
**Azure Dynamics Corporation
(A Development Stage Enterprise)
Consolidated Financial Statements**

For the year ended December 31, 2003, six months ended December 31, 2002
and the year ended June 30, 2002

Auditors' Report	2
Consolidated Financial Statements	
Consolidated Balance Sheets	3
Consolidated Statements of Operations and Deficit	4
Consolidated Statements of Cash Flows	5
Notes to Consolidated Financial Statements	6-23
Supplementary Information	24



BDO Dunwoody LLP
Chartered Accountants
and Advisors

1900, 801 – 6 Avenue S.W.
Calgary, Alberta Canada T2P 3W2
Telephone: (403) 266-5608
Fax: (403) 233-7833

Driving Growth

Auditors' Report

To the Shareholders of Azure Dynamics Corporation

We have audited the consolidated balance sheets of Azure Dynamics Corporation (a development stage enterprise) as at December 31, 2003 and 2002, and June 30, 2002 and the consolidated statements of operations and deficit and cash flows for the year ended December 31, 2003, six months ended December 31, 2002, and the year ended June 30, 2002, respectively. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2003 and 2002, and June 30, 2002 and the results of its operations and its cash flows for the year ended December 31, 2003, the six months ended December 31, 2002, and the year ended June 30, 2002, respectively, in accordance with Canadian generally accepted accounting principles.

"signed BDO Dunwoody LLP"

Chartered Accountants

Calgary, Alberta
March 11, 2004

Azure Dynamics Corporation
(A Development Stage Enterprise)
Consolidated Balance Sheets

As at	December 31 2003	December 31 2002	June 30 2002
Assets			
Current			
Cash and cash equivalents (Note 5)	\$ 9,075,219	\$ 1,030,594	\$ 1,896,248
Accounts receivable	337,794	28,253	68,327
Contributions receivable (Note 12)	780,459	264,455	567,626
Prepaid expenses	61,655	13,320	53,961
	<u>10,255,127</u>	<u>1,336,622</u>	<u>2,586,162</u>
Employee loans (Note 8(i))	91,727	259,214	259,214
Property and equipment (Note 6)	162,048	276,036	372,019
Other assets (Note 7)	117,279	95,992	97,005
	<u>\$ 10,626,181</u>	<u>\$ 1,967,864</u>	<u>\$ 3,314,400</u>

Liabilities and Shareholders' Equity

Current

Accounts payable and accrued liabilities	\$ 567,692	\$ 347,313	\$ 442,625
Obligations under capital leases	-	9,796	13,748
	<u>567,692</u>	<u>357,109</u>	<u>456,373</u>

Obligations under capital leases

	-	-	2,575
	<u>567,692</u>	<u>357,109</u>	<u>458,948</u>

Shareholders' equity

Share capital (Note 10(b))	23,991,665	11,788,905	11,195,038
Special warrants (Note 10(c))	-	90,000	-
Contributed surplus (Note 10(c)(viii and ix))	167,798	-	-
Deficit	(14,100,974)	(10,268,150)	(8,339,586)
	<u>10,058,489</u>	<u>1,610,755</u>	<u>2,855,452</u>
	<u>\$ 10,626,181</u>	<u>\$ 1,967,864</u>	<u>\$ 3,314,400</u>

Approved on behalf of the Board:

"signed D. Campbell Deacon" Director
D. Campbell Deacon

"signed Dennis A. Sharp" Director
Dennis A. Sharp

Azure Dynamics Corporation
(A Development Stage Enterprise)
Consolidated Statements of Operations and Deficit

