
Three months and six months ended June 30, 2008 compared to the three months and six months ended June 30, 2007 and the year ended December 31, 2007

MANAGEMENT'S DISCUSSION AND ANALYSIS

Three months and six months ended June 30, 2008 compared to the three months and six months ended June 30, 2007.

This "Management's Discussion and Analysis" has been prepared as of August 12, 2008 and should be read in conjunction with the unaudited consolidated financial statements of Azure Dynamics Corporation ("Azure" or the "Company") for the three months and six months ended June 30, 2008 and the audited consolidated financial statements of the Company for the year ended December 31, 2007.

FORWARD LOOKING STATEMENTS

This MD&A contains forward-looking statements related to Azure's financial and other projections, expected future plans, events, financial and operating results, objectives and performance, as well as underlying assumptions, all of which involve risks and uncertainties. When used in this MD&A, the words "believe", "anticipate", "intend", "estimate", "expect", "project" and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain such words. These statements reflect management's current beliefs and are based on information currently available to Azure's management and are subject to certain risks, uncertainties and assumptions. Actual results may differ materially from management expectations as projected in such forward-looking statements for a variety of reasons and no assurances can be given as to actual future results, performance or prospects. Factors that may cause such differences include, but are not limited to, the early stage of development of the Company; a lack of product revenues and a history of losses; the need for additional financing; uncertainty as to commercial viability; uncertainty as to product development and commercialization milestones being met; uncertainty as to the market for the Company's products and unproved acceptance of the Company's technology; competition; uncertainty as to target markets; dependence upon third parties; changes in environmental policies; uncertainty as to patent and proprietary rights; availability of management and key personnel; available regulatory approvals and conflicts of interest by directors and officers of the Company. More detailed information about these and other factors that could affect Azure's operations or financial results are included in Azure's filings with Canadian securities regulatory authorities. Azure does not assume any obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law. Because of these risks, uncertainties and assumptions, readers should not place undue emphasis on Azure's forward-looking statements.

BUSINESS STRATEGY OF THE COMPANY AND OVERALL PERFORMANCE

The Company has developed proprietary electric and hybrid electric technology principally for the light to heavy duty commercial vehicle category (the "Technology"). Azure has expertise in the areas of vehicle controls software, power electronics, electric machine design, vehicle systems engineering and vehicle integration. The principal business of Azure is the supply of hybrid electric vehicle ("HEV") and electric vehicle ("EV") control and powertrain systems. The Company also has an established portfolio of proprietary component products that compliment its core technical skills and makes use of an extensive industry supplier base to offer complete powertrain solutions to its target market.

Azure has identified three primary target markets, which includes; general delivery, shuttle-bus and electric solutions. Over the past seven years, the Company has primarily been engaged in the development and testing of its Technology. Certain of the Company's products are now generating commercial revenues while other products are still in the development stage. Generally, Azure does not intend to be the ultimate manufacturer of components or assembler of powertrain systems; rather, the Company uses the supply capacity that exists within the commercial vehicle industry to assemble products to its specifications which are then distributed via existing industry channels to the customer.

Azure seeks to closely align its product development and sales efforts with recognised industry partners (Original Equipment Manufacturer's, component suppliers, and customers) thereby gaining access to product development support and established distribution networks which can help accelerate the penetration of its

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electric and hybrid electric products into the commercial vehicle markets. The Company has concluded arrangements with Ford Motor Company ("Ford"), StarTrans (a business division of Supreme Corporation) and Utilimaster Corporation ("Utilimaster"), which have facilitated a concentration of the Company's efforts around its core programs for Azure CitiBus™ (G1 series hybrid) and Balance™ Hybrid Electric (P1 parallel hybrid) to serve two of its primary target markets; general delivery and shuttle buses.

Azure's third area of focus is referred to as Electric Solutions. This includes products such as electric drive systems, components and variants of Low Emission Electric Power (LEEP) such as LEEP Lift and LEEP Freeze. Azure has concluded arrangements with Kidron, a division of VT Specialized Vehicles Corporation, for the branding, marketing and sale of Azure's LEEP Freeze systems throughout the North American refrigerated truck body segment. The Company also signed a Memorandum of Understanding (MOU) for the branding, marketing and sale of Azure's LEEP Lift systems with Altec, a leading manufacturer of aerial boom trucks for the electric utility, telecommunications and contractor markets. Lastly, the Company has variety a supply agreement with Electro Autos Eficaces of Mexico ("EAE") for electric drive systems and components.

On April 15, 2008, the Company announced that it began listing on the International OTCQX under the symbol "AZDDF". U.S. investment bank, Merriman Curhan Ford & Co. (NASDAQ:MERR), will serve as Azure's Investment Bank Principal American Liaison ("PAL") on the International OTCQX, responsible for providing guidance on Azure's International OTCQX-listing requirements and arranging a comprehensive suite of U.S. capital markets services.

On April 17, 2008 the Company appointed James C. Gouin to its Board of Directors, who recently joined Tower Automotive LLC as Chief Financial Officer following a distinguished career at Ford Motor Company ("Ford"). Gouin's extensive career in the automotive industry started in 1979 when he joined Ford as an analyst in the engine division. During his 28 year Ford career, Gouin served in a number of senior management positions including: Vice President, Contoller, Chief Accounting Officer during the company's first year of Sarbanes-Oxley compliance and Chief Financial Officer of North American Operations. His last position with Ford was as Vice President, CFO, Strategy & Business Development of International Operations.

