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Years Ended December 31, 2008 and 2007

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## MANAGEMENT'S DISCUSSION AND ANALYSIS

### Year Ended December 31, 2008 ("2008") compared to the Year Ended December 31, 2007 ("2007")

*This "Management's Discussion and Analysis" has been prepared as of March 31, 2009 and should be read in conjunction with the audited consolidated financial statements of Azure Dynamics Corporation ("Azure" or the "Company") for the year ended December 31, 2008 (the "Financial Statements").*

### 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 Manufacturers, component suppliers, and customers) thereby gaining access to product development support and established distribution networks which can help accelerate the penetration of its 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

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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 sells a variety of electric drive systems either direct to companies or through its distributors like Electro Automotive.

81 hybrid electric and 38 electric vehicle systems were shipped during the fourth quarter. Included in the 81, Balance™ Hybrid Electric stripped chassis; 78 were shipped to Purolator, 1 unit was shipped to a body builder for Con Edison and 1 unit was shipped to one of our Ford dealerships. 1 series hybrid Citibus™ was shipped to Startrans. Furthermore, of the 38 electric vehicle systems shipped in the quarter, 31 Force Drive™ were delivered to various customers and 7 LEEP™ Freeze systems were shipped to Kidron in which 6 were delivered to Buchy Foods in Ohio.

During the fourth quarter the Company aggressively continued its efforts to establish its distribution through Ford dealerships. On October 29, 2008 the Company announced that it had signed Sales & Service agreements with eight additional Ford dealerships, bringing the total dealership agreements to fourteen. 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.

**Azure G1 Hybrid and Citibus™ (series hybrid):**

The Azure G1 series hybrid delivery vans and Citibus™ 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 series hybrid vehicles have accumulated over 930,000 miles as of December 31, 2008. The vehicles are deployed in Montreal, Ottawa, Toronto and Vancouver. Eight of the 19 diesel hybrids have now surpassed 3 years in service, while all of the 30 gas series hybrids have exceeded one and a half years in service. Overall the fleet operating uptime remains greater than 98%. In addition to the Purolator fleet, BOEDC has operated 10 of their Citibus™ hybrids for 13 months.

As of December 31, 2008 the Company had shipped 16 of the 59 Azure CitiBus™ hybrid chassis (series hybrid) to Startrans for bus body build for various customers. 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.

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.

The Company incurred \$2.5 million (2007 – \$4.0 million) in gross research and development expenses for the year ended December 31, 2008 related to the Azure CitiBus™ (series hybrid) product line. Expenses continue to decreased compared to the prior year due to this product line being mostly complete with the exception of ongoing incidental development as mentioned above. During 2008, the Company recognized approximately \$2.3 million (2007 - \$1.8 million) in revenue on the sale of 16 shuttle buses. The Company has a plan to sell the additional buses in inventory and has established a list of potential customers. The Company continues to aggressively pursue these sales opportunities.

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**Balance™ Hybrid Electric (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 year, the Company completed the design release and production start of the 2009 model year version of the Balance™ hybrid stripped chassis. The 2009 model year shuttle bus is scheduled for production release early in the 1<sup>st</sup> quarter of 2009. Also in the fourth quarter, the Company substantially completed the build of 105 units for Purolator which were delivered to Purolator and were in the commissioning process. All 105 units are expected to be in service in the Greater Toronto Area early in the new year. The final Altoona Test Report was released to the public in November and the Balance™ Hybrid Electric shuttle bus is now eligible for funding programs administered by the Federal Transit Administration (FTA) in the United States. With the Citibus™ and Balance™ shuttle bus both having completed Altoona testing, Azure is the only Company to have two hybrid shuttle buses through Altoona testing.

Altoona testing subjects vehicle to a lifetime of usage in just a few months at the Altoona PA accelerated durability test center where harsh road conditions mimic real-world conditions endured by a commercial shuttle bus over a seven year, 200,000 mile cycle.

