 expense to attend the meeting. No other cash compensation is paid to these non-employee directors. During the second quarter of 2010, the four non-employee directors as a group were paid a total of \$1,400 to attend the 2009 year-end results meeting.

Financial Position

The following table outlines the changes in the balance sheet from December 31, 2009 to June 30, 2010:

	Change (\$)	Change (%)	Explanation
Cash and short-term investments	(274,026)	(16.1)	See statements of cash flow.
Accounts receivable	845	1.1	Insignificant change.
Prepaid expenses and deposits	14,156	46.8	Increase primarily due to \$12,831 deposit for custom parts ordered.
Inventory	305,471	45.4	Inventory of electronics and fuel injector parts has increased since December 31, 2009 to meet anticipated future demand.
Property, plant and equipment	(10,777)	(6.4)	Net decrease due to purchase of production tooling of \$6,975 offset by YTD amortization of \$17,752.
Intangible assets	(229)	(14.2)	Net decrease due solely to YTD amortization of \$229.
Accounts payable & accrued liabilities	50,926	34.7	Increase due to increase purchases of inventory in Q2 to meet anticipated future demand
Advances from customers	(4,096)	(3.5)	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. 86% of these advances were from one customer.
Capital stock	-	-	No change to report.
Contributed surplus	25,980	4.4	Increase from December 31, 2009 due solely to impact of YTD stock-based compensation expense of \$25,980.
Deficit	37,370	5.2	The increase in the deficit is due to the impact of the YTD 2010 net loss of (\$37,370).

Net income(loss) and cash flow

AFS reported net income for the quarter ended June 30, 2010 of \$30,058 or \$0.00 per share on a basic and diluted basis. The net income in the comparable quarter in 2009 was \$149,283 or \$0.01 per share on a basic and diluted basis. Offsetting this net income was an overall decrease in working capital in the second quarter of 2010 of (\$113,348) compared with a decrease in working capital of (\$321,795) in the same quarter of 2009. The decrease in working capital in the second quarter of 2010 was primarily due to a decrease in accounts receivable of (\$46,833), a decrease in prepaid expenses and deposits of (\$2,441), and a decrease in inventory of (\$20,754). These were offset by a decrease in accounts payable and accrued liabilities of (\$148,451) and a decrease in advances from customers of (\$34,925).

Cash outflow from operations for the second quarter of 2010 was (\$61,310) compared to a cash outflow of (\$143,188) in the second quarter of 2009. Excluding the change in non-cash items such as amortization and stock-based compensation expense of (\$7,344), this change of (\$81,878) was due to the change in working capital during the three months of (\$208,447),

offset by a \$119,225 decrease in net income in the second quarter of 2010 over the second quarter of 2009.

Capital stock

The following common shares and stock options were outstanding as of June 30, 2010:

	Number	\$
Common shares	17,486,580	2,512,301

	Outstanding	Exercisable
Stock options	824,000	740,400

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 six months ended June 30, 2010, there was a total decrease in cash of \$274,026 from the December 31, 2009 balance. Excluding non-cash transactions such as amortization and stock-based compensation expense of \$43,961, this decrease was primarily due to an decrease in working capital of (\$273,642) combined with net loss from operations of (\$37,370) and purchase of equipment of (\$6,975).

At June 30, 2010, the Company's capital resources included total working capital of \$2,214,659. This is comprised of cash and short-term investments of \$1,422,089, inventory of \$977,926, accounts receivable of \$77,538, and prepaid expenses and deposits of \$44,372 offset by accounts payable and accrued liabilities of \$197,326 and advances from customers of \$109,940.

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 June 30, 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

AFS continues to concentrate on growing the engine management system side of its business, primarily with sales to vehicle manufacturers that are producing CNG light commercial vehicles. This strategy has already shown good results, with significant growth in revenue

from such products recorded over the past twelve months. The Company is concentrating its sales efforts on customers in India that are considering introduction of vehicle models that will use natural gas as a fuel. The sales cycle for such projects is long. Twelve to twenty-four months may pass between the initial engineering work for a CNG vehicle and its start of production. AFS tries to become involved in this work at the earliest possible stage in order to maximize the chance that the Company's products will be selected. In addition, AFS is working with customers in other areas of the world where diesel engine trucks and buses are being converted to use CNG. While the number of vehicles being converted is generally much lower than is seen in serial production by a vehicle manufacturer, sales revenue per vehicle can be higher due to additional products required, such as fuel injectors and pressure regulators.

Critical accounting estimates

There are no changes to our critical accounting estimates in the six months ended June 30, 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, accounting for stock-based compensation, 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 third 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 is now conducting a detailed review of the net book values assigned to property, plant and equipment and will test for 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 on 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", "trend", "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.

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