On May 12, 2008, the Company announced the appointment of Jay A. Sandler to the position of Vice President of Sales. Sandler comes to Azure with a breadth of experience and most recently was the former Vice President of Commercial Products at Workhorse Custom Chassis LLC, a Division of Navistar. Prior to Workhorse, Sandler was Vice President of Sales, Marketing and Fixed Operations for Bering Truck from 1998 to 1999 and served as the Director of North American Field Operations, Heavy Vehicle Systems for Arvin Meritor (formerly) Rockwell International from 1994 to 1998. From 1991 to 1994, he was Vice President and a Director of Rockwell Wabco Vehicle Control Systems in Troy, MI and served in a number of management positions with Rockwell and Eaton Corporation between 1972 and 1991.

Forty nine hybrid electric and 37 electric vehicle systems were shipped during the second quarter. Including 35 gasoline, Balance™ Hybrid Electric (P1 parallel hybrid) Ford E-450 vehicles; 15 were shipped to AT&T and 20 were shipped to FedEx Express.. The Company also completed shipment on an order from the Pennsylvania Department of Transportation ("PennDOT") for 10 Azure CitiBus™ (G1 series hybrid) shuttle buses with an option for 15 additional buses at a later date. Four additional Azure CitiBus™ (G1 series hybrid) shuttle buses were shipped to several other customers. Furthermore, the Company shipped 37 Force Drive™ electric vehicle systems to various customers.

During the second quarter the Company announced that in order to leverage the existing sales and service channels as well as to support the burgeoning fleet of hybrid vehicles, the Company signed Sales & Service agreements with four Ford dealerships. These agreements allow Ford dealers to serve the growing market demand for Azure's new fuel efficient, low maintenance and environmentally friendly, Balance™ Hybrid Electric (P1 parallel hybrid) Ford E-450 commercial vehicle.

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The Company plans to sign approximately 50 dealers in the next year in major metro markets in the United States and Canada. The Company has already identified 33 initial target markets. Prior to these agreements, Azure had been selling direct to market. However, expected demand and recently announced orders from major fleet owners like AT&T and FedEx have encouraged the Company to broaden its distribution network by partnering with highly-regarded commercial vehicle specialists.

Azure CitiBus™ (G1 series hybrid):

The Azure CitiBus™ (G1 series hybrid) product is specifically designed for inner-city use and is highly suitable for urban general delivery vans and shuttle busses which both have demanding start and stop drive-cycles.

Purolator's fleet of 49 G1 series hybrid vehicles have accumulated over 700,000 miles as of June 30, 2008. The vehicles are deployed in Montreal, Ottawa, Toronto and Vancouver. Two of the 19 diesel hybrids have now surpassed 3 years in service, while the 30 G1 gas series hybrids will soon be approaching a year and a half in service. Production of the additional vehicles to Purolator on their current contract commenced during the quarter. It is expected that these vehicles will be delivered in the third quarter. These vehicles will be built on the Ford Balance P1 Balance parallel hybrid platform.

As of June 30, 2008 the Company had completed assembly of 59 units in a low volume production build of the Azure CitiBus™ (G1 series hybrid). The hybrid cab chassis' will be completed into shuttle buses in the coming quarters to meet anticipated customer sales demands. To date, 15 of the 59 units have been shipped.. The product has completed durability testing at Altoona and is eligible for funding programs administered by the Federal Transit Administration (FTA) in the United States. Azure has signed agreements with various StarTrans bus distributors across North America and therefore has access to a distributor network for the targeted shuttle bus market in the US and Canada.

Development activity this quarter has been focused on completing the design and validation of an improved air conditioning system option which has been added to the certain buses already in service, as well as releasing the design for an ultra-capacitor which can be used as an alternative energy storage device on these vehicles. Testing required for Canadian certification is expected to be completed in the third quarter, with certification expected to be granted shortly thereafter. Most of the development work is complete on product; however, we expect incremental work to continue throughout the final production build of the shuttle buses.

For the quarter and year ended June 30, 2008, the Company incurred \$0.8 million and \$1.1 million respectively (2007 – \$1.1 million and \$2.4 million respectively) in gross research and development expenses related to the Azure CitiBus™ (G1 series hybrid) product line. Expenses decreased compared to the prior quarter due to this product line being mostly complete with the exception of ongoing incidental development as mentioned above. It is expected this development will be mostly completed by the end of the third quarter, 2008. Furthermore, for this quarter, the Company recognized approximately \$1.9 million (2007 – \$Nil) in revenue on the sale of 14 shuttle buses. Year to date, the Company recognized \$2.1 million (2007 - \$Nil) in revenue on the sale of 15 shuttle buses.

Balance™ Hybrid Electric (P1 parallel hybrid):

The agreement to develop a parallel hybrid powertrain on the Ford E-series chassis provides Azure with an avenue to achieve rapid penetration of a higher volume market for commercial vehicles in North America. The Company is launching into production both a stripped hybrid chassis for general delivery vans as well as a cutaway hybrid chassis for use in shuttle buses and other vocational trucks.

During the quarter, the Company completed the production readiness phase of the main, Balance™ Hybrid Electric development program. Within the production readiness phase, the Company completed a pre-production and pilot build and started production of hybrid stripped and cutaway chassis. In addition to this production launch, the Company completed a 4.5 month evaluation of a Hybrid step van with FedEx Express

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in Sacramento in April 2008 and continued both long and short term demonstrations with other customers. The Company also started the accelerated 7 year Altoona durability test on the shuttle bus variant. Once the testing is complete, the, Balance™ Hybrid Electric shuttle bus will be eligible for funding programs administered by the Federal Transit Administration (FTA) in the United States. The test is planned for completion in the third quarter of this year. The 2009 model year development activity also continued within the quarter and it is expected that production will shift to the 2009 model year chassis in the fourth quarter of 2008.

