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

For the years ended December 31, 2005 and 2004

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## Auditors' Report

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### 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, 2005 and 2004 and the consolidated statements of operations and deficit, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these 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 financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the 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, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

*BDO Dunwoody LLP*

**Chartered Accountants**

Toronto, Ontario  
February 8, 2006

*BDO Dunwoody LLP is a Limited Liability Partnership registered in Ontario*

**Azure Dynamics Corporation**  
**(A Development Stage Enterprise)**  
**Consolidated Balance Sheets**  
**(Stated in Thousands)**

<b>As at</b>	<b>December 31 2005</b>	December 31 2004
	\$	\$
<b>ASSETS</b>		
<b>Current</b>		
Cash and cash equivalents (Note 6)	20,721	14,313
Accounts receivable	1,004	211
Contributions receivable (Note 15)	597	998
Inventory and related prepayments (Note 7)	2,696	1,199
Prepaid expenses	980	284
	25,998	17,003
<b>Restricted cash (Note 4)</b>	698	-
<b>Property and equipment (Note 9)</b>	5,573	539
<b>Other assets (Note 8)</b>	61	-
<b>Intangible assets (Note 10)</b>	12,133	271
<b>Goodwill (Note 3)</b>	2,932	-
	47,395	17,813
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Current</b>		
Accounts payable and accrued liabilities	3,403	1,697
Customer deposits and deferred revenue	1,574	-
Current portion of notes payable (Note 4)	2,558	-
	7,535	1,697
<b>Long-term</b>		
Deferred Revenue	1,038	-
	1,038	-
<b>Shareholders' equity</b>		
Share capital (Note 13)	80,701	37,693
Contributed surplus (Note 13)	2,316	722
Deficit	(44,195)	(22,299)
	38,822	16,116
	47,395	17,813

Approved on behalf of the Board:

"signed D. Campbell Deacon" Director

D. Campbell Deacon

"signed Dennis A. Sharp" Director

Dennis A. Sharp

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

**Azure Dynamics Corporation**  
**(A Development Stage Enterprise)**  
**Consolidated Statements of Operations and Deficit**  
**(Stated in Thousands)**

	For the years ended December 31		Cumulative
	2005	2004 **	Since Inception **
	\$	\$	
<b>Revenues</b>	4,608	-	4,608
<b>Cost of sales</b>	3,835	-	3,835
<b>Gross Margin</b>	773	-	773
<b>Expenses</b>			
Engineering, research, development and related costs, net	11,443	3,754	20,567
Selling and marketing	3,360	1,852	7,091
General and administrative	8,178	2,766	18,139
<b>Total expenses</b>	22,981	8,372	45,797
<b>Loss from operations</b>	(22,208)	(8,372)	(45,024)
Interest and other income, net	290	208	841
Foreign currency gains/(losses)	22	(34)	(12)
<b>Net loss for the period</b>	(21,896)	(8,198)	(44,195)
Deficit, beginning of period	(22,299)	(14,101)	-
<b>Deficit, end of period</b>	(44,195)	(22,299)	(44,195)
<b>Loss per share - basic</b>	(0.15)	(0.10)	
Weighted average number of shares - basic *	142,224	86,254	

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

\*\* Certain reclassifications have been made to the December 31, 2004 and Cumulative Since Inception comparative numbers to conform to the current period presentation

**Azure Dynamics Corporation**  
**(A Development Stage Enterprise)**  
**Consolidated Statements of Cash Flows**  
**(Stated in Thousands)**

	For the years ended December 31		Cumulative Since Inception *
	2005	2004 *	
	\$	\$	\$
<b>Cash flows from operating activities</b>			
Net loss for the period	(21,896)	(8,198)	(44,195)
Adjustments for:			
Amortization of property and equipment and other assets	661	270	1,495
Amortization of intangible assets	1,591	-	1,591
Unrealized foreign currency losses	170	-	170
Accretion expense on convertible debentures	-	-	74
Amortization of deferred financing costs	-	-	88
Lease termination	-	-	458
Common shares issued in exchange for services	-	28	78
Stock option compensation expense	1,618	497	2,247
	<u>(17,856)</u>	<u>(7,403)</u>	<u>(37,994)</u>
Changes in non-cash working capital items	(362)	(381)	(1,529)
Movement due to exchange rate impact	(76)	-	(76)
Net changes in non-cash working capital	<u>(438)</u>	<u>(381)</u>	<u>(1,605)</u>
	<b>(18,294)</b>	<b>(7,784)</b>	<b>(39,599)</b>
<b>Cash flows from financing activities</b>			
Issuance of common shares (net of costs)	26,287	15,696	60,444
Alternative Investment Market listing costs	-	(1,000)	(1,000)
Capital Assurance Agreement costs	-	(965)	(965)
Convertible debenture funds received (net of costs)	-	-	2,009
Issuance of special warrants	-	-	3,500
Repayment of obligations under capital lease	-	-	(27)
Repayment of long term debt	-	-	(50)
Principal payments on notes payable	(42)	-	(42)
Movement due to exchange rate impact	(374)	-	(374)
	<u>25,871</u>	<u>13,731</u>	<u>63,495</u>
<b>Cash flows from investing activities</b>			
Acquisition of property and equipment	(864)	(598)	(2,267)
Acquisition of other assets	(71)	(203)	(766)
Changes in restricted cash	(698)	-	(698)
Cash acquired from acquisition of subsidiary, net of costs	365	-	365
Changes in loans to employees	-	92	92
	<u>(1,268)</u>	<u>(709)</u>	<u>(3,274)</u>
<b>Increase in cash and cash equivalents</b>	<b>6,309</b>	<b>5,238</b>	<b>20,622</b>
Exchange gain on cash held in foreign currency	99	-	99
Cash and cash equivalents, beginning of period	<u>14,313</u>	<u>9,075</u>	<u>-</u>
<b>Cash and cash equivalents, end of period</b>	<b>20,721</b>	<b>14,313</b>	<b>20,721</b>

\* Certain reclassifications have been made to the December 31, 2004 and Cumulative Since Inception comparative numbers to conform to the current period presentation

**Years ended December 31, 2005 and 2004**

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## **1. Nature of Operations and Basis of Presentation**

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Azure Dynamics Corporation (the "Company") or ("ADC") is incorporated under the laws of Alberta. The Company is a development stage enterprise, involved in the development and supply of electric and hybrid electric powertrains and vehicle control systems for commercial vehicle and military applications.

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 additional 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 development projects and from the sale of components to 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.

