Management's Discussion and Analysis **November 8, 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 nine months ended September 30, 2010 and the notes contained therein.

Operating Results

Sales revenue	**Three months ended September 30**			**Nine months ended September 30**		
($ thousand, except %)	**2010**	**2009**	**Change**	**2010**	**2009**	**Change**
Engine management systems	461	294	167	1,286	705	581
Pressure regulators	237	58	179	478	619	(141)
Ignition systems and other parts	24	8	16	135	41	94
Fuel injectors	76	28	48	202	74	128
Subtotal product sales	**798**	**388**	**410**	**2,101**	**1,439**	**662**
Engineering services	28	41	(13)	85	309	(224)
Total	**826**	**429**	**397**	**2,186**	**1,748**	**438**
Gross margin on product sales	40%	42%	(2%)	44%	43%	1%

Engine management system sales in the third quarter of 2010 increased by 57% compared to sales of the same product in Q3 of 2009. Most of this growth occurred in India, as vehicle manufacturers continue to increase production of light trucks fueled by compressed natural gas. That market segment is where most AFS engine controllers are used. In addition, the transition to newer, more stringent emissions rules in India which came into effect in the second quarter of 2010 is now essentially complete. Manufacturers are now in full production of models that meet these new requirements Revenue from sales of natural gas pressure regulators was up approximately four times in the three month period ended September 30, 2010 compared to the same quarter of 2009, primarily due to an order from a customer in Europe for spare parts for vehicles built prior to the first quarter of 2009. This order was filled during the third quarter. It is uncertain if such orders might occur again in future. Sales of AFS fuel injectors in the third quarter of 2010 were more than two and one half times higher than in the third quarter of 2009, as customers in both India and the USA increased their purchases. Margin on product sales during the quarter decreased slightly due to increased sales of pressure regulators, which are lower margin products, compared to engine management systems. Engineering services revenue during the third quarter of 2010 was lower than recorded in the same period of 2009. Engineering revenue in both periods was primarily from customer support activities which vary from month to month, and which are billed monthly or quarterly.

The decrease of ($141) in sales of natural gas pressure regulators in the first nine 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, offset to some extent by the spare parts order mentioned above.

Historical summary financial information:

($ thousand, except per share amounts)	**2010**			**2009**				**2008**
	Q3	**Q2**	**Q1**	**Q4**	**Q3**	**Q2**	**Q1**	**Q4**
Gross revenue	831	827	541	666	429	659	663	1,253
Net income (loss)	35	30	(67)	21	(110)	149	(107)	200
Net income (loss) per share	0.00	0.00	(0.00)	0.00	(0.00)	0.01	(0.01)	0.01

The above quarterly revenue results show the effects of the significant sales of natural gas pressure regulators in the last quarter of 2008, compared to the third and fourth quarters of 2009 and the first three quarters of 2010, where regulator sales were much lower due to the previously announced cessation, in 2009, of production of a European vehicle that used AFS pressure regulators. Increased sales of engine management systems in Q2 and Q3 of 2010 are due primarily to sales to customers in India that are ramping up production of natural gas fuelled vehicles. Sales of pressure regulators were elevated in Q3 of 2010 by the previously mentioned order for spare parts in Europe.

Operating and administrative expenses

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

Operating and administrative expenses	**Three months ended September 30**			**Nine months ended September 30**		
($ thousand, except % change)	**2010**	**2009**	**Change**	**2010**	**2009**	**Change**
Engineering & product development	143	144	(0.6%)	440	438	0.4%
Administrative & other	90	95	(5.2%)	277	316	(12.3%)
Sales & marketing	61	46	40%	159	148	7.4%
Total	**294**	**285**	**3.1%**	**876**	**902**	**(2.9%)**

The decrease in total operating and administrative expense of ($39,000) or (12.3%) for the nine months ended September 30, 2010 was primarily due to a decrease in consulting fees of ($23,780), a decrease in insurance expense of approximately ($9,500) and a decrease in office supplies of approximately ($1,800).