	Years ended December 31		Six months ended December 31		Year ended June 30	Cumulative Since Inception
	2003	2002	2002	2002	2002	
	(Unaudited)					
Revenue						
Contract sales	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 258,066
Other	47,383	51,818	18,833	78,469	78,469	186,551
	47,383	51,818	18,833	78,469	78,469	444,617
Cost of contract sales	-	-	-	-	-	101,073
	47,383	51,818	18,833	78,469	78,469	343,544
Expenses						
Research and development, net (Note 12)	1,143,599	1,845,360	690,574	2,395,838	2,395,838	5,632,710
Selling and marketing	718,345	772,737	320,904	756,341	756,341	1,977,775
General and administrative	1,306,474	1,665,759	708,432	1,652,848	1,652,848	4,575,247
Rent	219,392	401,230	117,239	408,913	408,913	943,534
Amortization of capital and other assets	198,684	193,603	110,248	163,061	163,061	563,874
Stock option compensation costs	131,426	-	-	-	-	131,426
Amortization of deferred financing costs	88,143	-	-	-	-	88,143
Accretion expense on convertible debentures	74,144	-	-	-	-	74,144
	3,880,207	4,878,689	1,947,397	5,377,001	5,377,001	13,986,853
Net loss for the period before other items	(3,832,824)	(4,826,871)	(1,928,564)	(5,298,532)	(5,298,532)	(13,643,309)
Lease termination (Note 4)	-	457,665	-	457,665	457,665	457,665
Net loss for the period	(3,832,824)	(5,284,536)	(1,928,564)	(5,756,197)	(5,756,197)	(14,100,974)
Deficit, beginning of period	(10,268,150)	(4,983,614)	(8,339,586)	(2,583,389)	(2,583,389)	-
Deficit, end of period	\$ (14,100,974)	\$ (10,268,150)	\$ (10,268,150)	\$ (8,339,586)	\$ (8,339,586)	\$ (14,100,974)
Earnings per share – basic *	(0.08)	(0.13)	(0.04)	(0.18)	(0.18)	
Weighted average number of shares – basic	47,425,079	41,381,502	43,682,571	31,691,179	31,691,179	

* No diluted earnings per share have been disclosed, as these would be anti dilutive.

The accompanying notes are an integral part of these consolidated financial statements.

Azure Dynamics Corporation
(A Development Stage Enterprise)
Consolidated Statements of Cash Flows

	Years ended December 31		Six months ended December 31	Year ended June 30	Cumulative Since Inception
	2003	2002	2002	2002	
Cash flows from operating activities		(unaudited)			
Net loss for the period	\$ (3,832,824)	\$ (5,284,536)	\$ (1,928,564)	\$ (5,756,197)	\$ (14,100,974)
Adjustments for:					
Amortization of capital and other assets	198,684	193,603	110,248	163,061	563,874
Lease termination (Note 4)	-	457,665	-	457,665	457,665
Common shares issued in exchange for services	25,000	-	-	-	50,000
Stock option compensation expenses	131,426	-	-	-	131,426
Accretion expenses of convertible debenture	74,144	-	-	-	74,144
Amortization of deferred financing costs	88,143	-	-	-	88,143
Changes in non-cash working capital items (Note 14)	(653,050)	(669,504)	288,574	(467,823)	(784,871)
	(3,968,477)	(5,302,772)	(1,529,742)	(5,603,294)	(13,520,593)
Cash flows from financing activities					
Issuance of common shares (net of costs)	9,952,940	5,876,987	593,867	5,078,120	18,461,414
Issuance of special warrants (net of costs)	-	-	90,000	-	3,500,000
Convertible debentures funds received (net of costs)	2,008,905	-	-	-	2,008,905
Changes in related party advances	-	-	-	14,156	-
Repayment of obligations under capital lease	(9,797)	(12,321)	(6,527)	(10,993)	(27,316)
Repayment of long term debt	-	-	-	-	(50,000)
	11,952,048	5,864,666	677,340	5,081,283	23,893,003
Cash flows from investing activities					
Acquisition of capital assets	(45,516)	(138,408)	605	(392,616)	(805,447)
Acquisition of subsidiary	-	-	-	-	(249,610)
Acquisition of intellectual properties	(60,467)	(59,604)	(13,857)	(62,864)	(149,959)
Changes in loans to employees	167,037	14,287	-	14,287	(92,177)
	61,054	(183,725)	(13,252)	(441,193)	(1,297,193)
Increase (decrease) in cash and cash equivalents	8,044,625	378,169	(865,654)	(963,204)	9,075,217
Cash and cash equivalents, beginning of period	1,030,594	652,425	1,896,248	2,859,452	2
Cash and cash equivalents, end of period	\$ 9,075,219	\$1,030,594	\$ 1,030,594	\$ 1,896,248	\$ 9,075,219

The accompanying notes are an integral part of these consolidated financial statements.

Azure Dynamics Corporation
(A Development Stage Enterprise)
Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

1. Nature of Operations and Basis of Presentation

Azure Dynamics Corporation ("the Company") ("ADC") is incorporated under the laws of Alberta. The Company was party to a reverse takeover transaction ("RTO") between ADC (the deemed acquiree) and Azure Dynamics Inc. ("ADI") (the deemed acquirer), effective April 24, 2001. The corporate structure is currently that ADI is the wholly owned subsidiary of ADC. ADI is incorporated under the laws of Canada. On December 31, 2002, in order to harmonize its financial reporting requirements with internal operations and its industry sector, management made application to change the reporting year-end for the consolidated entities to December 31 from June 30.