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## **2. Significant Accounting Policies**

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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 the Company and of its wholly owned subsidiaries since the date of acquisition. The Company has four wholly owned subsidiaries; Azure Dynamics Inc., which is incorporated under the Canada Business Corporations Act ("CBCA"); Azure Dynamics Corporation of America (inactive) and Azure Dynamics Incorporated, both of which are incorporated under the laws of the state of Delaware, U.S.A.; and Azure Dynamics Limited, which is incorporated under the laws of England and Wales. Business acquisitions are accounted for using the purchase method. Investments in joint ventures are accounted for using the proportional consolidation method.

(b) Revenue recognition

Certain product lines within Solectria (acquired in January 2005 - see note 3) are no longer considered development stage. Therefore the Company now 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 collectibility is reasonably assured.

In addition, the Company recognizes revenues on long term engineering contracts within these product lines 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.

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**Years ended December 31, 2005 and 2004**

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## **2. Significant Accounting Policies (b) (cont'd.)**

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The Company also recognizes revenues related to a technology and software licensing agreement (see note 11). The agreement provided for non-refundable payments which are being recognized in revenue on a straight-line basis over the period of the license agreement.

Revenues earned from product lines that are considered in the development stage are reflected as a reduction of the related research and development costs.

Customer deposits and deferred revenue primarily represent fees paid by customers in advance of products being shipped, contract revenue recognized, and the license agreement referred to in note 11.

(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 related revenues are recognized 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) 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.

(f) Inventory and related prepayments

Inventory is comprised of product, spare parts, product components and materials held for resale or use in the Company's product development activities or customer projects and include prepayments made for components on order. Work in progress inventory is comprised of material, labour and a portion of overhead costs relating to in-progress customer and internal orders. Inventory is valued at the lower of cost or net realisable value.

**Years ended December 31, 2005 and 2004**

**2. Significant Accounting Policies (cont'd.)**

(g) Accrued warranty liabilities

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.

(h) Property and equipment

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

Workshop equipment	5 years	Office furniture and equipment	5 years
Computer software	2 to 3 years	Automotive	3 to 5 years
Computer hardware	3 years	Leasehold improvements	1 to 12 years
Tooling	3 to 5 years	Buildings	10 years

(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) Intangible assets

Intangible assets represent the fair value of identifiable intangible assets acquired in a purchase business combination. The customer order backlog asset is amortized as the underlying orders are executed. Amortization of the product technology asset is provided on a straight-line basis over the estimated useful life of 10 years.

(k) Goodwill

Goodwill represents the excess of purchase price over the fair value of identifiable assets acquired in a purchase business combination. Goodwill is not amortized but is subject to annual fair value impairment tests or is adjusted if changes in circumstances indicate that the carrying value may not be recoverable.

(l) Variable interest entities

Effective January 1, 2005, the Company adopted Accounting Guideline 15 – Consolidation of Variable Interest Entities (“AcG 15”). This guideline requires the consolidation of certain variable interest entities (“VIE”) for annual or interim periods beginning on or after November 1, 2004. The Real Estate Joint Venture that is described in note 4 is by definition a VIE. The Company has assessed the impact of AcG 15 and determined that the Company is not the primary beneficiary of the variable interest entity and accordingly, the implementation of AcG 15 has not had any impact on the consolidated financial statements.

(m) 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

Years ended December 31, 2005 and 2004

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## 2. Significant Accounting Policies (m) (cont'd.)

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financial instruments. The fair values of these financial instruments approximate their carrying values, unless otherwise noted.

(n) Foreign currency translation

Monetary assets and liabilities of integrated operations that are not denominated in Canadian Dollars are translated at the rate of exchange prevailing at the period end, while revenues and expenses are translated at average rates of exchange during the period. Exchange gains and losses arising on the translation of the accounts are included in consolidated earnings. Non-monetary items are translated at historical exchange rates. All of the Company's foreign subsidiaries' operations are considered to be integrated.

For the year ended December 31, 2005, a foreign exchange gain of \$22,000 was recognized in the consolidated earnings (2004 - foreign exchange loss of \$34,000).

(o) 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.

(p) Stock based compensation

The Company grants stock options to officers, directors, employees and consultants pursuant to a stock option plan described in Note 13(c). 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 the consolidated earnings over the vesting period of the options. 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.

(q) 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.

(r) Use of estimates

The preparation of consolidated financial statements requires the Company's management to make estimates and assumptions that affect the amounts reported in these consolidated financial statements and notes thereto. Significant areas requiring management to make estimates include inventory valuation, product warranty obligations, revenue recognition and recoverability of intangibles and goodwill. Actual results could differ from those estimates.

(s) Comparative figures

Certain comparative figures have been restated to be consistent with current year financial statement presentation.

**Years ended December 31, 2005 and 2004**

**3. Acquisition of Solectria**

On January 31, 2005, the Company completed the acquisition of Solectria Corporation ("Solectria"), a U.S. based hybrid electric powertrain and components supplier. The Company acquired all of the outstanding shares of Solectria in exchange for 25,297,655 of its common shares, resulting in Solectria's former shareholders owning approximately 19.8% of the Company's issued and outstanding common shares at that time. Singapore Technologies Kinetics Ltd. ("STK"), a major Solectria shareholder, held approximately 11% of the Company's common shares immediately post-closing. Solectria now operates as Azure Dynamics Incorporated.

The Company's common shares traded at a weighted average price of approximately \$0.88 prior to, and immediately after, the acquisition was announced on December 17, 2004. After considering trading discounts for block share trades and typical issue costs the fair market value of the shares was deemed to be \$0.66. The Company issued 25,297,655 common shares, with a deemed value of \$16.7 million, and paid cash of \$0.4 million in settlement of the purchase price. Total consideration, including acquisition expenses of \$0.7 million, is \$17.8 million.

