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

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

As at	September 30 2004 (Unaudited)	December 31 2003 (Audited)	September 30 2003 (Unaudited)
	\$	\$	\$
ASSETS			
Current			
Cash and cash equivalents	9,032,576	9,075,219	1,320,724
Accounts receivable	268,422	337,794	155,499
Contributions receivable	842,224	780,459	-
Inventory and related prepayments	603,802	-	-
Prepaid expenses	343,595	61,655	20,003
Deferred financing costs	-	-	182,029
	11,090,619	10,255,127	1,678,255
Employee loans	-	91,727	107,799
Deferred costs	530,084	-	-
Property and equipment	509,696	162,048	184,665
Other assets	112,698	117,279	115,154
	12,243,097	10,626,181	2,085,873
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current			
Accounts payable and accrued liabilities	1,488,372	567,692	753,653
Convertible debentures	-	-	2,070,772
	1,488,372	567,692	2,824,425
Shareholders' equity			
Share capital	29,633,074	23,991,665	11,850,125
Special warrants	-	-	90,000
Convertible debentures	-	-	177,500
Contributed surplus	692,074	167,798	86,489
Deficit	(19,570,423)	(14,100,974)	(12,942,666)
	10,754,725	10,058,489	(738,552)
	12,243,097	10,626,181	2,085,873

* 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 September 30		For the nine months ended September 30	
	2004	2003	2004	2003
	\$	\$	\$	\$
Revenue				
Other	60,869	9,540	147,959	23,390
Expenses				
Research and development, net	1,333,797	703,418	2,212,635	1,058,864
Selling and marketing	454,844	140,862	1,189,914	434,627
General and administrative	579,767	250,756	1,694,426	834,667
Rent and ancillary	200,784	53,606	382,612	167,442
Amortization of property and equipment and other assets	44,577	43,924	137,821	130,081
Accretion expense on convertible debentures	-	32,272	-	32,272
Amortization of deferred financing costs	-	39,953	-	39,953
	2,613,769	1,264,791	5,617,408	2,697,906
Net loss for the period	(2,552,900)	(1,255,251)	(5,469,449)	(2,674,516)
Deficit, beginning of period	(17,017,523)	(11,687,415)	(14,100,974)	(10,268,150)
Deficit, end of period	(19,570,423)	(12,942,666)	(19,570,423)	(12,942,666)
Loss per share - basic	(0.03)	(0.03)	(0.07)	(0.06)
Weighted average number of shares - basic	87,322,084	45,044,375	83,592,765	45,024,998

* 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
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Unaudited Consolidated Statements of Cash Flows

	For the three months ended		For the nine months ended	
	September 30		September 30	
	2004	2003	2004	2003
	\$	\$	\$	\$
Cash flows from operating activities				
Net loss for the period	(2,552,900)	(1,255,251)	(5,469,449)	(2,674,516)
Adjustments for:				
Amortization of property and equipment and other assets	44,577	43,924	137,821	130,081
Common shares issued in exchange for services	-	6,250	27,500	18,750
Stock option compensation expense	126,153	25,122	467,718	86,489
Accretion expense on convertible debentures	-	32,272	-	32,272
Amortization of deferred financing costs	-	39,953	-	39,953
Changes in non-cash working capital items	(340,794)	(153,357)	42,545	(456,436)
	(2,722,964)	(1,261,087)	(4,793,865)	(2,823,407)
Cash flows from financing activities				
Issuance of common shares (net of costs)	2,648,298	36,220	7,072,826	36,220
Alternative Investment Market listing costs	(211,790)	-	(967,443)	-
Capital Assurance Agreement costs	(965,000)	-	(965,000)	-
Research and development sponsorship funds received	-	-	-	1,000,000
Convertible debentures funds received (net of costs)	-	1,994,019	-	1,994,019
Repayment of obligations under capital lease	-	(2,573)	-	(9,796)
	1,471,508	2,027,666	5,140,383	3,020,443
Cash flows from investing activities				
Acquisition of property and equipment	(64,404)	(5,636)	(451,444)	(8,882)
Acquisition of other assets	(17,999)	(24,159)	(29,444)	(48,990)
Changes in loans to employees	-	150,966	91,727	150,966
	(82,403)	121,171	(389,161)	93,094
Increase (decrease) in cash and cash equivalents	(1,333,859)	887,750	(42,643)	290,130
Cash and cash equivalents, beginning of period	10,366,435	432,974	9,075,219	1,030,594
Cash and cash equivalents, end of period	9,032,576	1,320,724	9,032,576	1,320,724

* 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

Nine Months ended September 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 hybrid electric vehicle control and powertrain 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 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 customer contributions and 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) Inventory and related prepayments

Inventory is comprised of product components, spare parts and consumables held for use in the Company's product development activities and customer projects. Inventory is valued at the lower of cost or net realisable value.

(b) Deferred costs

The costs incurred by the Company in respect of capital financing and related transactions are deferred on the balance sheet and are recognized as charges to the appropriate equity capital account either when the related transaction is concluded or over a corresponding amortization period.

Azure Dynamics Corporation
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Notes to the Consolidated Financial Statements

Nine Months ended September 30, 2004 and 2003 (unaudited)

2. Significant Accounting Policies - continued

(c) 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 year end, while revenues and expenses are translated at average rates of exchange during the year. 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. The Company had no self-sustaining subsidiaries at September 30, 2004.