Sales and marketing expenses for the three months ended September 30, 2010 have increased 40% over the same period in 2009. This is primarily due to a one-time adjustment of $14,000 to resolve a payment issue with a distributor.

For the three months ended September 30, 2010, employee wages and benefits accounted for 76% or $235,796 (2009 - 83% or $235,856) of the total operating and administrative expenses recognized. For the nine months ended September 30, 2010, employee wages and benefits accounted for 83% or $724,377 (2009 – 81% or $732,239) 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.

Compensation of Executive and Directors

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

Named Executive Officer (1)	September 30	Salary ($)	Bonus ($)	Other Compensation ($)
Jim Perry, President and Chief Executive Officer	2010	137,250	NIL	(2)
	2009	137,250	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	-	-	248,000	-	21,870	-

(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 $0.235 at September 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 third quarter of 2010, no amounts were paid to these directors.

Financial Position

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

	Change ($)	Change (%)	Explanation
Cash and short-term investments	(133,583)	(7.8%)	See statements of cash flow.
Accounts receivable	58,014	75.6%	Increase primarily due to a large shipment at quarter end; this receivable has since been collected.
Prepaid expenses and deposits	(11,839)	(39.1%)	Decrease primarily due to monthly amortization of prepaid insurance, and a deposit applied to custom order now received.
Inventory	290,531	43.2%	Inventory of electronics and fuel injector parts has increased since December 31, 2009 to meet anticipated future demand.
Property, plant and equipment	(5,344)	(3.2%)	Net decrease due to purchase of production tooling and emission testing equipment of $21,840 offset by YTD amortization of $27,184.
Intangible assets	(344)	(21.4%)	Net decrease due solely to amortization of $344.
Accounts payable & accrued liabilities	170,332	116.3%	Increase due to increase purchases of inventory in Q3 to meet anticipated future demand.
Advances from customers	(9,428)	(8.2%)	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	38,970	100%	Increase from December 31, 2009 due solely to impact of YTD stock-based compensation expense of $38,970.
Deficit	2,440	0.3%	The increase in the deficit is due to the impact of the YTD 2010 net loss of ($2,440).

Net income (loss) and cash flow

AFS reported net income for the quarter ended September 30, 2010 of $34,931 or $0.00 per share on a basic and diluted basis. The net loss in the comparable quarter in 2009 was ($110,149) or ($0.00) per share on a basic and diluted basis. In addition to this net income, there was an overall increase in working capital in the third quarter of 2010 of $97,840 compared with a similar increase in working capital of $95,262 in the same quarter of 2009. The increase in working capital in the third quarter of 2010 was primarily due to a decrease in prepaid expenses and deposits of ($25,995), a decrease in inventory of ($14,940) and an increase in accounts payable and accrued liabilities of $119,406. These were offset by an increase in accounts receivable of $57,169, and a decrease in advances from customers of ($5,332).

Cash flow from operations for the third quarter of 2010 was $155,309 compared to a cash flow of $13,953 in the third quarter of 2009. This change of $141,355 was primarily due to the increase in net income in the third quarter of 2010 over the third quarter of 2009 of $145,079, the increase in working capital during the three months of $2,578, offset by a decrease in amortization of ($6,302).

Capital stock

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

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

	Outstanding	**Exercisable**
Stock options	824,000	824,000

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 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 an 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 and net income from operations of $34,930 offset by purchases of equipment totaling ($14,865).

At September 30, 2010, the Company's capital resources included total working capital of $2,257,262. This is comprised of cash and short- term investments of $1,562,532, inventory of $962,986, accounts receivable of $134,707, and prepaid expenses and deposits of $18,377 offset by accounts payable and accrued liabilities of $316,732 and advances from customers of $104,608.

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 $1.5 million as at September 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, such as the USA, 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 nine months ended September 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 phas*e, 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 substantially completed the second phase. The Company is 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 has conducted a detailed review of the net book values assigned to property, plant and equipment and no impairment was identified. It has also been determined that no componentization will be required. Therefore, this detailed review resulted in 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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