
Azure Dynamics Corporation
(A Development Stage Enterprise)
Unaudited Interim Consolidated Financial Statements
For the three months and six months ended June 30, 2006

CONTENTS

Consolidated Balance Sheets	2
Consolidated Statements of Operations and Deficit	3
Consolidated Statements of Cash Flows	4
Notes to Consolidated Financial Statements	5 - 18

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

As at	June 30 2006 (Unaudited)	December 31 2005 (Audited)	June 30 2005 (Unaudited)
	\$	\$	\$
ASSETS			
Current			
Cash and cash equivalents	10,747	20,721	12,784
Accounts receivable	1,130	1,004	1,326
Contributions receivable	639	597	1,757
Inventory and related prepayments	4,328	2,696	2,700
Prepaid expenses	1,017	980	910
	17,861	25,998	19,477
Restricted cash	670	698	778
Property and equipment	5,789	5,573	5,524
Other assets	44	61	61
Intangible assets, net of amortization (note 3)	11,411	12,133	12,949
Goodwill (note 3)	2,932	2,932	2,888
	38,707	47,395	41,677
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current			
Accounts payable and accrued liabilities	3,043	3,403	2,635
Customer deposits and deferred revenue	912	1,574	271
Current portion of notes payable (note 4)	2,427	2,558	238
	6,382	7,535	3,144
Long-term			
Deferred revenue	986	1,038	1,120
Notes payable	-	-	2,486
	986	1,038	3,606
Shareholders' equity			
Share capital (note 5)	82,178	80,701	66,184
Contributed surplus (note 5)	2,768	2,316	1,564
Deficit	(53,607)	(44,195)	(32,821)
	31,339	38,822	34,927
	38,707	47,395	41,677

Certain reclassifications have been made to the June 30 2005 comparative numbers to conform to the current period presentation

Approved on behalf of the Board:

"D. Campbell Deacon" Director

"Dennis A. Sharp" Director

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 three months ended June 30 (unaudited)		For the six months ended June 30 (unaudited)	
	2006	2005	2006	2005
	\$	\$	\$	\$
Revenues	1,205	1,525	2,353	2,509
Cost of sales	1,129	1,253	1,972	1,946
Gross Margin	<u>76</u>	<u>272</u>	<u>381</u>	<u>563</u>
Expenses				
Engineering, research, development and related costs,	2,320	3,298	4,737	6,006
Selling and marketing	823	801	1,548	1,448
General and administrative	1,935	2,060	3,752	3,663
Total expenses	<u>5,078</u>	<u>6,159</u>	<u>10,037</u>	<u>11,117</u>
Loss from operations	<u>(5,002)</u>	<u>(5,887)</u>	<u>(9,656)</u>	<u>(10,554)</u>
Interest and other income, net	118	41	255	82
Foreign currency gains/(losses)	38	246	(11)	(50)
Net loss for the period	<u>(4,846)</u>	<u>(5,600)</u>	<u>(9,412)</u>	<u>(10,522)</u>
Deficit, beginning of period	<u>(48,761)</u>	<u>(27,221)</u>	<u>(44,195)</u>	<u>(22,299)</u>
Deficit, end of period	<u>(53,607)</u>	<u>(32,821)</u>	<u>(53,607)</u>	<u>(32,821)</u>
Loss per share - basic	<u>(0.03)</u>	<u>(0.04)</u>	<u>(0.06)</u>	<u>(0.08)</u>
Weighted average number of shares - basic *	158,638	141,203	157,569	133,095