The Company has accounted for the acquisition using the purchase method and the results of operations of Solectria have been consolidated into the Company's earnings with effect from February 1, 2005. The aggregate purchase price of \$17.8 million was allocated to the assets acquired and liabilities assumed based on their estimated fair values as follows:

<u>(Stated in thousands of dollars)</u>	
Current assets (including cash of \$625)	\$ 3,074
Restricted cash	745
Property and equipment	4,678
Other assets	53
Intangible assets	13,400
Goodwill	2,932
Current liabilities	(4,428)
Notes payable	(2,700)
	<u>\$ 17,754</u>

Assets and liabilities are recorded based on their estimated fair values at January 31, 2005. Intangible assets are comprised of:

<u>(Stated in thousands of dollars)</u>	
Customer order backlog	\$ 900
Product technology	12,500
	<u>\$ 13,400</u>

**4. Investment in Real Estate Joint Venture**

The Company's US subsidiary (formerly Solectria) owns a 50% interest in ND Solectria LLC, a joint venture partnership with NDNE Real Estate, Inc., a real estate development corporation. The investment in the real estate joint venture, which is accounted for using the proportional consolidation method, was formed for the purpose of holding property located in Woburn, Massachusetts. On October 1, 2001, the Company entered into a lease agreement for the Woburn property. The Company provided a security deposit of US\$400,000 (Cdn\$465,000) and made guarantees of an additional US\$600,000 (Cdn\$698,000) that is in the form of a letter of

**Years ended December 31, 2005 and 2004**

**4. Investment in Real Estate Joint Venture (cont'd).**

credit, which is collateralized by certain cash equivalents. NDNE Real Estate, Inc. maintains the unilateral right to sell the property during the lease term and manages the property. The Company is entitled to 50% of earnings of ND Solectria LLC. During the year ended December 31, 2005 the Company's interest in earnings from the real estate joint venture amounted to \$154,000.

The Company's 50% proportional interest in ND Solectria LLC is included in the consolidated balance sheets as follows:

(Stated in thousands of dollars)

		<b>December 31, 2005</b>
Cash and equivalents	\$	<b>310</b>
Accounts receivable		<b>15</b>
Property and equipment		<b>3,225</b>
<b>Total assets</b>	<b>\$</b>	<b>3,550</b>
Accounts payable and accrued liabilities	\$	<b>296</b>
Note payable – current		<b>2,558</b>
Shareholders' equity		<b>696</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$</b>	<b>3,550</b>

The note payable is the Company's proportionate share of a mortgage on the Boston property owned by ND Solectria LLC. The note is repayable on November 20, 2006, bears interest at 6.50 %, and is secured by the mortgaged premises. As both parties are jointly and severally liable for repayment of the note payable, the maximum exposure to loss as a result of its involvement with this entity is \$5.1 million.

The Company's 50% proportional interest in ND Solectria LLC is included in the consolidated statements of operations and deficit as follows:

(Stated in thousands of dollars)

		<b>For the year ended December 31, 2005</b>
General and administrative	\$	<b>(338)</b>
Other Expense		<b>184</b>
<b>Net income</b>	<b>\$</b>	<b>154</b>

The Company's 50% proportional interest in ND Solectria LLC is included in the consolidated cash flow statement as follows:

(Stated in thousands of dollars)

		<b>For the year ended December 31, 2005</b>
Net Income	\$	<b>154</b>
Amortization		<b>65</b>
Principle payments on note payable		<b>(48)</b>
Changes in short term assets and liabilities		<b>139</b>
Cash and cash equivalents beginning of period		<b>-</b>
<b>Cash and cash equivalents end of period</b>	<b>\$</b>	<b>310</b>

Years ended December 31, 2005 and 2004

**5. Financial Instruments**

At December 31, 2005, substantially all of the Company's cash was held at a recognized Canadian national financial institution. As a result, the Company was exposed to all of the risks associated with that institution.

The Company holds monetary assets and liabilities that are denominated in foreign currencies and is therefore exposed to foreign currency exchange risk.

**6. Cash and Cash Equivalents**

(Stated in thousands)	<b>December 31 2005</b>	December 31 2004
Cash in bank	\$ 20,721	\$ 14,313
Restricted cash	698	-
	<b>\$ 21,419</b>	<b>\$ 14,313</b>

Restricted cash consists of short term U.S. treasury bills pledged as security with a bank as the collateral for a letter of credit which forms part of the security deposit for the facility in Woburn, Massachusetts (note 4).

**7. Inventory and Related Prepayments**

(Stated in thousands)	<b>December 31 2005</b>	December 31 2004
Components and finished goods	\$ 1,524	\$ 281
Work in progress	1,029	561
Prepayments – components on order	143	357
	<b>\$ 2,696</b>	<b>\$ 1,199</b>

**8. Other Assets**

Other assets consist of a loan receivable, related to an asset sale completed by Solectria in November 2004. The repayment terms on the loan include four quarterly interest payments of \$900 each, which commenced on February 1, 2005 and concluded on November 1, 2005, and eight quarterly payments of principal and interest, in the amount of \$8,000, to commence on February 1, 2006 and conclude on August 1, 2007.

Years ended December 31, 2005 and 2004

**9. Property and Equipment**

(Stated in thousands)	December 31, 2005		
	Cost	Accumulated Amortization	Net book Value
Workshop equipment	\$ 419	\$ 170	\$ 249
Computer software	967	731	236
Computer hardware	1,100	862	238
Tooling	92	17	75
Office furniture and equipment	274	145	129
Automotive	215	108	107
Building	4,287	426	3,861
Leasehold improvements	915	237	678
	<b>\$ 8,269</b>	<b>\$ 2,696</b>	<b>\$ 5,573</b>

  

	December 31, 2004		
	Cost	Accumulated Amortization	Net book Value
Workshop equipment	\$ 209	\$ 113	\$ 96
Computer software	464	286	178
Computer hardware	317	193	124
Tooling	92	1	91
Office furniture and equipment	68	35	33
Automotive	13	13	-
Leasehold improvements	19	2	17
	<b>\$ 1,182</b>	<b>\$ 643</b>	<b>\$ 539</b>

**10. Intangible Assets**

(Stated in thousands)	December 31, 2005		
	Cost	Accumulated Amortization	Net book Value
Patents	\$ 340	\$ 126	\$ 214
Trademarks	56	20	36
Customer order backlog	900	371	529
Product technology	12,500	1,146	11,354
	<b>13,796</b>	<b>1,663</b>	<b>12,133</b>

  

	December 31, 2004		
	Cost	Accumulated Amortization	Net book Value
Patents	\$ 305	\$ 61	\$ 244
Trademarks	38	11	27
	<b>\$ 343</b>	<b>\$ 72</b>	<b>\$ 271</b>

**Years ended December 31, 2005 and 2004**

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### **10. Intangible Assets (cont'd).**

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The costs of acquiring and applying for patents, trademarks and licensed are capitalized and amortized on a straight-line basis over their estimated useful lives of five years. The customer order backlog and product technology assets were a result of the Solectria acquisition (see note 3). The value of the customer order backlog asset of \$900,000 was derived based upon the expected free cash flow contribution of the Solectria backlog at the time of the acquisition. The free cash flow was discounted at 25% to present value. The backlog asset is amortized as revenues from the backlog as the underlying orders are executed. It is expected that the majority of the backlog revenues will be recognized within two years of the acquisition date of January 31, 2005. The value of the product technology asset of \$12.5 million was derived based upon the expected free cash flow attributable to future revenues that are based upon the acquired technology. The cash flows were discounted at 25% to present value. The product technology asset is amortized on a straight-line basis over a 10 year period.

