
Azure Dynamics Corporation
(A Development Stage Enterprise)
Unaudited Interim Consolidated Financial Statements
For the six months ended June 30, 2004

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

As at	June 30 2004 (Unaudited)	December 31 2003 (Audited)	June 30 2003 (Unaudited)
	\$	\$	\$
ASSETS			
Current			
Cash and cash equivalents	10,366,435	9,075,219	432,974
Accounts receivable	400,368	337,794	61,714
Contributions receivable	602,343	780,459	72,680
Prepaid expenses	491,173	61,655	41,174
	11,860,319	10,255,127	608,542
Employee loans	-	91,727	257,429
Deferred costs (note 2(a))	815,497	-	-
Property and equipment	482,287	162,048	212,663
Other assets	102,281	117,279	101,286
	13,260,384	10,626,181	1,179,920
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current			
Accounts payable and accrued liabilities	1,265,007	567,692	372,125
Obligations under capital leases	-	-	2,575
	1,265,007	567,692	374,700
Deferred sponsorship contributions	-	-	527,363
Shareholders' equity			
Share capital	28,503,537	23,991,665	11,813,905
Special warrants	-	-	90,000
Contributed surplus	509,363	167,798	61,367
Deficit	(17,017,523)	(14,100,974)	(11,687,415)
	11,995,377	10,058,489	277,857
	13,260,384	10,626,181	1,179,920

* Certain comparative numbers have been restated as described in Note 3(e).

Approved on behalf of the Board:

"D. Campbell Deacon" Director

"Dennis A. Sharp" Director

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

	For the three months ended June 30		For the six months ended June 30	
	2004	2003	2004	2003
	\$	\$	\$	\$
Revenue				
Other	47,417	7,674	87,090	13,850
Expenses				
Research and development, net	609,394	69,548	878,838	355,446
Selling and marketing	386,947	151,948	735,070	293,765
General and administrative	597,757	281,927	1,114,659	583,911
Rent and ancillary	110,485	56,843	181,828	113,836
Amortization of property and equipment and other assets	52,530	43,265	93,244	86,157
	<u>1,757,113</u>	<u>603,531</u>	<u>3,003,639</u>	<u>1,433,115</u>
Net loss for the period	(1,709,696)	(595,857)	(2,916,549)	(1,419,265)
Deficit, beginning of period	<u>(15,307,827)</u>	<u>(11,091,558)</u>	<u>(14,100,974)</u>	<u>(10,268,150)</u>
Deficit, end of period	(17,017,523)	(11,687,415)	(17,017,523)	(11,687,415)
Loss per share - basic *	(0.02)	(0.01)	(0.04)	(0.03)
Weighted average number of shares - basic	84,032,618	45,031,042	81,779,593	45,019,716

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

** Certain comparative numbers have been restated as described in Note 3(e).

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

	For the three months ended		For the six months ended	
	June 30		June 30	
	2004	2003	2004	2003
	\$	\$	\$	\$
Cash flows from operating activities				
Net loss for the period	(1,709,696)	(595,857)	(2,916,549)	(1,419,265)
Adjustments for:	-	-		
Amortization of property and equipment and other assets	52,530	43,265	93,244	86,157
Common shares issued in exchange for services	20,625	6,250	27,500	12,500
Stock option compensation expense	140,337	16,674	341,565	61,367
Changes in non-cash working capital items	681,581	(373,833)	383,339	(303,079)
	(814,623)	(903,501)	(2,070,901)	(1,562,320)
Cash flows from financing activities				
Issuance of common shares (net of costs)	362,681	-	4,484,372	-
Deferred costs	(815,497)	-	(815,497)	-
Research and development sponsorship funds received	-	1,000,000	-	1,000,000
Repayment on obligations under capital lease	-	(3,702)	-	(7,222)
	(452,816)	996,298	3,668,875	992,778
Cash flows from investing activities				
Acquisition of property and equipment	(165,183)	(3,246)	(387,040)	(3,246)
Acquisition of other assets	(7,586)	(7,293)	(11,445)	(24,832)
Changes in loans to employees	68,509	-	91,727	-
	(104,260)	(10,539)	(306,758)	(28,078)
Increase (decrease) in cash and cash equivalents	(1,371,699)	82,258	1,291,216	(597,620)
Cash and cash equivalents, beginning of period	11,738,134	350,716	9,075,219	1,030,594
Cash and cash equivalents, end of period	10,366,435	432,974	10,366,435	432,974

* Certain comparative numbers have been restated as described in Note 3(e).