The Company delivered 20 pre-production step vans to FedEx Express in California and the vehicles began revenue service. These pre-production units allowed the Company to get the production line and production process validated. Additionally the Company completed the hybridization of 15 units for AT&T, these units will begin service in the third quarter once their body builds are complete. P1, Balance™ Hybrid shuttle bus chassis' were delivered to four different bus body builders in the current quarter in order for these body builders to evaluate and market the P1, Balance™ Hybrid version of the E-450. Balance™ Hybrid Electric shuttle bus chassis' were delivered to four different bus body builders in the current quarter in order for these body builders to evaluate and market the Balance™ Hybrid Electric version of the E-450. In addition to this pre-production fleet launch, the Company signed four Ford dealerships to sales and service agreements and has plans on signing agreements with up to 50 different Ford dealerships within the next year. These Ford dealerships will be trained to support sales and service of the Company's Ford based hybrid products.

For the quarter and year ended June 30, 2008, the Company incurred \$2.0 million and \$3.5 million respectively (2007 - \$0.7 million and \$1.2 million respectively) in research and development expenses related to internally funded P1 projects. The Company anticipates further costs for product development will be incurred in 2008 in order to validate this product. No costs have been deferred or capitalized. Furthermore, for the quarter and year to date, the Company recognized approximately \$1.1 million (2007 - \$Nil) in revenue on the sale of 35 Balance™ Hybrid Electric systems to FedEx and AT&T.

Electric Solutions:***Low Emission Electric Power (LEEP):***

Electric Drive Solutions consists of Azure's Low Emission Electric Power (LEEP) and electric drive components. The product name LEEP refers to all systems whereby clean electric power is generated via the vehicles' powertrain (and, in some cases, via the grid) to supply a range of auxiliary systems (e.g. pumps, refrigeration, etc.) and export power applications. The Company is currently developing two variants: a refrigeration variant (LEEP Freeze) and a utility/telecom truck variant (LEEP Lift).

The Company has a supply agreement with Kidron for the LEEP Freeze refrigeration units that encompass branding, marketing and sale of Azure's LEEP Freeze systems throughout the North American refrigerated truck body market. The agreement structures Azure providing Kidron with LEEP Freeze systems for integration into their cold plate refrigerated truck and truck body units. Kidron will market this product through its direct sales force and distribution channels across North America. The LEEP Freeze system developed for Kidron stores cooling potential in the cold plate refrigeration system when the engine is running. When the engine is off, the cold plate is used to maintain refrigeration temperatures in the box. The LEEP Freeze system has the potential to replace the ancillary motors/generators used in the other method of cooling refrigerated trucks, thereby reducing fuel consumption, noise and emissions. The LEEP Freeze refrigeration design is complete and released and the Company is supporting Kidron in sales development activities for the product. The Company anticipates initial deliveries under this supply agreement will commence in 2008 and is preparing production capability accordingly.

The Company has signed a memorandum of understanding (MOU) with Altec, a leading manufacturer of aerial boom trucks for the electric utility, telecommunications and contractor markets. The MOU includes the branding, marketing and sale of Azure's LEEP Lift systems within the electric utility and telecom markets and will see the maker of hybrid electric and electric components supplying LEEP Lift systems that are

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specifically adapted to the boom truck applications. The LEEP Lift system is specifically designed to be installed on these trucks, in which a boom is driven by a hydraulic pump that is normally powered by a transmission power take-off unit. The LEEP Lift system charges onboard high-voltage batteries while the truck is in a normal drive cycle, and when the truck is stationary and the boom is active, the motor/generator drives the hydraulic pump and 12VDC loads using the stored energy to minimize use of the truck's engine during time spent at work sites. The development of two demonstration vehicles with the Company continued within the quarter. The Company anticipates purchase orders for initial prototype deliveries to commence in 2008, with purchase orders for production deliveries to commence in 2009, and is preparing production capability accordingly.

For the quarter and year ended June 30, 2008, the Company incurred \$0.2 million and \$0.3 million respectively (2007 – \$0.1 million for both prior quarter and year to date) in research and development expenses related to internally funded LEEP projects. The Company anticipates further costs for product development will be incurred in 2008 as it addresses the various LEEP variants as mentioned above (i.e. telecom and utility). No costs have been deferred or capitalized and no sales revenue has been earned from these projects. Furthermore, for the quarter and year to date, no revenue has been recognized on the sales of these product lines.

Force Drive™ Electric Vehicle Systems and components:

The Company has developed a full range of electric drive components, including AC motors, inverters and converters, controllers and battery chargers. Full powertrain kits or electric drive sub-components can be ordered.

In the second quarter of 2007, the Company announced it had signed a supply agreement with Electro Autos Eficaces (EAE) of Mexico. The initial agreement is for 1,000 Force Drive™ electric vehicle systems for integration into the Nissan Tsuru platform, which is commonly used in the municipal fleet of Mexico City. The Tsuru will be converted from gasoline powered vehicles to electric vehicles. During the quarter, the Company continued the production of drive systems planned for delivery against a 200 unit release within the supply agreement. Azure's scope of supply for the 1,000 drive systems includes the motor, controller, gearbox and DC/DC converters. The Company sold 37 Force Drive™ electric vehicle systems during the quarter to other customers.