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### **11. Related Party Transactions**

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- a) During the year ended December 30, 2005, the Company paid \$315,000 (2004 - \$350,000) to a private company controlled by the Chief Executive Officer for remuneration in respect of an employment contract.
  - b) In November 2003, Solectria entered into a Transfer of Technology and Software Licensing Agreement ("TTA Agreement") with STK. Under the terms of the agreement, the Company transferred specified technology to STK and granted an exclusive license to use and manufacture the technology. 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 (Cdn\$1.2 million). As discussed in note 2(b), revenues from the TTA Agreement are being recognized on a straight-line basis over the period of the license agreement. As of December 31, 2005, the Company has deferred revenue associated with the TTA Agreement in the amount of \$1.0 million. During the twelve months ended December 31, 2005, revenues recognized by the Company from the sale of products to STK and its related companies and from certain other contractual arrangements totalled approximately \$137,000. As of December 31, 2005, accounts receivable includes \$11,000 due from STK and customer deposits includes \$41,000 received from STK.
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### **12. Pension Contributions**

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After an executive officer or employee has completed one year of service, the Company may contribute up to 5% of the officer's or employee's base salary to a self-directed registered retirement plan. The resultant pension contribution expense is recorded in the period that the services are rendered by the officer or employee. The Company incurred pension contribution expenses of \$137,000 for the twelve months ended December 31, 2005 (2004 - \$83,000).

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### **13. Share Capital, Special Warrants and Stock Options**

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- (a) Authorized
  - Unlimited common shares without par value
  - Unlimited preferred shares without par value, non cumulative, redeemable, and non voting

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

Years ended December 31, 2005 and 2004

**13. Share Capital, Special Warrants and Stock Options (cont'd).**

(b) Issued and outstanding common shares (amounts stated in thousands of dollars)

	Number of shares		Amount
	Pre RTO	Post RTO	
Balance, June 30, 1999	2	2	\$ -
Issued to acquire certain intellectual properties	5,199,998	7,279,998	-
Equity financing	1,794,500	2,512,300	2
Equity financing	2,600,000	3,640,000	650
Issued for services	100,000	140,000	25
Balance, June 30, 2000	9,694,500	13,572,300	\$ 677
Equity financing	6,574,600	9,204,440	2,298
Issued for services	120,000	168,000	-
Balance before RTO (i)	16,389,100	22,944,740	2,975
RTO transaction		1,526,269	(275)
Share issue costs on RTO transaction			(248)
Issued on exercise of options		178,000	45
Balance, June 30, 2001		24,649,009	\$ 2,497
Equity financing (ii)(iv)		8,000,000	3,511
Equity financing (iii)(iv)		10,400,000	5,000
Issued on exercise of options		266,700	67
Equity financing (v)		240,000	120
Balance, June 30, 2002		43,555,709	\$ 11,195
Issued on exercise of options		125,333	34
Equity financing (vi)		1,300,000	560
Balance, December 31, 2002		44,981,042	\$ 11,789
Issued in lieu of non-executive director fees		50,000	25
Issued on exercise of options		164,000	42
Equity issue cost recovery		-	16
Special warrants converted to shares (vi)		200,000	90
Equity financing (viii)		25,382,126	9,858
Debenture conversion (vii)		7,386,668	2
Balance, December 31, 2003		78,163,836	\$ 23,992
March 2004 private placement (ix)		4,861,110	3,892
Issued on exercise of agent compensation options (viii)		2,325,508	1,178
Issued on exercise of stock options		896,665	298
Issued in lieu of non-executive directors fees		42,307	28
Issued on exercise of warrants (viii)		12,623,185	7,836
TSX listing costs (x)		-	(145)
July 2004 public offering (xi)		3,811,250	2,557
Capital Assurance Agreement costs (xi)		-	(983)
AIM listing costs (xii)		-	(1,000)
Issued pursuant to the Capital Assurance Agreement (xi)		67,875	42
Balance, December 31, 2004		102,791,736	37,693
Issued on acquisition of Solectria (xiii)		25,297,655	16,697
Equity financing (xiv)		12,805,000	11,630
Issued on exercise of warrants (xv)		3,605,625	3,391
Equity financing (xvi)		11,050,000	11,009
Issued on exercise of stock options		584,256	281
<b>Balance, December 31, 2005</b>		<b>156,134,272</b>	<b>80,701</b>

**Years ended December 31, 2005 and 2004**

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**13. Share Capital, Special Warrants and Stock Options 13(b) (cont'd).**

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- (i) 14,288,200 common shares were subject to escrow restrictions pursuant to an RTO. There are no common shares subject to escrow restrictions as at December 31, 2005 (December 31, 2004 – nil).
- (ii) On June 28, 2001, the Company completed a non-brokered placement of 8,000,000 Special A Warrants at a price of \$0.45 each for net proceeds of \$3.5 million, after deducting issue costs of \$89,000. Each Special A Warrant entitled the holder to receive, at no additional cost, one common share.
- (iii) On January 29, 2002, the Company completed a non-brokered placement of 10,400,000 Special B Warrants at a price of \$0.50 each for net proceeds of \$5.0 million, after deducting issue costs of \$200,000. Each Special B Warrant entitled the holder to receive, at no additional cost, one common share.
- (iv) On February 5, 2002, the Company received a receipt for its final prospectus (dated January 31, 2002) from the British Columbia, Alberta, and Ontario Securities Commissions relating to the qualification of 8,000,000 Common Shares issuable upon the exercise of 8,000,000 Special A Warrants and 10,400,000 Common Shares issuable upon the exercise of 10,400,000 Special B Warrants, whereupon the Special A and B Warrants were exercised and converted into common shares.
- (v) Effective June 30, 2002, the Company entered into a private placement subscription agreement for 240,000 common shares of the Company, at a price of \$0.50 per share, for gross proceeds of \$120,000 in conjunction with a lease termination.
- (vi) On November 21, 2002, the Company completed a private placement of 1,300,000 units of the Company (the "Unit Financing"), at a price of \$0.50 per unit, for net proceeds of \$560,000 after deducting issue costs estimated at \$90,000. Under the Unit Financing, each unit was comprised of one common share of the Company and one quarter warrant, each whole warrant exercisable into one common share at \$0.55, until November 30, 2003. These warrants expired unexercised on December 1, 2003.