Azure Dynamics Corporation
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Notes to the Consolidated Financial Statements

Six Months ended June 30, 2004 and 2003 (unaudited)

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. ADI is incorporated under the laws of Canada and is a wholly owned subsidiary of ADC. On December 31, 2002, the Company changed the reporting year-end for the consolidated entities to December 31 from June 30. On March 9, 2004, the Company incorporated Azure Dynamics U.S. Inc. under the laws of the State of Delaware, USA. On April 6, 2004, the Company incorporated Azure Dynamics UK Limited under the laws of England and Wales. Azure Dynamics U.S. Inc. and Azure Dynamics UK Limited are wholly owned subsidiaries of ADC.

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 assets and liabilities that might be necessary should the Company be unable to continue in business. The unaudited interim consolidated financial statements and notes do not include all disclosures required for annual statements and should be read in conjunction with the audited financial statements for the year ended December 31, 2003.

2. Significant Accounting Policies

The unaudited interim consolidated financial statements of the Company have been prepared by management in accordance with generally accepted accounting principles in Canada. The accounting policies and methods of application used in preparation of these financial statements are consistent with the December 31, 2003 audited financial statements except as stated below.

(a) Deferred costs

The costs incurred by the Company in respect of capital financing and related transactions are deferred on the balance sheet until such time as the transactions are concluded, at which time the deferred costs are recognized as charges to the appropriate equity capital account.

3. Share Capital, Warrants and Stock Options

(a) Authorized

Unlimited common shares without par value

Unlimited preferred shares without par value, non cumulative, redeemable, and non voting

Azure Dynamics Corporation
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Notes to the Consolidated Financial Statements

Six Months ended June 30, 2004 and 2003 (unaudited)

3. Share Capital, Warrants and Stock Options (Cont'd.)

(b) Issued and outstanding common shares

	Number of Common Shares	Amount
Balance, December 31, 2003	78,163,836	\$ 23,991,665
Private placement	4,861,110	3,896,399
Issued on exercise of agent's compensation options	80,000	39,600
Issued on exercise of stock options	756,665	245,846
Issued in lieu of non-executive directors fees	42,307	27,500
Issued on exercise of warrants	725,000	449,500
TSX listing costs		(146,973)
Balance, June 30, 2004	84,628,918	\$ 28,503,537

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 \$0.90 per share), for net proceeds of \$3,896,399 after deducting share issue costs of \$287,851.

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, \$146,973, have been charged to the share capital account.

(c) Warrants

In conjunction with a private placement financing, completed December 1, 2003, the Company issued 12,691,060 warrants, each warrant being exercisable into one common share of the Company, at a price of \$0.62 per share, until December 1, 2004. As at June 30, 2004, there were 11,966,060 warrants outstanding.

(d) Stock options

The Company has a stock option plan (the "Plan") for which up to 10,350,000 common shares can be reserved for issuance to executive officers and directors, employees and consultants. The exercise price of the options is determined by the Board of Directors' based on their best estimate of the fair value of the common shares at the grant date, subject to applicable stock exchange pricing policies. The options have a maximum term of five years and generally vest over a twelve to twenty-four month period.

As at June 30, 2004, the Company had 7,765,561 stock options outstanding under the Plan and 2,245,508 agent's compensation options outstanding. Of the total 10,011,069 options outstanding, 7,632,474 were exercisable at a weighted average exercise price of \$0.50 per common share. The stock options expire on various dates between December 1, 2004 and May 18, 2009.

Stock option transactions for the six months ended June 30, 2004, and the number of stock options outstanding are summarized as follows:

	Number of Optioned Common Shares #	Weighted Average Exercise Price \$
<u>Executive Officers, Directors, Employees and Consultant Options:</u>		
Balance, December 31, 2003	6,173,000	0.44
Options granted	2,364,227	0.72
Options exercised	(756,665)	0.33
Options expired/cancelled	(15,001)	0.56
Balance, June 30, 2004	7,765,561	0.53

Azure Dynamics Corporation
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Notes to the Consolidated Financial Statements

Six Months ended June 30, 2004 and 2003 (unaudited)

3. Share Capital, Warrants and Stock Options (Cont'd.)

(d) Stock options (Cont'd.)

	Number of Optioned Common Shares #	Weighted Average Exercise Price \$
<u>Agent's Compensation Options:</u>		
Balance, December 31, 2003	2,325,508	0.495
Options exercised – March 2004	(80,000)	0.495
Balance June 30, 2004	2,245,508	0.495
Total Options Outstanding, June 30, 2004	10,011,069	0.52

As at June 30, 2004, the numbers of optioned common shares outstanding and exercisable are as follows:

Expiry date	Number outstanding #	Number exercisable #	Exercise price \$
December 1, 2004	2,245,508	2,245,508	0.495
December 31, 2004	250,000	125,000	0.70
April 25, 2006	1,870,000	1,870,000	0.25
August 20, 2006	160,000	160,000	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 7, 2007	20,000	20,000	0.71
March 11, 2007	1,150,000	1,150,000	0.73
April 12, 2007	30,000	30,000	0.94
May 1, 2007	145,000	145,000	0.80
January 1, 2008	235,000	231,667	0.50
February 1, 2008	147,334	98,223	0.50
August 25, 2008	475,000	183,333	0.30
September 26, 2008	750,000	250,000	0.48
January 1, 2009	1,547,227	515,742	0.65
February 1, 2009	100,000	33,333	0.85
March 22, 2009	25,000	8,333	1.06
May 3, 2009	312,000	104,001	0.90
May 18, 2009	130,000	43,334	0.90
	10,011,069	7,632,474	

(e) Stock compensation expense

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%, expected life – 4 to 5 years, expected dividend yield - nil, and expected volatility – ranging from 17% to 30%. The Company recorded a compensation expense charge of \$341,565 for the six months ended June 30, 2004.