The successful completion of this test qualifies Ford E-450 shuttle buses built with Azure's Balance Hybrid electric drive train system for Federal Transit Authority (FTA) programs of up to 80% funding when purchased by public transit agencies across the United States. In addition to FTA programs, Azure's Balance Hybrid electric may qualify for up to a \$3,000 US Federal tax credit and/or numerous individual state agency programs.

The in-service Balance™ Hybrid fleet, including 20 FedEx Express trucks, 15 AT&T trucks and early miles on Purolator trucks have accumulated over 150,000 miles. The vehicles continue to demonstrate reliability with uptime over 97%. The 4 Balance™ Hybrid shuttle bus chassis which were delivered Startrans, Goshen Coach, Glaval and Turtle Top remain in use as marketing vehicles. A 2009 model Balance™ hybrid will be delivered to Champion Bus in the first quarter of 2009.

Also within the year, the Company developed and tested advancements to the current production Balance™ Hybrid system which will increase system efficiency as well as reduce the cost and weight versus the current system. The Company was able to demonstrate in test cells and prototype vehicles further advancements to its industry first belt starter generator system on a V8 engine. The production release of the next generation system is scheduled to launch in 2010 along with advanced Lithium battery pack technology.

The Company incurred \$6.3 million (2007 - \$3.6 million) in research and development expenses for the year ended December 31, 2008 related to internally funded Balance™ Hybrid Electric projects. The Company anticipates further costs for product development will be incurred in future quarters in order to validate this product. No costs have been deferred or capitalized. During 2008, the Company recognized approximately \$3.8 million (2007 - \$Nil) in revenue on sale of 149 shuttle buses, which were launched into production in the year.

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**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 and telecommunications 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 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. Within the year, 9 LEEP™ Freeze systems were shipped to Kidron in which 6 were delivered to Buchy Foods in Ohio.

The Company has signed a memorandum of understanding (MOU) with Altec, a leading manufacturer of aerial boom trucks for the utility, telecommunications and contractor markets. 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. During the 4<sup>th</sup> quarter a second prototype truck was built and commissioned, with additional testing performed on it. This truck will be delivered to Altec in the 1<sup>st</sup> quarter of 2009. The initial unit demonstrated approximately 30% fuel savings versus a conventional truck on a representative test cycle. The Company anticipates purchase orders for production deliveries to commence in 2009, and is preparing production capability accordingly.

The Company incurred \$0.8 million (2007 – \$0.1 million) in research and development expenses for the year ended December 31, 2008 related to internally funded LEEP projects. The Company anticipates further costs for product development will be incurred in 2009, in order to complete this product. No costs have been deferred or capitalized. During 2008, the Company recognized approximately \$0.1 million (2007 - \$Nil) in revenue on sale of 9 LEEP™ Freeze systems, which were launched into production in the year.

***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. The Company sold 31 Force Drive electric vehicle systems during the quarter to various customers engaged in the manufacture or conversion of pure electric vehicles.

In the second quarter of 2007, the Company announced it had signed a supply agreement with Electro Autos Eficaces (EAE) of Mexico. The Company has inventory on hand to supply initial delivery requirements for EAE as well as other ForceDrive™ system sales. Deliveries against this order have not yet commenced for reasons outside of the Company's control. As a direct result of the delays and uncertainty currently surrounding whether or not the program will launch, management has begun to evaluate alternative uses for the inventory and where possible sold against current Force Drive systems demand.

For the year ended December 31, 2008, the Company incurred minimal cost of \$0.1 million (2007 – \$0.1 million) in research and development expenses related to internally funded Electric Drive System projects. The Company does not anticipate additional product development in 2009. 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

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capitalized. Furthermore during 2008, the Company recognized approximately \$1.2 million (2007 – \$0.01 million) 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 148 at December 31, 2008. The Company leases facilities in Vancouver (20,000 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.