The Company is a development stage enterprise, involved in developing adaptive hybrid electric vehicle control systems to be used in commercial vehicle applications. The Company has not yet determined the ultimate economic viability of the products under development. The Company is currently in the process of testing its control systems. All costs incurred to date have been recorded as research and development expense. No commercial revenue has been generated from the sale of its products to date.

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles on a going concern basis which presumes the realization of assets and discharge of liabilities in the normal course of business for the foreseeable future. There are several development stages to be completed before the marketability, if any, of the Company's technology can be determined. While the Company has derived limited revenue from the performance of research and development projects for third parties, its ability to continue operations is uncertain and dependent upon the successful completion of technical development of the technology, obtaining additional financing and achieving profitable operations. The outcome of these matters cannot be predicted at this time. These consolidated financial statements do not include any adjustments to the amounts and liabilities that might be necessary should the Company be unable to continue in business.

2. Significant Accounting Policies

The consolidated financial statements of the Company have been prepared by management in accordance with Canadian generally accepted accounting principles. The preparation of consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. The consolidated financial statements have, in management's opinion, been properly prepared using careful judgment with reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

(a) Consolidation

The consolidated financial statements include the accounts of ADI since July 1, 1999, the date it commenced operations, and the accounts of ADC since the effective RTO date of April 24, 2001.

(b) Revenue recognition

Revenue from contractual projects is to be recognized on a percentage-of-completion basis based on the ratio of actual costs incurred to the estimated total cost to complete the project. Provision for loss on contracts is recorded in the period in which the loss is determined.

Azure Dynamics Corporation
(A Development Stage Enterprise)
Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

2. Significant Accounting Policies (cont'd.)

(c) Research and development costs

Research costs are expensed in the year incurred. Development costs are expensed in the year incurred unless the Company believes a development project meets generally accepted criteria for deferral and amortization. No development costs have been deferred to date.

Reimbursements of eligible costs pursuant to government assistance programs are recorded as a reduction of research and development costs when the related costs have been incurred. Claims not settled by the balance sheet date are recorded as "Contributions receivable" on the consolidated balance sheets. The determination of the amount of the claim, and hence the receivable amount, requires management to make calculations based on its interpretation of eligible expenditures in accordance with the terms of the programs. The reimbursement claims submitted by the Company are subject to review by the relevant government agencies. Although the Company has used its best judgment and understanding of the related program agreements in determining the receivable amount, it is possible that the amounts could increase or decrease by a material amount in the near term dependent on the review and audit by the government agency.

The government assistance programs typically incorporate repayment provisions that are contingent upon future trigger-events. In these cases, a repayment liability is recorded when the event occurs or it is considered more likely than not that the event will occur. With respect to repayments in the form of future royalty payments based on sales levels achieved, the liability will be recorded as sales are made by the Company.

(d) Investment tax credits

The benefits of investment tax credits for scientific research and development expenditures are recognized in the year the qualifying expenditure is made provided there is reasonable assurance of recoverability. The investment tax credit reduces the carrying cost of expenditures for capital assets and research and development expense. Since becoming a public company, the Company is no longer eligible to receive cash refunds from the investment tax credit program – all past investment tax credits receivable in cash have been collected. Since becoming a public company, investment tax credits earned are being carried forward to reduce future federal taxes payable. These investment tax credits have not been recorded as their ultimate utilization is uncertain.

(e) Property and equipment

Property and equipment are recorded at cost, less accumulated amortization. Amortization is provided on a straight-line basis over the estimated useful life of the assets.

The following is a summary of estimated useful lives of the assets:

Laboratory equipment	5 years	Office furniture and equipment	5 years
Computer software	2 years	Automotive	3 years
Computer hardware	3 years	Leasehold improvements	1 to 5 years

(f) Cash and cash equivalents

The Company considers bank balances (including temporary bank overdrafts) and all highly liquid instruments purchased with an original maturity of three months or less to be cash equivalents.

(g) Financial instruments

The Company carries a number of financial instruments. Unless otherwise indicated, it is management's opinion that the Company is not exposed to significant interest, currency or credit risks arising from these financial instruments. The fair values of these financial instruments approximate their carrying values, unless otherwise noted.