Six Months ended June 30, 2004 and 2003 (unaudited)

3. Share Capital, Warrants and Stock Options (Cont'd.)

(e) Stock compensation expense (Cont'd.)

The comparative numbers for the three and six months ended June 30, 2003 have been restated to include the compensation expense related to options granted during that period. As the change in accounting policy was first implemented in the fourth quarter of 2003, with effect from January 1, 2003, the compensation expense was not previously recorded in the quarterly reporting. Total compensation expense for the three and six months ended June 30, 2003 was \$16,674 and \$61,367, respectively.

4. Related Party Transactions

- a) During the six months ended June 30, 2004, the Company incurred costs of \$1,709 (2003 - \$7,826) in respect of administrative services provided by Vizon SciTec (formerly B.C. Research Inc.), a significant shareholder.
- b) During the six months ended June 30, 2004, the Company incurred costs of \$38,067 (2003 - \$74,842) in respect of leased premises and equipment provided by Vizon SciTec.
- c) During the six months ended June 30, 2004, the Company paid \$121,500 (2003 - \$124,167) to a company controlled by an officer/director for services rendered to the Company in his capacity as an executive officer.

5. Commitments

Effective February 10, 2004, the Company entered into a sublease and license agreement for premises located at 3900 North Fraser Way, Burnaby, Canada and relocated its Vancouver-based operations to this site. The sub-lease arrangements were such that the Company shared access to the facility with the head leaseholder until May 1, 2004. Effective May 1, 2004, the Company has entered into a five year lease agreement for the premises directly with the Landlord, and also effective May 1, 2004 has entered into a sublease and licence agreement with the outgoing leaseholder, whereby that party continues to share access to the facility until July 31, 2004.

The annual lease commitments relating to this facility, as included in the schedule of commitments in Note 13 to the audited consolidated financial statements for the year ended December 31, 2003, are as follows:

2004	\$ 86,025
2005	\$ 175,150
2006	\$ 179,800
2007	\$ 181,350
2008	\$ 181,350
2009	\$ 60,450

Six Months ended June 30, 2004 and 2003 (unaudited)

6. Subsequent Events

On July 27, 2004, the Company announced that it had closed an equity financing, whereby the Company issued 3,811,250 new common shares, at a price of \$0.80 per Unit, for gross proceeds of \$3,049,000. 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 of the Company subscribed for \$95,000 of the offering.

Simultaneously, the Company entered into the Capital Assurance Agreement pursuant to which it is ensured to receive by December 15, 2004 approximately \$8.5 million which the Company could otherwise receive upon the exercise of the Corporation's outstanding common share purchase warrants and agent compensation options. The Company has 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 has entered into a binding agreement with a number of parties (the "Obligors") which provides that, to the extent any Old Warrants are not exercised for any reason by their expiry time on December 1, 2004, the Obligors will, on a pro rata basis, subscribe for common shares of the Company at a price of \$0.60 per share, being the weighted average exercise price of the Old Warrants. In consideration for entering into the Capital Assurance Agreement, the Obligors will collectively receive a cash fee of \$765,000 of which \$510,000 was paid on July 27, 2004 and the balance of \$255,000 is due on December 16, 2004. Ludgate Investments Limited, an investment dealer in the United Kingdom, was paid an agent's fee of \$200,000 for services rendered to the Company in connection with the Capital Assurance Agreement. 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 at an exercise price of \$1.00 up until July 27, 2005. Holders of the Obligor Warrants will not be able to exercise such warrants until December 16, 2004. A director of the Company undertook an Obligor obligation of \$600,000 and in connection with this undertaking will receive a cash fee of \$54,000 and 120,000 Obligor Warrants.

On August 6, 2004 the Company filed an admission document for a secondary listing of its shares and certain warrants on the Alternative Investment Market ("AIM") of the London Stock Exchange and the shares/warrants were admitted for trading on August 12, 2004.

As at June 30, 2004 the Company estimated that it had incurred costs of \$815,497 in legal, accounting and advisory fees in respect of the aforementioned capital and financing arrangements. These costs have been deferred on the balance sheet pending the conclusion of the transactions at which time the costs will be charged to the appropriate capital account.