**Other Operational Developments****Johnson Controls-Saft Agreement**

On January 13, 2009 Azure Dynamics and Johnson Controls-Saft entered into a new supply agreement that will provide some of the world's most advanced lithium-ion (Li-ion) hybrid battery technology to power commercial vehicles in North America. The five-year supply agreement signals progress in the development of a U.S. supply base to help build an infrastructure for development and manufacture of hybrid electric vehicles.

**Restructuring**

On January 15, 2009 In light of today's economic challenging marketplace, Azure Dynamics reduced 25% of its current workforce along with expected reductions in all discretionary expense and a focus on actions to offset recent component cost increases. In addition the Company plans to further rationalize its product development efforts to focus on existing products and is actively working with its customers on potential new programs that involve sharing of development costs. Azure is also taking steps to enable the Company to access low cost U.S. and Canadian government loans supporting development of more fuel efficient vehicles.

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## OPERATING RESULTS, CASH FLOWS AND FINANCIAL CONDITION

*Selected Annual information (Stated in thousands, except per share amounts)*

| Years ended        | December 31,<br>2008 | December 31,<br>2007 | December 31,<br>2006 |
|--------------------|----------------------|----------------------|----------------------|
| Revenue            | \$ 7,651             | \$ 2,801             | \$ 5,771             |
| Net loss           | \$ (38,867)          | \$ (30,235)          | \$ (23,434)          |
| Net loss per share | \$ (0.12)            | \$ (0.14)            | \$ (0.14)            |
| Total assets       | \$ 43,691            | \$ 55,887            | \$ 56,299            |

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

|                                   | Q4, 2008<br>(Oct-Dec) | Q3, 2008<br>(Jul-Sep) | Q2, 2008<br>(Apr-Jun) | Q1, 2008<br>(Jan-Mar) |
|-----------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| Revenue                           | \$ 2,573              | \$ 1,325              | \$ 3,383              | \$ 370                |
| Gross margin                      | \$ (4,079)            | \$ (807)              | \$ (182)              | \$ (147)              |
| Expenses, net                     | \$ (10,453)           | \$ (7,502)            | \$ (7,937)            | \$ (7,760)            |
| Net loss for the period           | \$ (14,532)           | \$ (8,309)            | \$ (8,119)            | \$ (7,907)            |
| Net loss per share                | \$ (0.04)             | \$ (0.03)             | \$ (0.03)             | \$ (0.03)             |
| Weighted average number of shares | 379,376               | 316,333               | 279,376               | 279,376               |

|                                   | Q4, 2007<br>(Oct - Dec) | Q3, 2007<br>(Jul - Sep) | Q2, 2007<br>(Apr - Jun) | Q1, 2007<br>(Jan-Mar) |
|-----------------------------------|-------------------------|-------------------------|-------------------------|-----------------------|
| Revenue                           | \$ 518                  | \$ 1,534                | \$ 593                  | \$ 156                |
| Gross margin                      | \$ (179)                | \$ (197)                | \$ (10)                 | \$ 89                 |
| Expenses, net                     | \$ (8,179)              | \$ (8,257)              | \$ (6,906)              | \$ (6,596)            |
| Net loss for the period           | \$ (8,359)              | \$ (8,454)              | \$ (6,916)              | \$ (6,507)            |
| Net loss per share                | \$ (0.03)               | \$ (0.04)               | \$ (0.03)               | \$ (0.03)             |
| Weighted average number of shares | 259,101                 | 198,276                 | 198,276                 | 198,275               |

### Results of Operations

For the year ended December 31, 2008, the Company incurred a net loss of \$38.9 million (\$0.12 per share) compared to a net loss of \$30.2 million (\$0.14 per share) in the prior year. The higher loss in the current year is primarily attributable to higher than expected product development costs and negative gross margin during the year. Product development costs were higher during the current year 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 year is primarily the result of production variances, increases in certain component costs and inventory write downs.

The Company incurred a net loss of \$14.5 million (\$0.04 per share) in the fourth quarter of 2008 compared to a net loss of \$8.4 million (\$0.03 per share) in the fourth quarter of the prior year. The higher loss in the current year quarter is related to the higher level of activities in product development as noted above. Gross margin was also lower by \$3.9 million in the current year quarter, which was primarily attributable to increases in certain component costs and inventory write downs.