For the quarter and year ended June 30, 2008, the Company incurred approximately \$8,400 and \$0.1 million respectively (2007 – \$0.1 million for both prior quarter and year to date) in research and development expenses related to internally funded Electric Drive System projects. The Company does not anticipate additional product development in 2008. The Company is currently in the process of production of electric drive kits for eventual sale to its customers. No costs have been deferred or capitalized and no sales revenue has been earned from these projects. Furthermore, for the quarter and year to date, the Company recognized approximately \$0.2 million and \$0.4 million respectively (2007 – \$0.1 million for both prior quarter and year to date) in revenue on the sale of Force Drive™ electric vehicle systems and components.

The total number of employees increased from 127 at the end of fiscal 2007 to 140 at June 30, 2008 (2007 – 122). The Company leases facilities in Vancouver (18,000 square feet), Boston (77,000 square feet) and Detroit, MI (36,000 square feet), as well as the service and support center in Mississauga, Canada. The Company considers that its various facilities are suitable to meet the foreseeable requirements for engineering, workshop, test, and administrative accommodations.

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OPERATING RESULTS, CASH FLOWS AND FINANCIAL CONDITION

Statement of Operations Discussion:

Selected Quarterly information: (stated in thousands except loss per share amounts):

	Q2, 2008 (Apr-Jun)	Q1, 2008 (Jan-Mar)	Q4, 2007 (Oct - Dec)	Q3, 2007 (Jul - Sep)
Revenue	\$ 3,383	\$ 370	\$ 518	\$ 1,534
Gross margin	\$ (182)	\$ (147)	\$ (179)	\$ (197)
Expenses, net	\$ (7,937)	\$ (7,760)	\$ (8,179)	\$ (8,257)
Net loss for the period	\$ (8,119)	\$ (7,907)	\$ (8,359)	\$ (8,454)
Net loss per share	\$ (0.03)	\$ (0.03)	\$ (0.03)	\$ (0.04)
Weighted average number of shares	279,376	279,376	259,101	198,276

	Q2, 2007 (Apr - Jun)	Q1, 2007 (Jan-Mar)	Q4, 2006 (Oct-Dec)	Q3, 2006 (Jul-Sep)
Revenue	\$ 593	\$ 156	\$ 3,008	\$ 411
Gross margin	\$ (10)	\$ 89	\$ 967	\$ (166)
Expenses, net	\$ (6,906)	\$ (6,596)	\$ (5,974)	\$ (8,849)
Net loss for the period	\$ (6,916)	\$ (6,507)	\$ (5,007)	\$ (9,015)
Net loss per share	\$ (0.03)	\$ (0.03)	\$ (0.03)	\$ (0.06)
Weighted average number of shares	198,276	198,275	166,913	159,206

For the quarter ended June 30, 2008, the Company incurred a net loss of \$8.1 million (\$0.03 per share) compared to a net loss of \$6.9 million (\$0.03 per share) in the comparable 2007 quarter. The higher loss in the current quarter is primarily attributable, higher than expected product development costs and negative gross margin during the current quarter. Product development costs were higher during the current quarter as the Company is expending most of its time and resources in developing and validating the Balance™ Hybrid Electric system. Negative gross margin during the quarter is primarily the result of typical negative production variances associated with lower volume early stage production.

There are currently no established seasonality patterns for the financial results of the Company over the past eight quarters. Historically, variations in revenues, gross margin, expenses and net loss are driven primarily by the timing of development projects which vary on a project by project basis. Financial results for the first and second quarter of 2008 reflect early production revenues from the above mentioned programs and it is expected that variations in future financial results will be driven by expected increases in orders as the Company gains additional customers and completes the product launches of the above mentioned programs.

Revenue: Revenue for the quarter ended June 30, 2008 was \$3.4 million (2007 – \$0.6 million). The higher revenue in the current quarter is attributable to sales of 14 Azure CitiBus™ (G1 series hybrid) shuttle buses and 35 Balance™ Hybrid Electric (P1 hybrid electric) systems as well as deliveries of 37 Force Drive™ electric vehicle systems and components to other customers. Revenue in the prior year quarter primarily related to deliveries of components in addition to after-sales service support. After considering direct and applicable indirect costs of sales, the gross margin contribution from revenue in the quarter was negative \$0.2 million (2007 – \$0.1 million). Gross margin as a percentage of sales was negative 5% in the quarter (2007 – negative 2%). Gross margin was negative during the quarter primarily as a result of typical negative production variances associated with lower volume early stage production.

Engineering, research, development and related costs, net: Before contributions, the Company expended \$5.7 million on engineering, research and development operations in the quarter (2007 – \$4.2 million),

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including \$3.4 million in respect of product development costs (2007 – \$2.4 million). The expenses were reduced by \$0.2 million (2007 – \$0.3 million) in respect of government contributions. At June 30, 2008, Azure employed 115 research, engineering, operations and technical personnel (2007 – 97). Engineers and technical personnel are either working on revenue contracts and sales orders, on servicing vehicles or products in the field, or on core product development programs. For product development and other unabsorbed overheads the direct costs and related overheads, net of customer or government contributions, are expensed.

Product development expenses of \$3.4 million (2007 – \$2.4 million) in the quarter include the continuation of Balance™ Hybrid Electric system development, costs related to the development and enhancement of system components and ongoing G1 maintenance.