The Company also completed a private placement of 200,000 Special Warrants of the Company (the "Special Warrant Financing"), at a price of \$0.50 per Special Warrant, for net proceeds of \$90,000 after deducting issue costs estimated at \$10k. Under the Special Warrant Financing, each Special Warrant was exercisable into one common share of the Company and one Warrant, each Warrant exercisable into one common share at \$0.55, until November 30, 2003. On November 30, 2003, the Special Warrants were exercised into 200,000 common shares of the Company and 200,000 Warrants; the Warrants, exercisable into common shares at \$0.55, expired unexercised on December 1, 2003.

- (vii) Effective July 31, 2003, the Company completed a \$2.2 million secured convertible debenture financing. On December 19, 2003 the Company redeemed the Debentures. All the Debenture holders elected to be redeemed by way of conversion and, in accordance with the terms of the Debentures, such conversion took place at a conversion price equal to \$0.30 per share thereby giving the holders 7,386,668 common shares of the Company.

As these debentures were considered to be compound financial instruments, the liability component and the equity component, as determined at initial recognition, were presented separately. The Company valued the equity component of these debentures using the 'residual value of equity component' method, whereby the liability component was valued first using the current market rates for comparable instruments, at the time of issuance, and the difference between the proceeds of the debentures issued and the fair value of the liability was assigned to the equity component.

Years ended December 31, 2005 and 2004

**13. Share Capital, Special Warrants and Stock Options (b) (vii) (cont'd).**

The resulting liability and equity values determined using this method, based on an 8% interest rate, was as follows:

Convertible debentures issued July 31, 2003	\$ 2,216
Less: equity component	<u>(178)</u>
	2,038
Accretion on conversion feature for the period	<u>75</u>
	2,113
Converted to equity during the period	<u>(2,113)</u>
<b>Balance, December 31, 2003</b>	<b>\$ -</b>

The Company accreted the equity component of the debentures on a pro rata basis over their term such that the debt would equal the original face value of the debentures upon maturity; an accretion charge to operations of \$74k was recorded in 2003.

Debenture issue costs, amounting to \$207,000, were recorded as deferred costs on the balance sheet; an amortization charge to operations of \$88,000 was recorded in 2003. On conversion of the debentures on December 19, 2003, the carrying value of the convertible debenture liability of \$2.1 million was credited to share capital and the unamortized balance of deferred debenture issue costs of \$119,000 was charged to share issue costs. Upon conversion, the debenture balance outstanding plus the original value of the equity component less the deferred issue costs with a combined total of \$2.2 million was credited to share capital.

- (viii) On December 1, 2003, the Company completed a private placement of 25,382,126 common shares of the Company ("Units"), at a price of \$0.42 per unit, for net proceeds of \$9.9 million after deducting issue costs of \$802,000. In conjunction with the financing, the Company issued 12,691,060 warrants, each warrant being exercisable into one common share of the Company at \$0.62 until December 1, 2004. The Company also issued 2,325,508 compensation options to agents, each option being exercisable into one common share of the Company at \$0.495 up until December 1, 2004. The Company recorded a charge of \$36,000 to share capital and a corresponding credit to contributed surplus in respect of the deemed issue costs of the warrants and options, based on their estimated fair values as of the date of grant calculated using the Black-Scholes model. All of the agent compensation options and 12,623,185 of the warrants were exercised by December 1, 2004. The remaining 67,875 warrants expired on December 1, 2004. In accordance with the terms in the Capital Assurance Agreement, described in Note 10(b) (xi), the Obligors subscribed for 67,875 common shares at \$0.62 per share in respect of the 67,875 unexercised warrants. Upon exercise of the warrants and agent compensation options, \$36,000 was released from contributed surplus and added to share capital.
- (ix) On March 10, 2004, the Company completed a private placement of 4,861,110 common shares of the Company at a price of £0.36 per share (approximately \$0.86 per share), for net proceeds of \$3.9 million after deducting share issue costs of \$0.3 million.
- (x) On June 4, 2004, the common shares of the Company commenced trading on the main board of the TSX and were de-listed from trading on the TSX Venture Exchange. The costs of listing the common shares on the TSX, totalling \$145,000, have been charged to the share capital account. The TSX listing was required to facilitate the July 2004 financing (Note 10(b) (xi)) and the AIM listing (Note 10(b) (xii)), as well as future financings.
- (xi) On July 27, 2004, the Company completed a public offering of 3,811,250 common shares of the Company at a price of \$0.80 per share. In addition, the Company issued 1,905,625 warrants entitling the holders to purchase one common share of the Company at a price of \$1.00 until July 27, 2005. Senior management subscribed for 118,750 of the total number of common shares issued.

**Years ended December 31, 2005 and 2004**

**13. Share Capital, Special Warrants and Stock Options (b) (xi) (cont'd).**

Net proceeds of the financing were \$2.6 million after deducting share issue costs of \$454,000 and deemed warrant issue costs of \$38,000, based on the estimated fair value of the warrants as of the date of grant calculated using the Black-Scholes model.

Simultaneously, the Company entered into a Capital Assurance Agreement pursuant to which it was ensured to receive by December 15, 2004 approximately \$8.5 million which the Company could otherwise receive upon the exercise of the Company's outstanding common share purchase warrants and agent compensation options. The Company had issued and outstanding 11,966,060 common share purchase warrants, each purchase warrant being exercisable at a price of \$0.62 until December 1, 2004 for one common share, and 2,245,508 common share agent compensation options, each agent option being exercisable at a price of \$0.495 until December 1, 2004 for one common share (collectively the "Old Warrants"). The Company entered into a binding agreement with a number of parties (the "Obligors") which provided that, to the extent any Old Warrants were not exercised for any reason by their expiry time on December 1, 2004, the Obligors would, on a pro rata basis, subscribe for common shares of the Company.

In consideration for entering into the Capital Assurance Agreement, the Obligors received a cash fee of \$765,000. In addition, the Obligors received 1,700,000 warrants (the "Obligor Warrants") of the Company. Each Obligor Warrant will permit the holder to acquire one Common Share of the Company at an exercise price of \$1.00 up until July 27, 2005. A director of the Company undertook an Obligor obligation of \$600,000 and in connection with this undertaking received a cash fee of \$54,000 and 120,000 Obligor Warrants. Total costs of the Capital Assurance Agreement of \$983,000 are comprised of the cash fee of \$765,000, an agents' fee of \$200,000 and the deemed warrant issue costs of \$18,000, based on an estimated fair value of the warrants as of the date of grant calculated using the Black-Scholes model.

