
Azure Dynamics Corporation
(A Development Stage Enterprise)
Unaudited Interim Consolidated Financial Statements
For the three months ended March 31, 2005

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

As at	March 31 2005 (Unaudited)	December 31 2004 (Audited)	March 31 2004 (Unaudited)
	\$	\$	\$
ASSETS			
Current			
Cash and cash equivalents	18,519,591	14,312,708	11,738,134
Accounts receivable	891,111	211,459	693,789
Contributions receivable	1,354,299	996,328	585,707
Inventory and related prepayments	2,439,832	1,199,078	-
Prepaid expenses	775,131	284,155	372,260
	<u>23,979,964</u>	<u>17,003,728</u>	<u>13,389,890</u>
Restricted cash	725,760	-	-
Employee loans	-	-	68,509
Property and equipment	5,382,138	538,972	350,950
Other assets	342,303	270,580	113,379
Intangible assets	13,116,668	-	-
Goodwill	2,875,485	-	-
	<u>46,422,318</u>	<u>17,813,280</u>	<u>13,922,728</u>
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current			
Accounts payable and accrued liabilities	2,175,015	1,697,306	741,298
Customer deposits and deferred revenue	1,397,829	-	-
Current portion of notes payable	372,000	-	-
	<u>3,944,844</u>	<u>1,697,306</u>	<u>741,298</u>
Long-term			
Notes payable	2,330,881	-	-
Shareholders' equity			
Share capital	66,144,780	37,693,510	28,120,231
Contributed surplus	1,222,702	721,831	369,026
Deficit	(27,220,889)	(22,299,367)	(15,307,827)
	<u>40,146,593</u>	<u>16,115,974</u>	<u>13,181,430</u>
	46,422,318	17,813,280	13,922,728

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 ending March 31	
	2005	2004 **
Revenues	\$ 983,891	\$ -
Cost of sales	692,850	-
Gross Margin	<u>291,041</u>	<u>-</u>
Expenses		
Engineering, research, development and related costs, net	2,707,402	307,920
Selling and marketing	647,156	365,022
General and administrative	1,603,796	570,068
Total expenses	<u>4,958,354</u>	<u>1,243,010</u>
Loss from operations	<u>(4,667,313)</u>	<u>(1,243,010)</u>
Interest and other income, net	42,447	39,673
Foreign exchange loss	<u>(296,656)</u>	<u>(3,516)</u>
Net loss for the period	<u>(4,921,522)</u>	<u>(1,206,853)</u>
Deficit, beginning of period	<u>(22,299,367)</u>	<u>(14,100,974)</u>
Deficit, end of period	<u>(27,220,889)</u>	<u>(15,307,827)</u>
Loss per share - basic	<u>(0.04)</u>	<u>(0.02)</u>
Weighted average number of shares - basic *	124,891,576	79,525,744

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

** Certain reclassifications have been made to the March 31, 2004 comparative numbers to conform to the current period presentation.

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

	For the three months ending March 31	
	2005	2004
	\$	\$
Cash flows from operating activities		
Net loss for the period	(4,921,522)	(1,206,853)
Adjustments for:		
Amortization of property and equipment and other assets	143,437	40,714
Amortization of intangible assets	283,333	-
Unrealized foreign exchange loss	299,612	-
Common shares issued in exchange for services	-	6,875
Stock option compensation expense	505,430	201,228
Changes in non-cash working capital items	(2,864,161)	(277,617)
	(6,553,871)	(1,235,653)
Cash flows from financing activities		
Issuance of common shares (net of costs)	11,750,260	4,101,066
Principal repayments of notes payable	(14,605)	-
Foreign exchange loss	(243,450)	-
	11,492,205	4,101,066
Cash flows from investing activities		
Acquisition of property and equipment	(290,328)	(221,857)
Acquisition of other assets	(96,518)	(3,859)
Cash acquired from acquisition of subsidiary, net of costs	421,523	-
Changes in loans to employees	-	23,218
Foreign exchange loss	(39,156)	-
	(4,479)	(202,498)
Increase in cash and cash equivalents	4,933,855	2,662,915
Exchange loss on cash held in foreign currency	(1,212)	-
Cash and cash equivalents, beginning of period	14,312,708	9,075,219
Cash and cash equivalents, end of period	19,245,351	11,738,134
Restricted cash *	725,760	-
Cash available	18,519,591	11,738,134

* Restricted cash represents monies invested in US treasury bills to support a Letter of Credit security deposit on a property lease agreement – see note 4.

