



ALTERNATIVE FUEL SYSTEMS (2004) INC.

Financial Statements

For the quarter ended
September 30, 2010

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)

	September 30 2010 \$	December 31 2009 \$
Assets		
Current assets		
Cash and short-term investments	1,562,532	1,696,115
Accounts receivable	134,707	76,693
Prepaid expenses and deposits	18,377	30,216
Inventory	962,986	672,455
	2,678,602	2,475,479
Property, plant and equipment	161,586	166,930
Intangible assets	1,262	1,606
	2,841,450	2,644,015
Liabilities		
Current liabilities		
Accounts payable and accrued liabilities	316,732	146,400
Advances from customers	104,608	114,036
	421,340	260,436
Shareholders' Equity		
Capital stock (note 3 (a))	2,512,301	2,512,301
Contributed surplus (note 3(c))	619,010	580,040
Deficit	(711,201)	(708,762)
	2,420,110	2,383,579
	2,841,450	2,644,015

Commitments and contingencies (note 5 and 6)

The accompanying notes form an integral part of these financial statements.

Approved by the Board of Directors

"Darshan Kailly" Director

"David Checkel" Director

ALTERNATIVE FUEL SYSTEMS (2004) INC.

Statements of Income (Loss) Comprehensive Income (Loss) 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	
	2010	2009	2010	2009
	\$	\$	\$	\$
Product revenue	798,289	387,890	2,100,571	1,439,342
Cost of revenue	482,771	223,016	1,259,336	810,828
Gross margin	315,518	164,874	841,235	628,514
Engineering revenue	27,875	40,989	85,069	309,198
Interest and other income	4,998	631	12,817	5,509
	348,391	206,494	939,121	943,221
Expenses				
Operating and administration				
Engineering and product development	142,934	144,078	439,668	437,726
Administrative and other	89,650	94,530	277,042	316,486
Sales and marketing	61,303	46,321	158,646	147,809
Amortization of property, plant & equipment	9,433	10,734	27,185	32,362
Amortization of intangible assets	115	5,116	344	15,346
Stock-based compensation (note 3(b))	12,990	12,990	38,970	39,781
Foreign exchange (gain) loss	(9,161)	(343)	(16,687)	8,706
Repayment of research funding (note 6)	6,196	3,217	16,392	13,186
	313,460	316,643	941,560	1,011,402
Income (loss) and comprehensive income (loss) for the period	34,931	(110,149)	(2,439)	(68,181)
Deficit - beginning of period	(746,132)	(619,699)	(708,762)	(661,667)
Deficit - end of period	(711,201)	(729,848)	(711,201)	(729,848)
Basic and diluted income per common share	0.00	(0.00)	(0.00)	(0.00)

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	
	2010	2009	2010	2009
	\$	\$	\$	\$
Cash provided by (used in):				
Operating activities				
Income (loss) for the period	34,931	(110,149)	(2,440)	(68,181)
Items not involving cash:				
Amortization	9,548	15,850	27,529	47,708
Stock-based compensation	12,990	12,990	38,970	39,781
	57,469	(81,309)	64,059	19,308
Change in non-cash working capital items	97,840	95,262	(175,802)	132,716
Cash flow from operations	155,309	13,953	(111,743)	152,024
Investing activity				
Purchase of property, plant & equipment & intangible assets	(14,866)	-	(21,840)	(15,084)
Increase(decrease) in cash and short-term investments	140,443	13,953	(133,583)	136,940
Cash and short-term investments - beginning of period	1,422,089	1,535,522	1,696,115	1,412,535
Cash and short-term investments - end of period	1,562,532	1,549,475	1,562,532	1,549,475

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, 2010 and September 30, 2009

(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, 2009. 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, 2009.

3. Capital stock

a) Authorized

Unlimited common voting shares without nominal or par value

	Number of shares	Amount
Balance – December 31, 2009 and September 30, 2010	17,486,580	\$2,512,301

b) Stock-based compensation

The Company’s stock option plan is described in Note 6 b) to the audited December 31, 2009 financial statements. From commencement of operations on March 31, 2004 to the current period ended September 30, 2010, the Company has outstanding 824,000 stock options, all of which are vested and exercisable.

During the quarter ended September 30, 2010, 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, 2010 (2009 - \$12,990).

c) Contributed surplus

The balance of contributed surplus is comprised of the following:

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Balance - December 31, 2008	\$537,714
Benefit on options exercised charged to share capital	(10,445)
Stock-based compensation expense for the year ended December 31, 2009	52,771
Balance - December 31, 2009	580,040
Stock-based compensation expense for the nine months ended September 30, 2010	38,970
Balance – September 30, 2010	\$619,010

4. 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. Company 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	
	2010	2009	2010	2009
India	539	311	1,446	765
U.S.A.	53	43	327	244
Europe	219	53	334	671
Asia	0	21	28	47
China	11	1	32	13
Canada and other	4	0	19	9
	826	429	2,186	1,749

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

b) Major customers

For the three months ended September 30, 2010, two individual customers accounted for 65% and 26% of the revenue respectively. For the three months ended September 30, 2009 two individual customers accounted for 72% and 10% of revenue respectively.

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Unaudited

For the nine months ended September 30, 2010 and September 30, 2009

(expressed in Canadian dollars)

For the nine months ended September 30, 2010, two individual customers accounted for 65% and 15% of the revenue respectively. For the nine months ended September 30, 2009, two individual customers accounted for 62% and 18% of the revenue respectively.

It should be noted that the largest customer in each of the above was the Company's agent in India, who in turn provides products to several end users.

As at September 30, 2010, one individual customer accounted for approximately 94.7 % of the accounts receivable. As at September 30, 2009, one individual customer accounted for 82% of the accounts receivable.

5. Commitments

AFS has renewed its lease for 5800 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.

6. Contingent liabilities

The Company has a contingent liability to repay funding from the National Research Council of Canada (the "NRC"). The original funding amount was \$310,000, repayable on a quarterly basis at a rate of 0.75% of gross sales recognized in the related period. During the quarter ended September 30, 2010, the Company repaid \$6,196 (2009 - \$3,217) to the NRC in respect of this government funding bringing the total repayments to date to approximately \$234,000 (balance at end of 2009- \$217,608).

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%.

7. 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

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(expressed in Canadian dollars)

considers the shareholder's equity to be the capital of the Company. As at September 30, 2010, the Company's capital stock totaled \$2,512,301.

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.

8. 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, 2010, 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

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production demand. As at September 30, 2010, 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.

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, 2010, the amount in cash and short-term deposits was \$1,562,532. 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 to partially mitigate this credit risk. Therefore, the Company estimates the risk of credit loss as low.

As at September 30, 2010, one individual customer accounted for approximately 94.7% of the accounts receivable. 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

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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.

9. Liquidity and capital resources

For the nine months ended September 30, 2010 there was a total decrease in cash of (\$133,583) from the December 31, 2009 balance. Excluding non-cash transactions such as amortization of \$27,529 and stock-based compensation expense of \$38,970, this decrease was primarily due to a decrease in working capital of (\$175,802), purchases of equipment totaling (\$21,840) and a net loss from operations of (\$2,440).

For the three months ended September 30, 2010 there was a total increase in cash of \$140,443 from the June 30, 2010 balance. Excluding non-cash transactions such as amortization of \$9,548 and stock-based compensation expense of \$12,990, this quarterly increase was primarily due to an increase in working capital of \$97,840 along with net income from operations of \$34,930.

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, 2010, the Company's capital resources included total working capital of about \$2.2 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.