On December 15, 2004, the Company issued 67,875 common shares to the Obligors, at \$0.62 per share, in respect of unexercised old warrants. A director of the Company subscribed for 4,791 common shares in respect of his Obligor commitment.

- (xii) On August 12, 2004, the Company obtained a secondary listing of its shares and certain warrants on the Alternative Investment Market ("AIM") of the London Stock Exchange. The costs of listing the common shares and warrants on the AIM, totalling \$1.0 million, have been charged to the share capital account. The listing was required to facilitate the Capital Assurance Agreement referred to in Note 10(b) (xi) above, as well as future financings.
- (xiii) On January 31, 2005, the Company acquired all of the outstanding shares of Solectria in exchange for 25,297,655 of its common shares at a deemed price of \$0.66 per common share.
- (xiv) On February 21, 2005, the Company completed a private placement financing of 12,805,000 common shares of the Company, at a price of £0.41 per share (approximately \$0.96), for net proceeds of \$11.6 million after deducting issue costs of \$0.6 million.
- (xv) Pursuant to a Capital Assurance Agreement, dated July 27, 2005, all of the 3,605,625 issued and outstanding July 2004 warrants were exercised into common shares by either the warrant holders or a syndicate of underwriters at a price of \$1.00 per common share. Net proceeds amounted to \$3.4 million after deducting costs and fees of \$0.2 million.
- (xvi) On September 8, 2005, the Company completed a private placement financing of 11,050,000 common shares of the Company, at a price of \$1.00 per share for gross proceeds of \$11.1 million. Net proceeds amounted to \$11.0 million after deducting issue costs of \$31,000.

Years ended December 31, 2005 and 2004

**13. Share Capital, Special Warrants and Stock Options (cont'd).**

(c) Stock Options

The Company has a stock option plan (the "Plan") which authorizes the Board to issue options to insiders, employees and service providers of the Corporation and its subsidiaries. The maximum number of common shares issuable under stock options, together with common shares as may be subject to options pursuant to other share compensation arrangements, shall not exceed 10% of the outstanding common shares. The exercise price shall not be lower than the closing trading price of the common shares on the TSX, on the last trading day prior to the date on which the option is granted. The options have terms ranging from one to seven years and generally vest over periods of up to twenty-four months. As at December 31, 2005, the Company had 14,030,914 stock options outstanding under the Plan. The stock options are exercisable at a weighted average exercise price of \$0.81 per common share. The stock options expire on various dates between January 18, 2006 and December 23, 2012.

Stock option transactions for the respective periods and the number of stock options outstanding are summarized as follows:

	Number of Optioned Common Shares	Weighted Average Exercise Price
<b>Executive Officers, Directors, Employees and Consultant Options:</b>		
Balance, June 30, 2000	-	\$ -
Options attributable to pre RTO	12,000	2.50
Options expired	(12,000)	2.50
Options granted	5,141,000	0.25
Options cancelled	(1,945,000)	0.25
Balance, June 30, 2001	3,196,000	0.25
Options granted	2,526,000	0.63
Options exercised	(266,700)	0.25
Options cancelled	(126,500)	0.28
Options expired	(9,200)	0.25
Balance, June 30, 2002	5,319,600	0.43
Options granted	20,000	0.53
Options exercised	(53,333)	0.30
Options expired	(281,267)	0.36
Balance, December 31, 2002	5,005,000	0.44
Options granted	1,990,000	0.44
Options exercised	(164,000)	0.26
Option cancelled	(75,000)	0.48
Options expired	(583,000)	0.50
Balance, December 31, 2003	6,173,000	0.44
Options granted	3,170,765	0.69
Options exercised	(896,665)	0.31
Options cancelled/expired	(268,335)	0.50
Balance, December 31, 2004	8,178,765	0.54
Options granted	6,648,137	0.97
Options exercised	(584,256)	0.44
Options cancelled/expired	(211,732)	0.84
<b>Balance, December 31, 2005</b>	<b>14,030,914</b>	<b>\$ 0.81</b>

Years ended December 31, 2005 and 2004

**13. Share Capital, Special Warrants and Stock Options (c) (cont'd).**

As at December 31, 2005, the numbers of optioned common shares outstanding and exercisable are as follows:

<b>Expiry date</b>	<b>Number outstanding</b>	<b>Number exercisable</b>	<b>Exercise price</b>
January 18, 2006	320,000	320,000	\$ 0.86
April 25, 2006	1,463,000	1,463,000	0.25
August 20, 2006	105,000	105,000	0.44
November 5, 2006	227,000	227,000	0.45
November 26, 2006	112,000	112,000	0.50
January 22, 2007	50,000	50,000	0.61
February 12, 2007	30,000	30,000	0.61
March 11, 2007	1,100,000	1,100,000	0.73
April 12, 2007	30,000	30,000	0.94
May 1, 2007	125,000	125,000	0.80
January 1, 2008	225,000	225,000	0.50
February 1, 2008	112,000	112,000	0.50
August 25, 2008	425,000	425,000	0.30
September 26, 2008	750,000	750,000	0.48
January 1, 2009	1,502,035	1,105,936	0.65
May 3, 2009	312,000	221,889	0.90
May 18, 2009	130,000	86,667	0.90
August 12, 2009	338,208	222,702	0.68
October 4, 2009	66,666	33,333	0.60
September 9, 2011	360,000	240,000	0.53
January 18, 2012	2,194,187	894,203	0.86
February 17, 2012	93,818	27,852	0.95
February 24, 2012	1,365,000	455,000	0.99
April 06, 2012	70,000	23,334	1.06
April 18, 2012	25,000	8,334	1.08
May 02, 2012	60,000	20,001	1.05
June 06, 2012	5,000	1,667	1.00
June 21, 2012	30,000	10,000	0.95
July 04, 2012	50,000	16,667	0.93
July 04, 2012	20,000	6,667	0.94
July 18, 2012	50,000	16,667	0.95
November 16, 2012	10,000	3,334	1.10
December 23, 2012	2,275,000	1,108,334	1.07
	<b>14,030,914</b>	<b>9,576,587</b>	

(d) Stock Option Compensation

Effective January 1, 2003, the Company adopted the revised recommendations in CICA Handbook Section 3870 whereby it measures compensation costs associated with stock-based compensation using the fair value method and the cost is recognized over the vesting period of the stock option. The fair value of each performance share and stock option is determined at each issue or grant date using the Black-Scholes model with the following assumptions: risk free interest rate - 5% (2004 - 5%), expected life - 4 years (2004 - 4 to 5 Years), expected dividend yield - nil (2004 - nil), and expected volatility - ranging from 33% - 35% (2004- 17% to 30%). The Company recorded a compensation expense charge of \$1.6 million to consolidated earnings for the year ended December 31, 2005 (2004 - \$0.5 million) with a corresponding credit to contributed surplus. Approximately \$24,000 was released from contributed surplus and added to share capital in respect of options exercised in 2005 (\$17,000 - 2004).