As a result of the early stage in the Company's development, 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 2008 reflect early production revenues from the

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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 and Gross Margin: Revenue for the year ended December 31, 2008 was \$7.7 million (2007 – \$2.8 million). The higher revenue in the current year is attributable to sales of 9 Azure CitiBus™ (G1 series hybrid) shuttle buses recorded in 2007 compared to 16 shuttle buses, 149 Balance Hybrid Electric (P1 hybrid electric) systems and 9 LEEP™ Freeze systems recorded in 2008. After considering direct and applicable indirect costs of sales, the gross margin contribution from revenue in the current year was negative \$5.2 million compared to \$0.3 million in the prior year (gross margin as percentage of sales was negative 68% in 2008 versus 11% in 2007). The decrease in gross margin contribution in the current year is a result of production variances, increases in certain component costs, and inventory write downs. Production variances incurred are typical negative production variances associated with lower volume early stage production. During the year the Company received notification of a significant price increase for a major component of its hybrid electric system. The Company is aggressively pursuing alternative options to mitigate the impact of this increase. However, as a direct result of this component price increase, the Company anticipates it will not be able to fully recover the inventory cost upon the sale of certain systems and accordingly has written down the inventory to the net realizable value.

Engineering, research, development and related costs, net: Before contributions, the Company expended \$21.5 million on engineering, research and development operations in 2008 (2007 – \$17.8 million), including \$11.6 million in respect of product development costs (2007 – \$10.0 million). In 2008, the Company reserved contributions receivable related to TPC of \$1.3 million, of which \$0.8 million related to 2007 which increased current year engineering, research and development costs. For the quarter, the Company expended \$6.0 million (2007 - \$5.0 million) on engineering, research and development operations and \$3.1 million (2007 – \$2.7 million) in product development. At December 31, 2008, Azure employed 118 research, engineering, operations and technical personnel (2007 – 102). 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 \$11.6 million (2007 – \$10.0 million) in the year included the continuation of Balance™ Hybrid Electric system development, costs related to the development and enhancement of system components and ongoing Azure CitiBus™ series hybrid maintenance.

During the year ended December 31, 2008, the Company claimed \$nil (2007 - \$1.1 million) of reimbursable costs. Reimbursable costs are recorded as a credit to research and development expenses on the income statement; claims not settled by the balance sheet date are recorded as assets (contributions receivable) on the balance sheet. Throughout 2008, the Company has held discussions with TPC with respect to extending the length of the program and also to modify the scope of the program to include additional costs related to the development of the P1 parallel hybrid program. Azure's application to request an amendment has been submitted and is currently under review. Management believes that its request will be approved. However, since TPC is under no contractual obligation to grant the requested amendment, the Company has fully reserved for this contribution receivable. As at December 31, 2008 contributions receivable related to TPC of \$1.3 million (2007 - \$1.1 million) has been fully reserved for while the Company continues to obtain finalization of its claims.

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 year 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 \$3.4 million in the year compared to \$3.7 million in 2007. Selling and marketing costs in the fourth quarter were \$1.0 million, compared to \$1.1 million in the fourth quarter of 2007. The decrease in the fourth quarter and in the current year is primarily related to lower salary levels. The headcount at December 31, 2008 was 9 employees (2007 – 9).

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General and administrative: General and administrative costs were \$7.3 million in the year compared to \$7.8 million in 2007. General and administrative costs in the fourth quarter was \$2.0 million, compared to \$1.9 million in the fourth quarter of 2007. Although the headcount is higher by four in the current year versus the prior year, the decrease is primarily related to lower salary levels as a result of the reorganization announced in early 2008. The headcount at December 31, 2008 was 21 (2007 – 17).