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

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

	For the three months ended June 30 (unaudited)		For the six months ended June 30 (unaudited)	
	2006	2005	2006	2005
	\$	\$	\$	\$
Cash flows from operating activities				
Net loss for the period	(4,846)	(5,600)	(9,412)	(10,522)
Adjustments for:				
Amortization of property and equipment and other assets	193	193	386	337
Amortization of intangible assets	408	425	808	708
Unrealized foreign currency gains/(losses)	387	(192)	170	68
Stock option compensation expense	214	342	639	848
	<u>(3,644)</u>	<u>(4,832)</u>	<u>(7,409)</u>	<u>(8,561)</u>
Changes in non-cash working capital items	(1,110)	(878)	(2,873)	(3,812)
Movement due to exchange impact	(43)	(33)	(39)	(32)
	<u>(1,153)</u>	<u>(911)</u>	<u>(2,912)</u>	<u>(3,844)</u>
Total Cash flows from operating activities	<u>(4,797)</u>	<u>(5,743)</u>	<u>(10,321)</u>	<u>(12,405)</u>
Cash flows from financing activities				
Issuance of common shares (net of costs)	673	39	1,290	11,789
Principle payments on notes payable	(14)	-	(28)	(15)
Movement due to exchange impact	(113)	(35)	(103)	(35)
Total Cash flows from financing activities	<u>546</u>	<u>4</u>	<u>1,159</u>	<u>11,739</u>
Cash flows from investing activities				
Acquisition of property and equipment	(367)	(165)	(601)	(456)
Acquisition of other assets	(54)	57	(69)	(39)
Changes in Restricted Cash	-	(13)	-	409
Movement due to exchange impact	(267)	-	(204)	-
Total Cash flows from investing activities	<u>(688)</u>	<u>(121)</u>	<u>(874)</u>	<u>(86)</u>
Decrease in cash and cash equivalents	(4,939)	(5,860)	(10,036)	(752)
Exchange Impact on Cash Held in Foreign Currency	(89)	177	62	1
Cash and cash equivalents, beginning of period	15,775	18,467	20,721	13,535
Cash and cash equivalents, end of period	<u>10,747</u>	<u>12,784</u>	<u>10,747</u>	<u>12,784</u>

Certain reclassifications have been made to the June 30 2005 comparative numbers to conform to the current period presentation.

Three Months and Six Months ended June 30, 2006 and 2005 (unaudited)

1. Nature of Operations and Basis of Presentation

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. 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, 2005. Certain reclassifications have been made to the June 30, 2005 comparative numbers to conform to the June 30, 2006 financial statement presentation.

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 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

Three Months and Six Months ended June 30, 2006 and 2005 (unaudited)

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

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.

The Company also recognizes revenues related to a technology and software licensing agreement (see note 6). 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 6.

(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

Three Months and Six Months ended June 30, 2006 and 2005 (unaudited)

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

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.

(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

Other assets of \$44,000 is related to a note receivable. Repayment of this note commenced on February 1, 2006 and will conclude on August 1, 2007.

(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. 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.

Three Months and Six Months ended June 30, 2006 and 2005 (unaudited)

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

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.

(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 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 quarter ended June 30, 2006, a foreign exchange gain of \$38,000 was recognized in the consolidated earnings (2005 - foreign exchange gain of \$246,000).

(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

Three Months and Six Months ended June 30, 2006 and 2005 (unaudited)

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

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 5(d). 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 period financial statement presentation.

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.

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

Three Months and Six Months ended June 30, 2006 and 2005 (unaudited)

3. Acquisition of Solectria (cont'd)

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>

Intangible assets included on the Consolidated Balance Sheet of \$11.4 million at June 30, 2006, \$12.1 million at December 30, 2005 and \$12.9 million at June 30, 2005 are net of amortization of \$2.1 million, \$1.4 million and \$0.5 million respectively.

4. Investment in Real Estate Joint Venture

The Company's US subsidiary, Azure Dynamics Incorporated (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

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

Three Months and Six Months ended June 30, 2006 and 2005 (unaudited)

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

guarantees of an additional US\$600,000 (Cdn\$698,000) that is in the form of a letter of 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 quarter ended June 30, 2006 the Company's interest in earnings from the real estate joint venture amounted to \$38,000 (\$76,000 year to date).

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

(Stated in thousands of dollars)

	June 30, 2006	June 30, 2005
Cash and equivalents	\$ 295	\$ 333
Accounts receivable	8	23
Property and equipment	3,165	3,273
Total assets	\$ 3,468	\$ 3,629
Accounts payable and accrued liabilities	\$ 281	\$ 310
Note payable – current	2,427	238
Note payable – long term	-	2,486
Shareholders' equity	760	595
Total liabilities and shareholders' equity	\$ 3,468	\$ 3,629

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 \$5.0 million at June 30, 2006.