Years ended December 31, 2005 and 2004

**13. Share Capital, Special Warrants and Stock Options (cont'd).**

(e) Contributed Surplus

(Stated in thousands)

Balance, December 31, 2004	\$ 722
Stock option compensation expense (Note 13(d))	1,618
Release to share capital on exercise of stock options (Note 13(d))	(24)
<b>Balance, December 31, 2005</b>	<b>\$ 2,316</b>

**14. Income Taxes**

As at December 31, 2005, the Company has unclaimed consolidated research and experimental development expenditures of \$7.5 million that are available to offset future taxable income. The Company also has \$70.9 million of consolidated non-capital tax losses that are available for carry forward to offset future taxable income, and \$4.3 million of consolidated investment tax credits that are available to offset future income taxes payable, that expire as follows:

(Stated in thousands)	<b>Non-Capital Losses</b>	<b>Investment Tax Credits</b>	<b>R&amp;D Tax Credits</b>
2006	\$ 6,394	\$ -	\$ 7
2007	3,782	30	6
2008	5,531	19	20
2009	5,744	212	20
2010	6,569	109	43
2011	-	720	37
2012	-	365	52
2013	-	198	-
2014	6,539	1,201	-
2015	12,049	1,486	-
2016	-	-	9
2017	352	-	21
2018	2,158	-	121
2019	52	-	47
2020	1,921	-	2
2021	5,456	-	52
2022	3,166	-	19
2023	1,932	-	-
2024	3,133	-	-
2025	4,783	-	-
Infinite	1,359	-	6,999
<b>Totals</b>	<b>\$ 70,920</b>	<b>\$ 4,340</b>	<b>\$ 7,455</b>

The Company also has consolidated net deductible temporary tax differences of \$3.4 million relating primarily to property and equipment and share issue costs, which may be used to offset future taxable income. Azure US deferred income taxes reflect the impact of temporary differences between the amounts of assets and liabilities for financial reporting purposes and such amounts as measured by tax laws, net of recorded valuation allowances. The temporary differences, which give rise to a significant portion of the deferred tax assets as of December 31, 2005, pertain primarily to net operating loss and research and development tax credit carryforwards and reserves on inventories and accounts receivable.

**Years ended December 31, 2005 and 2004**

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#### **14. Income Taxes (cont'd).**

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The ability of the Company to utilize the losses and other tax balances carried forward in the future is not reasonably assured and therefore has not been recognized in the financial statements. The effective tax rate for the Corporation is approximately 36%. The difference between the effective rate and the actual rate of nil% is attributable primarily to the fact that no future tax asset has been recorded for available loss carry forwards as their ultimate utilization is not reasonably assured.

Section 382 of the US Tax Reform Act of 1986 contains provisions that may limit the amount of net operating loss and tax credit carryforwards that the Company may use in any one year in the event of certain cumulative changes in ownership over a three-year period in excess of 50%, as defined. The Company believes it has experienced a change in ownership in excess of 50%; however, the amount of the limitation has not yet been determined.

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#### **15. Projects Under Development**

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The strategy of the Company is to deploy its Technology into viable powertrain products for light to heavy duty commercial and military vehicle markets. Initial commercial markets include urban delivery, postal, courier, taxi and shuttle-bus applications. Azure's products fall within four broad powertrain categories – G1 (series) for vehicles in the medium-duty weight range 7,500 to 16,000 lbs. gross vehicle weight ("GVW"), G2 (series) for the light-duty weight range 5,000 to 7,500 lbs. GVW, P1 (parallel) for the medium-heavy weight category of 10,000 to 19,000 lbs. GVW, and P2 (parallel) for the over 19,000 lbs. GVW heavy weight category. The Company also develops components. The primary activities and associated revenues and costs during the year can be summarized within these categories as follows:

(a) Series Hybrid and Electric Vehicle 7,500 to 14,000 lbs GVW ("G1") Development Project

The Company's current focus is on development of a series hybrid powertrain package for commercial vehicles in the weight class 7,500 to 14,000 lbs GVW (gross vehicle weight) and demonstration of the proprietary smart energy management system. The vehicles in this class typically deliver urban mail and packages and are also used in small shuttle bus applications. The Company is active in a number of G1 customer programs.

The Company incurred \$4.9 million in research and development expenses for the year ended December 31, 2005 (2004 – \$2.9 million) related to these projects. No costs have been deferred or capitalized and no revenue has been earned from this project.

(b) Parallel Hybrid and Electric Vehicle 10,000 to 19,000 lbs GVW ("P1") Development Project

In February 2005, the Company was awarded a contract by AM General LLC of South Bend, Indiana. The contract is to develop a parallel hybrid High Mobility Multipurpose Wheeled Vehicle ("HMMWV") integrated with a third generation Auxiliary Power Distribution System ("APDS") (P1 product).

The company recorded \$0.9 million in revenues in the year related to this funded development project (recognised on a percentage of completion basis).

The build of a P1 delivery truck for the United States Postal Service ("USPS") was in progress and has since been delivered in the first quarter of 2006. Also in respect of P1, in August 2005 the Company announced that it has signed an agreement with a large North American based company to purchase and test an Azure parallel hybrid electric delivery vehicle.

The Company incurred \$0.5 million in research and development expenses for the year ended December 31, 2005 (2004 – \$nil) related to internally funded P1 projects. No costs have been deferred or capitalized

**Years ended December 31, 2005 and 2004**

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**15. Projects Under Development (b) (cont'd).**

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and no revenue has been earned from these projects.

(c) Series Hybrid and Electric Vehicle 5,000 to 7,500 lbs GVW ("G2") Development Project

During 2005, Azure's G2 product was successfully tested in second generation form in a taxi in the United Kingdom and in an all-electric van. The Company also substantially completed the initial design and development of an integrated electric transaxle. The transaxle is a unique hi-speed gearbox with an integrated differential that is designed to fit in the smaller G2 platform. The Company continues to evaluate alternative vehicle platforms for its G2 hybrid and electric powertrain with which it can progress the development through to production.