Azure Dynamics Corporation
(A Development Stage Enterprise)
Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

2. Significant Accounting Policies (cont'd.)

(h) Foreign currency translation

The Company follows the temporal method of accounting for the translation of foreign currency amounts into Canadian dollars. Under this method monetary assets and liabilities are translated into Canadian dollars at the exchange rate in effect at the balance sheet date. Revenue and expenses are translated at monthly average exchange rates throughout the year. Foreign exchange gains or losses are reflected in the results of operations.

(i) Other assets

The costs of acquiring and applying for patents, trademarks and licensed technology are capitalized and amortized on a straight-line basis over their estimated useful lives of five years.

The costs of acquiring and applying for patents, trademarks and licensed technology costs do not necessarily reflect present or future values and the ultimate amount recoverable will be dependent upon the successful development and commercialization of products based on these intellectual properties. Management reviews the intellectual properties for impairment whenever events or changes in circumstances indicate that full recoverability is questionable. Management measures any potential impairment by comparing the carrying value to the undiscounted amounts of expected future cash flows.

(j) Future income taxes

Income taxes are accounted for using the liability method of tax allocation. Future income taxes are recognized for the future income tax consequences attributable to differences between the carrying values of assets and liabilities and their respective income tax bases. Future income tax assets and liabilities are measured using substantively enacted income tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in rates is included in earnings in the period that includes the enactment date. Future income tax assets are recorded in the consolidated financial statements if realization is considered more likely than not.

(k) Stock based compensation

The Company grants stock options to officers, directors, employees and consultants pursuant to a stock option plan described in Note 10(d). Prior to December 31, 2002, no compensation was recognized for this plan when stock options were granted. Any consideration received on the exercise of stock options or the purchase of stock was credited to share capital. Effective January 1, 2003, the Company accounts for its stock-based compensation programs using the fair-value method. Under this method, compensation expense related to these programs is recorded in the statement of income over the vesting period. The compensation expense amount is determined 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 are based on management's best estimate of the expected volatility over the term of the stock option as of the date of grant. As such, the amounts reported as compensation expense are subject to measurement uncertainty as the expense amount may vary significantly based on the volatility factor used.

(l) Deferred financing costs

Financing costs relating to the issue of debt instruments are deferred on the balance sheet and are amortized over the terms of the debt instruments.

Azure Dynamics Corporation
(A Development Stage Enterprise)
Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

2. Significant Accounting Policies (cont'd.)

(m) Earnings per share

Basic earnings per common share are computed by dividing earnings by the weighted average number of common shares outstanding for the period. Diluted per share amounts reflect the potential dilution that could occur if securities or other contracts to issue common shares were exercised or converted to common shares. The treasury stock method is used to determine the dilutive effect of stock options and other dilutive instruments, in accordance with standards approved by the Canadian Institute of Chartered Accountants.

(n) Debt instruments

On the issue of convertible debt instruments, the liability component and the equity component as determined at initial recognition, is presented separately. The Company values the equity component of debt instruments using the 'residual value of equity component' method, whereby the liability component is valued first using the current market rates for comparable instruments, at the time of issuance, and the difference between the proceeds of the debt instrument issued and the fair value of the liability is assigned to the equity component. The liability element is subsequently reported at amortized cost. Accretion of the debt discount is recognized in the income statement over the duration of the debt instrument. The value of the equity conversion option recognized at the time of issuance is not changed in future periods. Upon conversion of convertible debt instruments, the remaining face value of the debt outstanding and the initial value attributed to the equity conversion option is attributed to the shares issued on conversion.

3. Business Combinations

Pursuant to the reverse takeover ("RTO") transaction, effective April 24, 2001, ADC effected a stock consolidation of 1 share for each 10 shares of its issued and outstanding shares resulting in 1,526,269 common shares issued and outstanding to its shareholders, on April 24, 2001. ADC, the legal acquirer, issued 22,944,740 common shares for the acquisition of ADI at a deemed price of \$0.25 per share. The acquisition has been accounted for as a purchase transaction with ADI being the deemed acquirer as the transaction was a reverse takeover. The carrying values of the assets and liabilities of ADC as at the effective date, April 24, 2001, were as follows:

Other current assets	\$ 3,843
Current liabilities	(30,116)
Working capital deficiency	(26,273)
Capital assets	1,700
Note payable to ADI	(250,000)
Net deficiency, attributed to the 1,526,269 common shares issued and outstanding prior to the RTO	\$ (274,573)

The excess of consideration given over the fair value of the net assets has been reflected as a reduction of share capital, representing the cost to ADI of becoming a public company by effecting a RTO.