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

	For three months ended June 30, 2006	For six months ended June 30, 2006
(Stated in thousands of dollars)		
General and administrative	\$ (78)	\$ (157)
Other expense	40	81
Net Income	\$ (38)	\$ (76)

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

Three Months and Six Months ended June 30, 2006 and 2005 (unaudited)

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

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)	For three months ended June 30, 2006	For six months ended June 30, 2006
Net Income	\$ 38	\$ 76
Amortization	20	39
Principle payments on note payable	(14)	(29)
Changes in short term assets and liabilities	(57)	(101)
Net change in cash	\$ (13)	\$ (15)
Cash and cash equivalents beginning of period	308	310
Cash and cash equivalents end of period	\$ 295	\$ 295

5. 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

b) Issued and outstanding common shares

(amount stated in thousands of dollars)	Number of Common Shares	Amount
Balance, December 31, 2005	156,134,272	\$ 80,701
Issued on exercise of stock options	3,005,173	1,290
Release of costs from contributed surplus on options exercised	-	187
Balance, June 30, 2006	159,139,445	\$ 82,178

c) Contributed surplus

(stated in thousands of dollars)	Amount
Balance, December 31, 2005	\$ 2,316
Stock option compensation expense	639
Release to share capital on exercise of stock options	(187)
Balance, June 30, 2006	\$ 2,768

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

Three Months and Six Months ended June 30, 2006 and 2005 (unaudited)

5. Share Capital, Warrants and Stock Options (d) (cont'd)

d) 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 June 30, 2006 the Company had 12,386,408 stock options outstanding under the Plan. The stock options are exercisable at a weighted average exercise price of \$0.93 per common share. The stock options expire on various dates between August 20, 2006 and May 11, 2017.

Stock option transactions for the six months ended June 30, 2006, and the number of stock options outstanding are summarized as follows:

	Number of Optioned Common Shares	Weighted Average Exercise Price \$
Executive Officer, Director, Employee and Consultant Options:		
Balance, December 31, 2005	14,030,914	0.81
Options granted	1,475,000	1.07
Options exercised	(3,005,173)	0.43
Options expired/cancelled	(114,333)	0.80
Balance, June 30, 2006	12,386,408	0.93

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

Three Months and Six Months ended June 30, 2006 and 2005 (unaudited)

5. Share Capital, Warrants and Stock Options (d) (cont'd)

As at June 30, 2006, the numbers of optioned common shares outstanding and exercisable are as follows:

Expiry Date	Number Outstanding	Number Exercisable	Exercise Price
August 20, 2006	105,000	105,000	0.44
November 5, 2006	127,000	127,000	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	1,000,000	1,000,000	0.73
April 12, 2007	30,000	30,000	0.94
May 1, 2007	65,000	65,000	0.80
January 1, 2008	225,000	225,000	0.50
February 1, 2008	112,000	112,000	0.50
August 25, 2008	275,000	275,000	0.30
September 26, 2008	235,000	235,000	0.48
January 1, 2009	1,380,088	1,380,088	0.65
May 3, 2009	312,000	312,000	0.90
May 18, 2009	130,000	130,000	0.90
August 12, 2009	303,211	194,371	0.68
October 4, 2009	33,333	-	0.60
September 9, 2011	240,000	120,000	0.53
January 18, 2012	2,160,854	1,517,537	0.86
February 17, 2012	65,922	39,611	0.95
February 24, 2012	1,335,000	890,013	0.99
April 6, 2012	70,000	46,667	1.06
April 18, 2012	25,000	16,667	1.08
May 2, 2012	60,000	40,001	1.05
June 6, 2012	5,000	3,334	1.00
June 21, 2012	30,000	20,001	0.95
July 4, 2012	50,000	16,667	0.93
July 4, 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	758,336	1.07
January 17, 2013	1,310,000	436,697	1.11
February 13, 2017	50,000	16,667	1.15
March 23, 2017	100,000	33,334	1.04
May 11, 2017	5,000	1,667	1.30
Grand Total	12,386,408	8,366,326	