The Company incurred \$0.4 million in research and development expenses for the year ended December 31, 2005 (2004 – \$0.3 million) related to this project. No costs have been deferred or capitalized and no sales revenue has been earned from this project.

(d) Parallel Hybrid and Electric Vehicle over 19,000 lbs GVW ("P2") Development Project

In June 2005, Azure was awarded a contract to supply Class 7 parallel hybrid electric drive systems into two Kenworth T300 delivery trucks for the Charmer-Sunbelt Group ("Charmer-Sunbelt") (P2 product). The Class 7 parallel is a second generation product design of the Company's and work has commenced to integrate the design into Charmer-Sunbelt's trucks. Delivery is scheduled for the second half of 2006.

The company recorded \$0.14 million in revenues in the year related to this funded development project (recognised on a percentage of completion basis).

The Company incurred \$0.1 million in research and development expenses for the year ended December 31, 2005 (2004 – \$0.3 million) related to internally funded P2 projects. No costs have been deferred or capitalized and no sales revenue has been earned from these projects.

(e) Component Development Projects

Component research and development efforts in the year included a contract to supply power electronics and drive systems to Engineered Air Systems Inc. ("EASI") for integration into the Chemical Biological Protective Shelter ("CBPS-M2"). The initial contract was to supply 26 systems valued at approximately \$5.2 million and in May 2005, the Company was awarded a contract for additional engineering scope related to this development effort valued at approximately \$0.6 million. In October 2005, the Company announced that it has received an additional order for 152 systems valued at approximately \$10.5 million. Delivery of product is scheduled to commence in late 2006 or early 2007.

The company recorded \$1.3 million in revenues in the year related to the funded development phase of this contract (recognised on a percentage of completion basis).

The Company incurred \$0.3 million in research and development expenses for the year ended December 31, 2005 (2004 – \$nil) related to internally funded component projects. No costs have been deferred or capitalized and no revenue has been earned from these projects.

(f) Development Cost Contribution Agreements

On March 31, 2002 the Company entered into a \$9.0 million Research and Development agreement with the Government of Canada, through its Technology Partnerships Canada ("TPC") program. The

**Years ended December 31, 2005 and 2004**

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**15. Projects Under Development (f) (cont'd).**

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agreement provides for a 26.6% contribution by TPC towards specified expenditures in respect of the research and development of the G1 and G2 hybrid electric and electric powertrains, up to a maximum reimbursement of \$9.0 million. The Company has claimed reimbursable costs amounting to \$1.3 million in the year ended December 31, 2005 (2004 – \$1.6 million). 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. As at December 31, 2005 contributions receivable of \$0.6 million (2004 – \$1.0 million) was recorded on the balance sheet. Cost reimbursement claims are subject to review by TPC. On March 23, 2005 the Company entered into a contract amendment with TPC whereby the project statement of work was updated and the project completion date was extended to March 31, 2007.

The Company has also received customer contributions amounting to \$0.4 million in the year ended December 31, 2005 (2004 – \$0.9 million) which are recorded as a credit to research and development expenses on the income statement. In total, contributions from all sources were \$1.7 million in the year ended December 31, 2005 (2004 – \$2.5 million).

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**16. Commitments**

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As of December 31, 2005, the Company has contractually committed to lease payments for premises and equipment requiring minimum payments in future periods as follows:

(Stated in thousands)

2006	\$ 1,396
2007	1,409
2008	1,319
2009	1,137
2010	1,037
2011	1,039
	<u>\$ 7,337</u>

- (a) Azure Dynamics Incorporated leases its operating facility in Woburn, Massachusetts under a non-cancellable lease agreement. Through a joint venture agreement, the Company has a 50% interest in the lessor, ND Solectria LLC (Note 4). The lease agreement provides for a minimum monthly rental payment plus certain operating costs. The Company's lease agreement contains escalation clauses and expires in September 2016.

In May, 2004 Azure Dynamics Inc. entered into a lease for a facility in Burnaby, British Columbia, which supports engineering and operations activities. The lease is for a 5 year term, concluding on April 20, 2009.

In June 2005, Azure Limited leased a workshop and test facility in Kenilworth, England to support its European operations. The lease agreement expires in July 2011.

- (b) Pursuant to a contractual agreement with the 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.

**Years ended December 31, 2005 and 2004**

**16. Commitments**

- (c) 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 sales or in accordance with a repayment schedule, with repayment amounts ranging from \$0 to \$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 2018 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.
- (d) Pursuant to an 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.
- (e) 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, ranging from one to two years 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.

**17. Changes in Non-Cash Working Capital Items**

(Stated in thousands)	<b>Year ended December 31, 2005</b>	Year ended December 31, 2004	Cumulative Since Inception
Accounts receivable	\$ (251)	\$ 126	\$ (655)
Contributions Receivable	400	(216)	(521)
Inventory and related prepayments	(348)	(1,198)	(1,547)
Prepaid expenses	(122)	(223)	(406)
Accounts payable and accrued liabilities	(1,037)	1,130	604
Customer deposits and deferred revenue	996	-	996
	<b>\$ (362)</b>	<b>\$ (381)</b>	<b>\$ (1,529)</b>

Years ended December 31, 2005 and 2004

**18. Segmented financial information**

Management currently organizes and views the Company's activities as one operating segment. A geographic analysis of revenues by customer locations and of assets employed is as follows:

(Stated in thousands)

	Revenues	Total Assets	Property, Plant, Equipment and Goodwill
	2005	December 31, 2005	December 31, 2005
Canada	\$ 18	\$ 23,744	\$ 664
United Kingdom	\$ 13	\$ 270	\$ 164
United States	\$ 4,440	\$ 23,381	\$ 7,677
Asia	\$ 137	\$ -	\$ -
<b>Total</b>	<b>\$ 4,608</b>	<b>\$ 47,395</b>	<b>\$ 8,505</b>

	2004	December 31, 2004	December 31, 2004
Canada	\$ -	\$ 17,813	\$ 539
<b>Total</b>	<b>\$ -</b>	<b>\$ 17,813</b>	<b>\$ 539</b>

The percentage of revenues derived from the Company's largest customers is as follows:

	Twelve months ended December 31, 2005 Percentage
First	29%
Second	20%
Third	6%
Others	45%
<b>Total</b>	<b>100%</b>

**19. Subsequent Events**

- (a) On January 17, 2006, the Company issued 1,310,000 employee stock options, exercisable at \$1.11 per share. The options vest over a twenty-four month period and expire on January 17, 2013.
- (b) During the period from December 31, 2005 to March 23, 2006, the Company issued 1,235,173 common shares upon the exercises of stock options.