Amortization: Amortization of property, equipment and other assets was \$1.0 million in the year and \$0.3 million in the fourth quarter compared to \$0.9 million for the year and \$0.3 million in the fourth quarter in 2007. Property and equipment primarily consists of workshop equipment, tooling, computer hardware and software. The Company purchased assets with a value of \$1.6 million in the year (2007 - \$1.4 million) and \$0.1 million in the fourth quarter (2007 – \$0.3 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 \$1.4 million in the year (2007 – \$1.4 million) and \$0.3 million in the fourth quarter (2007 - \$0.3 million). Amortization of property, equipment and other assets are allocated to the relevant cost categories on the Statement of Operations.

Other expenses: Other expenses totalled \$0.6 million year to date (2007 - \$2.6 million) and \$7 thousand in the fourth quarter (2007 - \$0.9 million). The 2007 expenses primarily related to severance cost for UK personnel in respect to the closure of the UK facility and severance costs related to senior management changes paid in respect to the Company's contractual obligations under employment arrangements.

Foreign currency losses: Foreign currency losses totalled \$403,000 (2007 – loss of \$82,000) for the year and \$340,000 in the fourth quarter (2007 - loss of \$28,000). These were mainly unrealised losses in respect of foreign currency cash balances which reversed out subsequent to the quarter and year end.

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**Balance Sheet Discussion:**

Cash and cash equivalents: Cash and cash equivalents at December 31, 2008 were \$13.8 million compared to \$24.1 million at December 31, 2007 and \$21.2 million at September 30, 2008. Net cash outflows were approximately \$10.3 million in the year compared to net cash outflows of \$3.3 million for the prior year. The increase in cash outflows of \$7.0 million in the current year is primarily attributable to the increased net loss (\$8.6 million higher after adjusting for non cash items), a lower level of net equity financings (\$3.5 million lower in the current year), partially offset by a decrease in non cash working capital of \$4.4 million and a decrease in capital expenditures (\$0.2 million lower in the current year). In the fourth quarter, the Company's cash and cash equivalents decreased by \$7.4 million compared to an increase of \$18.2 million in the fourth quarter of 2007. The increase in cash outflows in the current year quarter of \$25.6 million is primarily a result of the higher net loss (\$6.4 million higher in the current year after adjusting for non cash items) and a lower level of net equity financings (\$28.0 million lower in the fourth quarter of the current year), partially offset by a decrease in non cash working capital of \$8.5 million and a decrease in capital expenditures (\$0.2 million lower in the current year).

Accounts receivable: Accounts receivable at December 31, 2008 were \$2.3 million compared to \$0.6 million at December 31, 2007 and \$3.1 million at September 30, 2008. The increase in accounts receivable is due to increased sales activity.

Contributions receivable: Contributions receivable were \$nil at December 31, 2008 (\$1.1 million at December 31, 2007, \$1.2 million at September 30, 2008). The decrease in the current year end compared to the balance at the end of the third quarter and prior year is related to the reserve of the TPC claim payments. Throughout 2008, the Company has held discussions with TPC with respect to extending the length of the program and also to modify the scope of the program to include additional costs related to the development of the P1 parallel hybrid program. Azure's application to request an amendment has been submitted and is currently under review. Management believes that its request will be approved. However, since TPC is under no contractual obligation grant the requested amendment, and in accordance with generally accepted accounting principles, the Company has fully reserved for this contribution receivable. As at December 31, 2008 contributions receivable related to TPC of \$1.3 million (2007 - \$1.1 million) has been fully reserved for as described above.

Inventory: Inventory and related prepayments were \$8.3 million at December 31, 2008 compared to \$10.2 million at December 31, 2007 and \$11.9 million at September 30, 2008. The lower inventory amount at December 31, 2008 compared to the prior year end and the third quarter is primarily due to the write downs of inventory to the net realizable value.

Prepaid expenses: Prepaid expenses at December 31, 2008 were \$0.7 million compared to \$0.7 million at December 31, 2007 and \$0.8 million At September 30, 2008.