Customer and government contributions were \$0.2 million in the quarter compared to \$0.3 million in the comparable quarter of 2007. All contributions in the quarter are associated with Technology Partnerships Canada (“TPC”). During the current quarter, the Company held additional discussions with TPC and as a result, TPC allowed the Company to claim monies against G1 series hybrid expenditures that went beyond the initial estimates submitted to TPC. The Company is also seeking additional re-imbusement from TPC for its programs, however, the outcome is uncertain and the Company has no update to provide at this time.

The Company is required to make royalty payments to TPC, EnCana Corporation and the National Resources Canada (NRCan) based on revenues in respect of specified products. During the current quarter no royalty payments were made. To date, the Company has made payments of \$16,500 each to both EnCana and NRCan. No payments have been made to TPC to date.

Selling and marketing: Selling and marketing costs were \$0.7 million in the quarter compared to \$0.9 million in the comparable quarter in 2007. The decrease is primarily related to lower salary levels. The selling and marketing headcount at June 30, 2008 was 7 (2007 – 8).

General and administrative: General and administrative costs were \$1.7 million in the quarter compared to \$2.2 million in the comparable quarter in 2007. Although the headcount is higher by one in the quarter versus the comparable quarter, the decrease is primarily related to lower salary levels as a result of the reorganization announced in the prior quarters. The headcount at June 30, 2008 was 18 (2007 – 17).

Amortization: Amortization of property, equipment and other assets was \$0.2 million in the quarter compared to \$0.2 million in the prior year. Property and equipment primarily consists of workshop equipment, tooling, computer hardware and software. The Company purchased assets with a value of \$0.3 million in the quarter (2007 - \$0.6 million) which also includes assets under capital lease. Other assets are primarily the cost of patents and trademarks. In addition, the intangible assets acquired as a result of the US acquisition noted above have been amortized by \$0.4 million in the quarter (2007 – \$0.4 million). Amortization of property, equipment and other assets are allocated to the relevant cost categories on the Statement of Operations.

Other expenses: Other expenses were \$0.1 million in the quarter which related to severance costs (2007 – \$Nil).

Foreign currency gains/losses: Foreign currency losses totalled \$65,000 in the quarter (2007 – loss of \$71,000). These were mainly unrealised gains and losses in respect of foreign currency cash balances which reversed out subsequent to the quarter end.

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Balance Sheet Discussion:

Cash and cash equivalents: Cash and cash equivalents at June 30, 2008 were \$5.4 million compared to \$24.1 million at December 31, 2007 and \$16.8 million at June 30, 2007. Net cash outflows were approximately \$8.3 million in the quarter compared to net cash outflows of \$3.9 million in the comparable quarter in 2007. The increase in cash outflows of \$4.4 million in the quarter is mainly attributable to the higher net loss during the quarter and increases in non cash working capital in the current quarter. The increase in non cash working capital is primarily related to the increase in inventory as a result of the build up of inventory required as the Company increases its revenue.

Accounts receivable: Accounts receivable at June 30, 2008 were \$3.2 million compared to \$0.6 million at December 31, 2007 and \$0.3 million at June 30, 2007. The increase in accounts receivable is mainly due to the increase in shipments during the quarter.

Contributions receivable: Contributions receivable were \$1.1 million at June 30, 2008 compared to \$1.1 million at December 31, 2007 and \$0.6 million at June 30, 2007. The increase in the current quarter compared to the year-end represents five quarters worth of claim amounts under the TPC program versus two outstanding at the year end. The increase compared to the prior quarter is due to timing of payments as there are now five quarters worth of claims outstanding dating back to April 1, 2007. During the quarter, the Company received the first quarter, 2007 payment from TPC. The higher balance is due to the fact that TPC had initiated a review of the program with Azure. That review has mostly been completed and the Company expects the amounts to be paid within the year.

Inventory and related prepayments: Inventory and related prepayments were \$11.4 million at June 30, 2008 compared to \$10.2 million at December 31, 2007 and \$5.4 million at June 30, 2007. The higher inventory amount at June 30, 2008 compared to the year end is due to the build up of Force Drive™ electric vehicle systems and additional work-in-process related to the Azure CitiBus™ (G1 series hybrid) and Balance™ Hybrid Electric (P1 parallel hybrid) product to support future orders and deliveries. The higher balance in the quarter compared to the comparable quarter in the prior year is attributable to the same items indicated above.

Prepaid expenses: Prepaid expenses at June 30, 2008 were \$1.0 million compared to \$0.7 million at December 31, 2007 and \$0.9 million at June 30, 2007.

Property and equipment: Net property and equipment which also includes assets under capital lease were \$5.9 million at June 30, 2008 compared to \$5.7 million at December 31, 2007 and \$5.9 million at June 30, 2007.

Goodwill and other intangibles: The Company accounted for the acquisition of Azure Dynamics Incorporated (its US subsidiary) using the purchase method, and in accordance with Canadian accounting standards, allocated the purchase price to identifiable assets, including intangibles. The excess of the purchase price consideration over identifiable assets is recorded as goodwill on the balance sheet (\$2.9 million). The Company identified the order book (\$0.9 million) and technology (\$12.5 million) as at-acquisition intangible assets. Intangible assets were \$8.7 million at June 30, 2008 (\$9.3 million at December 31, 2007 and \$9.9 million at June 30, 2007). The lower amount in 2008 is attributable to amortization.