Three Months ended March 31, 2005 and 2004 (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. The Company derives revenue from the sale of components and products, and from value-added engineering services provided to third parties. Many of its products have several development stages to be completed before their marketability, if any, can be determined. The Company has incurred significant research and development costs and hence has recorded operational losses. Its ability to continue operations is uncertain and dependent upon the successful completion and marketing of its products under development, obtaining additional financing, if required, 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, 2004. Certain reclassifications have been made to the March 31, 2004 comparative numbers to conform to the March 31, 2005 financial statement presentation.

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, 2004 audited financial statements except as stated below.

a) Consolidation

The consolidated financial statements include the accounts of the Company and of its wholly owned subsidiaries since the date of acquisition. Business acquisitions are accounted for using the purchase method. Investments in joint ventures are accounted for using the proportional consolidation method.

b) 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.

Three Months ended March 31, 2005 and 2004 (unaudited)

2. Significant Accounting Policies – continued

c) Revenue recognition

The Company recognizes revenues on sales of its 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. 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 on a straight-line basis over the period of the license agreement.

The Company reports contract revenues 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.

Customer deposits and deferred revenue primarily represent fees paid by customers in advance of products being shipped and the license agreement referred to in note 6.

d) Inventory and related prepayments

Inventory is comprised of product; spare parts, product components and materials, and consumables 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 orders. Inventory is valued at the lower of cost or net realisable value.

e) 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.

f) Property, plant 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 life 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

Three Months ended March 31, 2005 and 2004 (unaudited)

2. Significant Accounting Policies – continued

g) 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.

h) 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.

i) Variable interest entities

During the quarter, 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 the accounting guideline 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.

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 will henceforth operate 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 \$16,696,452, and paid cash of \$373,509 in settlement of the purchase price. Total consideration, including acquisition expenses of \$627,632, is \$17,697,592.

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Notes to the Consolidated Financial Statements

Three Months ended March 31, 2005 and 2004 (unaudited)

3. Acquisition of Solectria – continued

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 \$17,697,592 was allocated to the assets acquired and liabilities assumed based on their estimated fair values as follows:

Current assets (including cash of \$625,390)	\$ 3,074,384
Restricted cash	744,720
Property and equipment	4,678,272
Other assets	53,478
Intangible assets	13,400,000
Goodwill	2,875,485
Current liabilities	(4,428,335)
Notes payable	(2,700,412)
	<u>\$ 17,697,592</u>

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

Customer order backlog	\$ 900,000
Product technology	12,500,000
	<u>\$ 13,400,000</u>

The purchase price allocation is preliminary. As of March 31, 2005 the Company recorded amortization of \$283,333 in respect of the intangible assets.

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 (Note 7). The Company provided a security deposit of US\$400,000 (Cdn\$483,840) and made guarantees of an additional US\$600,000 (Cdn\$725,760) that is collateralized by certain cash equivalents which are pledged. 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 March 31, 2005 the Company's interest in earnings from the real estate joint venture amounted to \$31,172.

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Three Months ended March 31, 2005 and 2004 (unaudited)

4. Investment in Real Estate Joint Venture - continued

The Company's 50% proportional interest in ND Solectria LLC is included in the financial statements as follows:

	March 31, 2005
Cash and equivalents	\$ 320,800
Property and equipment	3,209,602
Total assets	\$ 3,530,402
Accounts payable and accrued liabilities	\$ 228,292
Note payable – current	372,000
Note payable – long term	2,330,881
Shareholder's equity	599,229
Total liabilities and shareholder's equity	\$ 3,530,402

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 6.75 %, 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 \$5,405,762.

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

	Number of Common Shares	Amount
Balance, December 31, 2004	102,791,736	\$ 37,693,509
Issued on acquisition of Solectria (i)	25,297,655	16,696,452
Equity financing (ii)	12,805,000	11,629,861
Issued on exercise of stock options	251,998	120,398
Release of costs from contributed surplus on options exercised	-	4,560
Balance, March 31, 2005	141,146,389	\$ 66,144,780

- i. 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.
- ii. 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 \$11,629,861 after deducting issue costs of \$625,856.

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Three Months ended March 31, 2005 and 2004 (unaudited)

5. Share Capital, Warrants and Stock Options - continued

c) Contributed surplus

Balance, December 31, 2004	\$ 721,832
Stock option compensation expense	505,430
Release to share capital on exercise of stock options	(4,560)
Balance, March 31, 2005	<u>\$ 1,222,702</u>

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, 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 terms ranging from five to seven years and generally vest over periods of up to twenty-four months. As at March 31, 2005, the Company had 11,811,572 stock options outstanding under the Plan of which 2,137,283 have been issued subject to shareholders' approval at the next annual general meeting. The stock options are exercisable at a weighted average exercise price of \$0.67 per common share. The stock options expire on various dates between January 18, 2006 and February 24, 2012.