Three Months and Six Months ended June 30, 2006 and 2005 (unaudited)

5. Share Capital, Warrants and Stock Options (cont'd)

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 of 5% (2005 – 5%), expected life of 4 years (2005 - 4 Years), expected dividend yield of nil (2005 - nil), and expected volatility of 35% (2005 - 35%). The Company recorded a compensation expense charge of \$0.2 million to consolidated earnings for the three months ended June 30, 2006 (2005 - \$0.3 million) and \$0.6 million year to date (2005 - \$0.8 million), with a corresponding credit to contributed surplus. Approximately \$119,000 was released from contributed surplus and added to share capital in respect of options exercised in the three month period (2005 - \$6,000) . On a cumulative basis, \$187,000 was released from contributed surplus and added to share capital in respect of options exercised (2005 - \$6,000).

6. Related Party Transactions

- a) 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 June 30, 2006, the Company has deferred revenue associated with the TTA Agreement in the amount of \$1.0 million. During the six months ended June 30, 2006, revenues recognized by the Company from the sale of products to STK and its related companies and from certain other contractual arrangements totalled approximately \$35,000. As of June 30, 2006, accounts receivable includes \$11,000 due from STK and customer deposits includes \$43,000 received from STK.
-

7. Commitments

As of June 30, 2006, the Company has contractually committed to lease payments for premises and equipment requiring minimum payments in future periods as follows:

(Stated in thousands of dollars)

2006	\$	749
2007		1,402
2008		1,308
2009		1,126
2010		1,026
2011		1,028
	\$	6,639

Three Months and Six Months ended June 30, 2006 and 2005 (unaudited)

7. Commitments (cont'd)

- (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.
- (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.

All other commitments have been disclosed in note 13 to the Company's annual financial statements.

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

Three Months and Six Months ended June 30, 2006 and 2005 (unaudited)

8. 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:

	Revenues		Total Assets	Property, Plant , Equipment and Goodwill
Stated in thousands				
	Three months ended June 30, 2006	Six months ended June 30, 2006	June 30, 2006	June 30, 2006
Canada	nil	nil	15,875	776
United Kingdom	179	182	363	170
United States	1,009	2,136	22,469	7,775
Asia	17	35	nil	nil
Total	1,205	2,353	38,707	8,721
	Three months ended June 30, 2005	Six months ended June 30, 2005	June 30, 2005	June 30, 2005
Canada	nil	nil	16,968	723
United Kingdom	nil	nil	366	47
United States	1,483	2,440	24,343	7,642
Asia	42	69	nil	nil
Total	1,525	2,509	41,677	8,412

Certain reclassifications to the June 30, 2005 comparative numbers to conform to the current period presentation.

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

	Three months ended June 30,		Six months ended June 30,	
	2006	2005	2006	2005
First	47%	33%	46%	32%
Second	15%	21%	11%	19%
Third	8%	17%	10%	12%
Others	30%	29%	33%	37%
Total	100%	100%	100%	100%

Three Months and Six Months ended June 30, 2006 and 2005 (unaudited)

9. Subsequent Events

- (a) On July 19, 2006 the Company announced that it has received a \$2.8 million components purchase order from DRS Sustainment Systems, Inc. (formerly DRS Engineered Air Systems Inc.), an operating unit of DRS Technologies, Inc. Under terms of the purchase order, Azure will deliver advanced power electronics, such as inverters, converters and under-the-hood export power components to DRS to be integrated into DRS's Chemical Biological Protective Shelter

- (b) On July 18, 2006 the Company announced it has signed a Memorandum of Understanding ("MOU") for the production of hybrid shuttle buses with StarTrans, a business division of Supreme Corporation. Under the proposed terms of the MOU, Azure will provide StarTrans with hybrid cab-chassis' on which StarTrans will assemble their shuttle bus body at its manufacturing facilities in Goshen, Indiana. Azure's hybrid cab-chassis is a derivative of Azure's series hybrid chassis integrated with a newly developed cab. When fully assembled, the Azure hybrid electric shuttle bus will be compliant with the United States' Buy-America program and after testing will be eligible for the Federal Transit Administrations funding for bus purchases.