Accounts payable and accrued liabilities: Accounts payable and accrued liabilities were \$4.4 million at June 30, 2008 compared to \$4.3 million at December 31, 2007 and \$3.4 million at June 30, 2007.

Customer deposits and deferred revenues: Current and long-term deferred revenue and customer deposits total \$1.2 million at June 30, 2008 compared to \$1.1 million at December 31, 2007 and \$1.8 million at June 30, 2007. The amount is attributable to the US operation and consists of deferred revenue that is primarily in respect of a payment received from Singapore Technologies Kinetics Ltd. ("STK") for a license agreement for certain technology that expires in 2020. The license agreement fee is being recognised in revenue over the

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17-year duration of the agreement. The lower balance in the current quarter compared to the prior year quarter is related to lower deposit amounts, which were reduced as the shuttle buses on which the deposits were paid were completed and delivered to the customers in the prior year.

Notes payable: The note payable is attributable to the US subsidiary and is the Company's proportionate share of a mortgage on the Boston property owned by ND Solectria LLC, in which the Company has a 50% interest. The note was refinanced in November 2006, is repayable on November 20, 2011, bears interest at a floating rate of the applicable Treasury rate plus 200 basis points and is secured by the mortgaged premises. As at June 30, 2008, total obligations under the notes payable were \$2.1 million compared to \$2.1 million at December 31, 2007 and \$2.3 million at June 30, 2007. The amount compared to the prior quarter June 30, 2007, is attributable to principle repayments.

Share capital: Share capital at June 30, 2008 was \$140.7 million compared to \$140.7 million at December 31, 2007 and \$112.8 million at June 30, 2007. The increase in share capital in the current quarter compared to the prior year quarter is primarily related to the equity financings in October 2007 (increase to share capital of \$27.8 million).

The number of common shares, options and deferred share units ("DSU's") issued and outstanding is presented in the following table:

	August 12, 2008	June 30, 2008	June 30, 2007
Common shares	279,376,177	279,376,177	198,276,177
Deferred Share Units	2,364,235	2,364,235	Nil
Stock options issued under the Stock Option Plan, with expiry dates ranging up until June 2, 2015 and average exercise price of \$0.67	17,815,126	17,815,126	15,515,128

During the period from June 30, 2008 to August 12, 2008, the Company did not issue common shares, stock options or DSU's.

RELATED PARTY TRANSACTIONS

In November 2003, Solectria entered into a Transfer of Technology and Software Licensing Agreement ("TTA Agreement") with Singapore Technologies Kinetics ("STK"). Under the terms of the agreement, STK has a non exclusive license to use and manufacture specified technology in specified Asian countries. The Company also provided STK with the training necessary for the transfer of the technology. The license expires in November 2020, and is subject to automatic one-year renewals thereafter. The Company received cash consideration for the license and transfer of technology, and for the training in the aggregate amount of US\$1.0 million. As discussed in note 2(b) of the June 30, 2008 Financial Statements, revenues from the TTA Agreement are being recognized on a straight-line basis over the period of the license agreement. As of June 30, 2008, the Company has deferred revenue associated with the TTA Agreement in the amount of \$0.8 million. During the three months ended June 30, 2008, revenues recognized by the Company from the sale of products to STK and its related companies and from certain other contractual arrangements totalled approximately \$15,000.

LIQUIDITY, CAPITAL RESOURCES AND RISK FACTORS

At June 30, 2008 the Company had \$6.6 million (June 30, 2007 – \$17.7 million) in net cash reserves. The Company invests its cash, in accordance with its investments policy, in highly-liquid, highly-rated financial instruments such as bankers acceptances and term deposits. At June 30, 2008 approximately \$1.2 million of cash was restricted (June 30, 2007 – \$0.8 million). The restricted cash is related to a security deposit in respect of the facility in Boston (\$0.8 million), a standby letter of credit associated with a customer contract (\$0.2 million), and a standby letter of credit related to the security deposit for the new facility in Oak Park (\$0.2 million). Working capital was \$17.5 million at June 30, 2008 compared to \$19.6 million at June 30, 2007.

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The Company has incurred losses since its inception as it has invested in the development of its Technology. Although the Company is active in a number of revenue-generating programs, it also continues to incur product development costs. As a result, the Company has relied on its financing activities to fund its operations. In addition, Azure has in the past, subject to TPC conditions, been eligible to access the grant of up to \$9.0 million available under the terms of the TPC contribution agreement. As at December 31, 2007 the Company had claimed approximately \$7.4 million in accordance with the terms of the TPC agreement. Through continued discussions with TPC; TPC has allowed the Company to claim expenditures in excess of the original estimates submitted to TPC at the inception of the program. Furthermore, the Company is currently in discussions with TPC to include additional development costs for cost reimbursement. However, at this time, the outcome of these discussions is uncertain.

The Company holds substantially all of its cash at a recognized Canadian national financial institution, and as such is exposed to all of the risks associated with that institution. The Company operates in foreign markets and has foreign subsidiaries and is therefore exposed to foreign currency exchange risk. Azure's operations are subject to all of the risks inherent in the establishment of a new business enterprise – please see Risk Factors – Annual Information Form, dated March 25, 2008 (this document and additional information relating to the Company is available for inspection at www.sedar.com). These risks include the practical risks of implementation and execution of its commercialization strategy (for example, the risk that Azure is delayed in the development of customer product requirements specified in development agreements, or is delayed in the process of establishing the infrastructure required to support its commercialization plans). To better manage all risk factors, the Company has a system of reporting and measuring progress towards milestones on a regular basis. The Company has an organization structure commensurate with its growth plans and has implemented an internal control and process system supported by an appropriate ERP system that encompasses all existing engineering/support operations. The Company recently completed its ISO certification at its Canadian location in Vancouver, B.C. The Boston, Massachusetts location already conforms to ISO. Management accepts the responsibility of ensuring that control systems and procedures are established and are effective and monitored and is required to report to the Board and its sub-committees on a regular basis on such matters.