Azure Dynamics Corporation
(A Development Stage Enterprise)
Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

4. Lease Termination

Effective June 30, 2002, the Company entered into a lease termination agreement whereby it was released from the terms and conditions of a five-year property lease agreement for office and facility premises. The premises were never occupied by the Company, and as a result of the lease termination, pre-occupation costs (leasehold improvements and prepaid expenses) were written-off in the year ended June 30, 2002.

A summary of the costs expensed and lease termination exit costs are as follows:

Lease termination payment	\$	205,000
Pre-occupation costs		247,665
Legal costs		5,000
	<u>\$</u>	<u>457,665</u>

In conjunction with the lease termination agreement, the landlords of the property agreed to subscribe for 240,000 common shares of the Company, at a price of \$0.50 per share, for gross proceeds of \$120,000.

5. Cash and Cash Equivalents

	December 31 2003	December 31 2002	June 30 2002
Cash (bank indebtedness) in bank	\$ 8,989,323	\$ 93,643	\$ (62,465)
Short term investments	35,896	886,951	1,908,713
Restricted investment	50,000	50,000	50,000
	<u>\$ 9,075,219</u>	<u>\$ 1,030,594</u>	<u>\$ 1,896,248</u>

The restricted investment is pledged as security with the bank against any overdrafts in the current account.

6. Property and Equipment

	December 31, 2003			
	Cost	Accumulated Amortization	Write-off of assets	Net book Value
Laboratory equipment	\$ 175,634	\$ 126,376	\$ -	\$ 49,258
Computer software	218,510	178,786	-	39,724
Computer hardware (ii)	178,196	130,548	-	47,648
Office furniture and equipment	48,374	24,568	-	23,806
Automotive	13,898	12,286	-	1,612
Leasehold improvements (i)	852	852	-	-
	<u>\$ 635,464</u>	<u>\$ 473,416</u>	<u>\$ -</u>	<u>\$ 162,048</u>

Azure Dynamics Corporation
(A Development Stage Enterprise)
Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

6. Property and Equipment (cont'd.)

	December 31, 2002			
	Cost	Accumulated Amortization	Write-off of assets	Net book Value
Laboratory equipment	\$ 175,634	\$ 66,538	\$ -	\$ 109,096
Computer software	184,254	145,916	-	38,338
Computer hardware (ii)	168,360	76,488	-	91,872
Office furniture and equipment	46,949	16,463	-	30,486
Automotive	13,898	7,654	-	6,244
Leasehold improvements (i)	852	852	-	-
	\$ 589,947	\$ 313,911	\$ -	\$ 276,036

	June 30, 2002			
	Cost	Accumulated Amortization	Write-off of assets	Net book Value
Laboratory equipment	\$ 175,634	\$ 48,984	\$ -	\$ 126,650
Computer software	184,254	102,602	-	81,652
Computer hardware (ii)	168,965	48,426	-	120,539
Office furniture and equipment	46,949	12,331	-	34,618
Automotive	13,898	5,338	-	8,560
Leasehold improvements (i)	204,826	9,163	195,663	-
	\$ 794,526	\$ 226,844	\$ 195,663	\$ 372,019

- (i) Pursuant to a lease termination agreement, effective June 30, 2002, the Company has written off leasehold improvements, with a net book value of \$195,663 – refer to Note 4.
- (ii) The cost of assets under lease as at December 31, 2003 was \$nil (\$27,410 less accumulated amortization of \$8,745 at December 31, 2002 and \$4,177 at June 30, 2002).

7. Other Assets

	December 31, 2003		
	Cost	Accumulated Amortization	Net book Value
Patents	\$ 122,400	\$ 30,455	\$ 91,945
Licensed technology	1	-	1
Trademarks	32,059	6,726	25,333
Deferred charge (i)	50,000	50,000	-
	\$ 204,460	\$ 87,181	\$ 117,279

	December 31, 2002		
	Cost	Accumulated Amortization	Net book Value
Patents	\$ 77,715	\$ 12,482	\$ 65,233
Licensed technology	1	-	1
Trademarks	16,278	2,780	13,498
Deferred charge (i)	50,000	32,740	17,260
	\$ 143,994	\$ 48,002	\$ 95,992