Property and equipment: Net property and equipment which also includes assets under capital lease were \$6.2 million at December 31, 2008 compared to \$5.7 million at December 31, 2007 and \$6.3 million at September 30, 2008. The increase compared to the prior year end is related to capital purchases of additional workshop equipment, tooling equipment and computer hardware and software offset by additional amortization. The premises occupied in Boston are leased from a joint venture ("ND Solectria LLC") established with a Boston real estate development Company, in which Azure is a 50% owner. The Company's proportionate share (50%) of the fair market value of the joint venture property and equipment is included within this account and was approximately \$3.0 million at December 31, 2008 (2007 - \$3.0 million).

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 \$8.0 million at December 31, 2008 (\$9.3 million at December 31, 2007 and

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\$8.3 million at September 30, 2008). The lower amount at the end of 2008 is attributable to amortization.

Accounts payable and accrued liabilities: Accounts payable and accrued liabilities were \$4.8 million at December 31, 2008 compared to \$4.3 million at December 31, 2007 and \$4.2 million at September 30, 2008.

Customer deposits and deferred revenues: Current and long-term deferred revenue and customer deposits total \$1.2 million at December 31, 2008 compared to \$1.1 million at December 31, 2007 and \$1.2 million at September 30, 2008. 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 17-year duration of the agreement.

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 December 31, 2008, total obligations under the notes payable were \$2.5 million compared to \$2.1 million at December 31, 2007 and \$2.2 million at September 30, 2008.

Share capital: Share capital at December 31, 2008 was \$165.0 million compared to \$140.7 million at December 31, 2007 and \$165.1 million at September 30, 2008. The increase in share capital at the current year end compared to the prior year is primarily related to the equity financings in August 2008 (increase to share capital of \$24.3 million).

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

|  | March 31,<br>2009 | December 31,<br>2008 | December 31,<br>2007 |
|--|-------------------|----------------------|----------------------|
| Common shares  | 379,376,177       | 379,376,177          | 279,376,177          |
| Deferred Share Units   | 3,686,857         | 3,686,857            | 2,124,727            |
| Stock options issued under the Stock Option Plan, with expiry dates ranging up until January 21, 2016 and average exercise price of \$0.40 | 28,679,126        | 15,080,126           | 14,451,626           |

During the period from December 31, 2008 to March 31, 2009, the Company did not issue common shares or DSU's.

**CUSTOMER DEPOSITS AND DEFERRED REVENUE**

In November 2003, Solectria entered into a Transfer of Technology and Software Licensing Agreement ("TTA Agreement") with Singapore Technologies Kinetics ("STK"), a former shareholder. 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 December 31, 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 December 31, 2008, the Company has deferred revenue associated with the TTA Agreement in the amount of \$0.8 million. During the year ended December 31, 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 \$62,000 (2007 - \$65,000).

**LIQUIDITY, CAPITAL RESOURCES AND RISK FACTORS**

At December 31, 2008 the Company had \$15.2 million (December 31, 2007 – \$25.3 million) in net cash

## Years Ended December 31, 2008 and 2007

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 December 31, 2008 approximately \$1.4 million of cash was restricted (2007 – \$1.2 million). The restricted cash is related to a security deposit in respect of the facility in Boston (\$1.0 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 \$ 19.8 million at December 31, 2008 compared to \$32.3 million at December 31, 2007. The decrease in working capital is primarily due to the lower cash balances at the current year end (lower by \$10.3 million).

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, 2008 the Company had claimed approximately \$7.5 million in accordance with the terms of the TPC agreement. Furthermore, the Company is currently in discussions with TPC to include additional development costs of up to \$1.2 million for cost reimbursement. However, at this time, the outcome of these discussions remains 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 31, 2009 (this document and additional information relating to the Company is available for inspection at [www.sedar.com](http://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 December 31, 2008 The Company had the following contractual obligations and operating lease commitments:

| (stated in thousands)               | Payments due by period |                  |           |           |               |
|-------------------------------------|------------------------|------------------|-----------|-----------|---------------|
|                                     | Total                  | Less than 1 year | 1-3 years | 4-5 years | After 5 years |
| Contractual Obligations             |                        |                  |           |           |               |
| Operating leases <sup>(1)</sup>     | 7,794                  | 1,360            | 2,650     | 2,609     | 1,175         |
| Purchase obligations <sup>(2)</sup> | 5,316                  | 5,316            | -         | -         | -             |
| Long term debt <sup>(3)</sup>       | 2,533                  | 74               | 2,459     | -         | -             |
| Capital leases <sup>(4)</sup>       | 374                    | 143              | 195       | 36        | -             |
| Total contractual obligations       | 16,017                 | 6,893            | 5,304     | 2,645     | 1,175         |

(1) See note 17 to the Financial Statements for details of facility operating leases

(2) Purchase obligations are agreements to purchase goods or services

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**Years Ended December 31, 2008 and 2007**

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- (3) See note 4 to the Financial Statements for details of long term debt  
(4) See note 10 to the Financial Statements for details of capital leases

***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 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.

**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 and P1 delivery van, 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.

**Years Ended December 31, 2008 and 2007**Warranty Provision

The Company generally warrants its products against defects and workmanship for a period of one to five 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.

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:

General standards of financial statement presentation

Effective January 1, 2008, the Company adopted the amendments to Section 1400, "General Standards of Financial Statement Presentation" related to management's responsibility to assess the ability of an entity to continue as a going concern. Management is required to make an assessment on an entity's ability to continue as a going concern and should take into account all available information about the future, which is at least but not limited to 12 months from the balance sheet date. Disclosure is required of material uncertainties related to events and conditions that may cast significant doubt upon the entity's ability to continue as a going concern. The adoption of this standard had no impact on the Company's presentation of its financial position or results of operations as at December 31, 2008 and for the year then ended.

Capital disclosures

Effective January 1, 2008, the Company adopted Section 1535 "Capital Disclosures". This standard 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

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**Years Ended December 31, 2008 and 2007**

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managing capital (note 15).

#### Inventories

Effective January 1, 2008, the Company adopted Section 3031 "Inventories", which is based on International Accounting Standard 2. Under the new standard, 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 standard also allows for the reversal of write-downs previously recognized (note 6).

#### Financial instruments – disclosure and presentation

Effective January 1, 2008, the Company adopted two new CICA standards related to the disclosure and presentation of financial instruments. Section 3862, "Financial Instruments Disclosure" and Section 3863 "Financial Instruments Presentation" replaced 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. The new presentation standard carries forward the former presentation requirements (note 16).

#### Goodwill and Intangibles 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 establishes 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.

#### Financial Statement Concepts

CICA Handbook Section 1000, Financial Statement Concepts has been amended to focus on the capitalization of costs that truly meet the definition of an asset and de-emphasizes the matching principle. The revised requirements are effective for annual and interim financial statements relating to fiscal years beginning on or after October 1, 2008. The Company is currently evaluating the impact of the adoption of this change on the disclosure within its financial statements.

#### International financial reporting standards (IFRS)

In February 2008, Canada's Accounting Standards Board confirmed that IFRS will replace Canadian GAAP for publicly accountable enterprises for financial periods beginning on and after January 1, 2011. The Company's first mandatory filing under IFRS will be the first quarter of 2011 which will contain IFRS compliant information on a comparative basis. Due to the anticipated changes to IFRS prior to transition, it is currently not possible to fully determine the impact on the Company's consolidated results.

#### Business combinations, consolidated financial statements and non-controlling interests

In January 2009, the CICA adopted sections 1582, "Business Combinations", 1601, "Consolidated Financial Statements", and 1602 "Non-Controlling Interests" which superseded current sections 1581, "Business Combinations" and 1600 "Consolidated Financial Statements". These sections will be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011. Earlier adoption is permitted. If an entity applies these sections before January 1, 2011, it is required to disclose that fact and apply each of the new sections concurrently. These new sections were created to converge Canadian GAAP to IFRS.

### **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

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**Years Ended December 31, 2008 and 2007**

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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.

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