CONTRACTUAL OBLIGATIONS AND OFF-BALANCE SHEET ARRANGEMENTS***Contractual obligations:***

As at June 30, 2008; aside from entering into standard lease agreements for certain equipment during the quarter, there were no other significant changes in our contractual obligations and commercial commitments from those reported in our "Management's Discussion and Analysis" for the year ended December 31, 2007.

Off-balance sheet arrangements:

Pursuant to a contractual agreement with National Research Council Canada, the Company is required to make royalty payments in the event that the Company successfully commercializes its intellectual properties specified in this agreement. The royalty payments, if any, are calculated at a rate of 1% of yearly gross sales earned from its intellectual properties. The obligation to make royalty payments expires at the earlier of January 2011 or when aggregate royalty payments reach \$296,000. To date, the Company has made payments in the amount of approximately \$16,500.

Pursuant to a contractual agreement with Technology Partnerships Canada ("TPC"), the Company is required to make royalty payments equal to the greater of 0.28% of yearly gross business revenues or in accordance with a fixed repayment schedule, with repayment amounts ranging from \$0.7 million to \$1.0 million per year starting in 2008 and totalling \$1.3 million, provided that certain minimum sales levels are achieved. The obligation to make royalty payments commences when the minimum sales levels are achieved and continues until the earlier of 2015 or when a cumulative payment ceiling of \$20.5 million is reached. On March 23, 2005, the Company entered into a contract amendment with TPC whereby the royalty payment period was extended to December 31, 2020. The Company has made no royalty payments to date.

Pursuant to a contractual agreement with EnCana Corporation, whereby EnCana sponsored the development of power train product, the Company is required to make royalty payments equal to 1% of gross revenue from

Three months and six months ended June 30, 2008 compared to the three months and six months ended June 30, 2007 and the year ended December 31, 2007

sales of the power train product up to a maximum payment of \$1.0 million. To date, the Company has made payments in the amount of approximately \$16,500.

The Company has entered into employment agreements with certain executive directors and officers. In addition to defining the terms of employment, the agreements entitle the executives to termination payments, of up to one year's compensation, and the immediate vesting of all options previously granted, in the event of termination without cause and in some cases in the event of termination due to a change in the control of the Company.

CHANGES IN ACCOUNTING POLICIES

Effective January 1, 2007, the Company adopted Section 1530 – Comprehensive Income, Section 3855 – Financial Instrument Recognition and Measurement, Section 3861 – Financial Instruments Disclosure and Presentation, and Section 3865 – Hedges, in accordance with the transitional provisions in each respective Section. As a result of the adoption of these Sections, the Company determined that currently, there was no current material impact on the consolidated financial statements.

Effective January 1, 2008, the Company adopted various new CICA standards as follows:

Section 3862, Financial Instruments Disclosure and Section 3863, Financial Instruments Presentation, which replaces Section 3861 Financial Instruments Disclosure and Presentation. The new disclosure standard increases the emphasis on the risks associated with both recognized and unrecognized financial instruments and how those risks are managed.

Section 1535, "Capital Disclosures," effective for annual and interim periods related to fiscal years beginning on or after October, 1, 2007. This section establishes standards for disclosing information about a Company's capital and how it is managed in order that a user of the financial statements may evaluate the Company's objectives, policies, and processes for managed capital.

Section 3031, "Inventories", in March 2007, which is based on International Accounting Standard 2. The new section replaced the existing section 3030, Inventories. Under the new section, inventories are required to be measured at the "lower of cost and net realizable value", which is different from the existing guidance of the "lower of cost and market". The new section also allows the reversal of any write-downs previously recognized.

Section 1400, General Standards on Financial Statement Presentation, has been amended to include requirements to assess and disclose an entity's ability to continue as a going concern. The changes are effective for interim and annual financial statements beginning on or after January 1, 2008. For the quarter ending March 31, 2008, the Company has adopted this section in its consolidated financial statements.

In all cases, the Company has either adopted the new section(s) or has determined that there was no material impact as a result of the new section(s) to the consolidated audited financial statements for the quarter ended March 31, 2008.

Three months and six months ended June 30, 2008 compared to the three months and six months ended June 30, 2007 and the year ended December 31, 2007

CRITICAL ACCOUNTING ESTIMATES

The consolidated financial statements are prepared in accordance with Canadian GAAP, which require management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements. The Company has identified the policies below as critical to the business operations and an understanding of the results of the business operations. The application of these and other accounting policies are described in note 2 to the consolidated financial statements. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of the statements, and the reported amounts of revenue and expenses during the reporting period. There can be no assurance that actual results will not differ from those estimates.

Revenue Recognition

Certain product lines within Solectria (acquired in January 2005 - see note 3 to the Financial Statements), in addition to the G1 Shuttle Bus, which was launched into production during 2007, are no longer considered development stage. Therefore the Company recognizes revenues on the sales of those products at the point of shipment, provided that the Company has evidence of an arrangement, the fee is fixed and determinable, delivery has occurred, title and risk of loss have passed to the customer, and collection is reasonably assured.