Stock option transactions for the three months ended March 31, 2005, 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, 2004	8,178,765	0.54
Options granted	4,018,137	0.91
Options exercised	(251,998)	0.48
Options expired/cancelled	(133,332)	0.78
Balance, March 31, 2005	11,811,572	0.67

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Three Months ended March 31, 2005 and 2004 (unaudited)

5. Share Capital, Warrants and Stock Options - continued

d) Stock options - continued

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

Expiry date	Number outstanding	Number exercisable	Exercise price \$
January 18, 2006	320,000	80,000	0.86
April 25, 2006	1,690,000	1,690,000	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	145,000	145,000	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	283,333	0.30
September 26, 2008	750,000	500,000	0.48
January 1, 2009	1,527,227	1,124,434	0.65
March 22, 2009	25,000	16,667	1.06
May 3, 2009	312,000	131,777	0.90
May 18, 2009	130,000	43,334	0.90
August 12, 2009	338,208	112,736	0.68
October 4, 2009	100,000	33,333	0.60
September 9, 2011	360,000	120,000	0.53
January 18, 2012	2,219,187	739,729	0.86
February 17, 2012	98,950	6,667	0.95
February 24, 2012	1,380,000	Nil	0.95
	11,811,572	7,018,010	

e) Stock compensation expense

The Company 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 - 5 years), expected dividend yield - nil (2004 - nil), and expected volatility - 35% (2004 - 17%). The Company recorded a compensation expense charge of \$505,430 for the three months ended March 31, 2005 (2004 - \$201,228).

6. Related Party Transactions

During the three months ended March 31, 2005, the Company paid \$76,500 (2004 - \$60,750) to a private company controlled by the Chief Executive Officer for remuneration in respect of an employment contract.

Three Months ended March 31, 2005 and 2004 (unaudited)

6. Related Party Transactions - continued

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\$1,000,000 (Cdn\$1,209,600). As discussed in note 2, revenues on the TTA Agreement are being recognized on a straight-line basis over the period of the license agreement. As of March 31, 2005, the Company has deferred revenue associated with the TTA Agreement in the amount of \$1,108,799. During the quarter ended March 31, 2005, revenues recognized by the Company from the sale of products to STK and its related companies and from certain other contractual arrangements amounted to approximately \$27,350. Accounts receivable includes \$14,042 due from STK as of March 31, 2005 and the Company has received customer deposits of \$41,356 from STK. Accounts payable include \$80,027 due to STK for component purchases.

7. Commitments

Solectria leases its operating facility in Boston, 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.

As of March 31, 2005, the Company’s future minimum lease commitments due under the non-cancellable lease agreement are as follows:

2005	\$ 666,800
2006	\$ 923,800
2007	\$ 1,028,100
2008	\$ 1,028,100
2009	\$ 1,028,100

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

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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:

Quarter ended March 31, 2005	Revenues	Total Assets	Property, Plant, Equipment and Goodwill
Canada	\$ nil	\$ 21,695,978	\$ 657,351
United Kingdom	\$ nil	\$ 351,171	\$ 38,430
United States	\$ 956,541	\$ 24,375,169	\$ 7,561,842
Asia	\$ 27,350	\$ nil	\$ nil
Total	\$ 983,891	\$ 46,422,318	\$ 8,257,623

Quarter ended March 31, 2004	Revenues	Total Assets	Property, Plant, Equipment and Goodwill
Canada	\$ nil	\$ 13,922,728	\$ 350,950
United Kingdom	\$ nil	\$ nil	\$ nil
Total	\$ nil	\$ 13,922,728	\$ 350,950

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

Quarter ended March 31, 2005	Percentage
First	31%
Second	16%
Third	14%
Others	39%
Total	100%

9. Subsequent Events

On April 6, 2005, the Company granted 70,000 options with an exercise price of \$1.06 per share to a director of the Company. The options have been issued subject to shareholders approval at the upcoming annual general meeting and vest over two years thereafter and expire on April 6, 2012.

On April 18, 2005, the Company granted 25,000 options with an exercise price of \$1.08 per share to an employee of the Company. The options have been issued subject to shareholders approval at the upcoming annual general meeting and vest over two years thereafter and expire on April 18, 2012.