In addition, the Company recognizes revenues on long term engineering contracts using the percentage of completion method. The revenue recognized is determined based on the total contract value and the percentage of the contract estimated completed at the end of the reporting period. Because of inherent uncertainties in estimating the costs to complete contracts in progress, it is possible that the estimates used will change within the near term. Changes in estimated job profitability are accounted for as changes in estimates in the current period. Where applicable, the entire amount of future estimated losses on contracts in progress are recognized when they become known.

Warranty Provision

The Company generally warrants its products against defects and workmanship for a period of one to three years from the date of shipment, subject to certain guidelines and exclusions. A provision has been established for this warranty obligation. In establishing the accrued warranty liability, management has estimated the likelihood that products sold will experience warranty claims and the estimated costs to resolve the claims received, taking into account the nature of the product and the past and projected claims experience with the products. Should these estimates prove to be incorrect, the Company may incur costs different from those provided for in the warranty provisions.

Inventory Provision

In establishing the appropriate provision for inventory obsolescence, management estimates the likelihood that inventory carrying values will be affected by changes in market demand for the Company's products and by changes in technology, which could make inventory on hand obsolete. The Company performs regular reviews to assess the impact of changes in technology, sales trends and other changes on the carrying value of inventory. Where it is determined that such changes have occurred and will have a negative impact on the value of inventory on hand, appropriate provisions are made. Unforeseen changes in these factors could result in additional inventory provisions being required.

Intangible Assets and Goodwill

As a result of the Solectria acquisition (see note 3 to the Annual Financial Statements), the Company recorded intangible assets and goodwill on the balance sheet. In accordance with Canadian GAAP, the Company does not amortize goodwill. Intangible assets are amortized over periods ranging from 2 to 10 years. At least annually, management reviews the carrying value of intangible assets and goodwill by segment for potential impairment. If circumstances indicate that impairment in the value of these assets has occurred, the impairment is recorded in the earnings of the current period.

Three months and six months ended June 30, 2008 compared to the three months and six months ended June 30, 2007 and the year ended December 31, 2007

Stock based compensation

The Company grants stock options to officers, directors, employees and consultants pursuant to the Company's stock option plan. The Company accounts for the stock-based compensation using the fair-value method as at the grant date. Under this method, compensation expense related to option grants is recorded in consolidated earnings over the vesting period of the options or, for consultants, as the work is performed. The compensation expense amount is based on the fair value of the option as estimated using the Black-Scholes option pricing model. The assumptions used in calculating the value of the stock options issued include management's best estimate, as of the date of grant, of the expected share price volatility over the term of the stock option and expected option life. As such, the amounts reported as compensation expense are subject to measurement uncertainty as the expense amount may vary significantly based on the assumptions used.

NEW ACCOUNTING PRONOUNCEMENTS AND DEVELOPMENT

Recent accounting pronouncements that have been issued but are not yet effective, and have a potential implication for the Company are as follows:

Goodwill and intangible assets

In February 2008, the CICA issued Section 3064 "Goodwill and intangible assets", replacing Section 3062, "Goodwill and other intangible assets". The new section will be applicable to financial statements relating to fiscal years beginning on or after October 1, 2008. Accordingly, the Company will adopt the new standards for its fiscal year beginning January 1, 2009. It established standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill are unchanged from the standards included in the previous Section 3062. The Company is currently evaluating the impact of the adoption of this new Section on its consolidated financial statements.

OTHER MD&A REQUIREMENTS

Management has designed disclosure controls and procedures to provide reasonable assurance that material information relating to the Company, including its consolidated subsidiaries, is made known to the Chief Executive Officer and the Chief Financial Officer by others within those entities, particularly during the period in which the annual filings of the Company are being prepared, in an accurate and timely manner in order for the Company to comply with its continuous disclosure and financial reporting obligations and in order to safeguard assets. Consistent with the concept of reasonable assurance, the Company recognizes that the relative cost of maintaining these controls and procedures should not exceed their expected benefits. As such, the Company's disclosure controls and procedures can only provide reasonable assurance, and not absolute assurance, that the objectives of such controls and procedures are met.

The Corporation's financial reporting procedures and practices have enabled the certification of Azure Dynamics' annual filings in compliance with Multilateral Instrument 52-109 "Certification of Disclosure in Issuers' Annual and Interim Filings". Management has designed such internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements and other annual filings in accordance with Canadian Generally Accepted Accounting Principles, except as noted below.

Given the size of the Company, the evaluation of the design of internal controls over financial reporting for the Company resulted in the identification of the following weaknesses:

Management is aware that due to its relatively small scale of operations there is a lack of segregation of duties due to a limited number of employees dealing with accounting and financial matters. However, management has concluded that considering the employees involved and the control procedures in place, including management and Audit Committee oversight, risks associated with such lack of segregation are not significant enough to justify the expense associated with adding employees to clearly segregate duties.

Three months and six months ended June 30, 2008 compared to the three months and six months ended June 30, 2007 and the year ended December 31, 2007

Management is aware that in-house expertise to deal with complex taxation, accounting and reporting issues may not be sufficient. The Company requires outside assistance and advice on new accounting pronouncements and complex accounting and reporting issues, which is common with companies of a similar size.

There have been no significant changes to the Company's internal control over financial reporting that occurred during the most recent interim period that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

ADDITIONAL INFORMATION

Additional information regarding Azure, including its Annual Information Form, can be found on SEDAR at www.sedar.com.