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

(b) Issued and outstanding common shares

	Number of Common Shares	Amount
Balance, December 31, 2003	78,163,836	\$ 23,991,665
March 2004 private placement (i)	4,861,110	3,892,287
Issued on exercise of agent compensation options	80,000	39,600
Issued on exercise of stock options	776,665	250,846
Issued in lieu of non-executive directors fees	42,307	27,500
Issued on exercise of warrants	725,000	449,500
TSX listing costs (ii)		(146,973)
July 2004 public offering (iii)	3,811,250	2,549,453
Capital Assurance Agreement costs (iii)		(453,361)
AIM listing costs (iv)		(967,443)
Balance, September 30, 2004	88,460,168	\$ 29,633,074

- i. 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 \$3,892,287 after deducting share issue costs of \$291,962.
- ii. 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 of \$146,973 have been charged to the share capital account.
- iii. 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. Net proceeds of the financing were \$2,549,453 after deducting share issue costs of \$461,434 and deemed warrant issue costs of \$38,113.

Azure Dynamics Corporation
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Notes to the Consolidated Financial Statements

Nine Months ended September 30, 2004 and 2003 (unaudited)

3. Share Capital, Warrants and Stock Options – continued

(b) Issued and outstanding common shares - continued

iii. Continued

Simultaneously, the Company entered into a 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 Company's outstanding common share purchase warrants and agent compensation options. The Company has issued and outstanding 11,966,063 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. 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 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. Total costs of the Capital Assurance Agreement of \$983,445 are comprised of the cash fee of \$765,000, an agents' fee of \$200,000 and the deemed warrant issue cost of \$18,445. The Capital Assurance Agreement costs were deferred on the balance sheet at closing and are being amortized to the share capital account evenly over the term of the agreement (July 27 to December 15, 2004). \$453,361 of deferred cost has been amortized to share capital as at September 30, 2004.

- iv. 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 of \$967,443 have been charged to the share capital account.

(c) Warrants

	Number of Warranted Common Shares	Weighted Average Exercise Price
<u>December 2003 Warrants:</u>		
Balance, December 31, 2003 (i)	12,691,063	\$ 0.62
Warrants exercised	(725,000)	0.62
Balance, September 30, 2004	11,966,063	0.62
<u>July 2004 warrants:</u>		
Warrants issued (ii)	3,605,625	1.00
Total warrant balance, September 30, 2004	15,571,688	0.71

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Nine Months ended September 30, 2004 and 2003 (unaudited)

3. Share Capital, Warrants and Stock Options – continued

(c) Warrants - continued

- i. In conjunction with a private placement financing completed on December 1, 2003, the Company issued 12,691,063 warrants, each warrant being exercisable into one common share of the Company, at a price of \$0.62 per share, until December 1, 2004.
- ii. In conjunction with the public offering of common shares and the Capital Assurance Agreement transactions completed on July 27, 2004, the Company issued 1,905,625 and 1,700,000 warrants, respectively. Each warrant entitles the holder thereof to purchase one common share of the Company at a price of \$1.00 until July 27, 2005.

(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 a twelve to twenty-four month period. As at September 30, 2004, the Company had 8,448,765 stock options outstanding under the Plan. In conjunction with the December 1, 2003 financing, the Company 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. At September 30, 2004 there are 2,245,508 agent compensation options outstanding. In total, there are 10,694,273 stock options outstanding, of which 8,415,102 are 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 September 9, 2011.

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

	Number of Optioned Common Shares	Weighted Average Exercise Price
<u>Executive Officer, Director, Employee and Consultant Options:</u>		
Balance, December 31, 2003	6,173,000	\$ 0.44
Options granted	3,070,765	0.69
Options exercised	(776,665)	0.32
Options expired/cancelled	(18,335)	0.55
Balance, September 30, 2004	8,448,765	0.54
<u>Agent Compensation Options:</u>		
Balance, December 31, 2003	2,325,508	\$ 0.495
Options exercised	(80,000)	0.495
Balance, September 30, 2004	2,245,508	0.495
Total Options Outstanding, September 30, 2004	10,694,273	\$ 0.53

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Nine Months ended September 30, 2004 and 2003 (unaudited)

3. Share Capital, Warrants and Stock Options – continued

(d) Stock options - continued

As at September 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	187,500	0.70
April 25, 2006	1,850,000	1,850,000	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	144,000	96,000	0.50
August 25, 2008	475,000	316,667	0.30
September 26, 2008	750,000	500,000	0.48
January 1, 2009	1,547,227	625,358	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	117,889	0.90
May 18, 2009	130,000	43,334	0.90
Aug 12, 2009	346,538	115,513	0.68
September 9, 2011	360,000	120,000	0.53
	10,694,273	8,415,102	

(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 \$467,718 for the nine months ended September 30, 2004.

The comparative numbers for the three and nine months ended September 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 nine months ended September 30, 2003 was \$25,122 and \$86,489, respectively.

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Notes to the Consolidated Financial Statements

Nine Months ended September 30, 2004 and 2003 (unaudited)

4. Related Party Transactions

During the nine months ended September 30, 2004, the Company paid \$198,000 (2003 - \$165,417) 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 continued to share access to the facility up 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	\$ 43,013
2005	\$ 175,150
2006	\$ 179,800
2007	\$ 181,350
2008	\$ 181,350
2009	\$ 60,450

6. Subsequent Events

On October 1, 2004, the Company granted 100,000 options with an exercise price of \$0.60 per share to an employee of the Company. The options vest over two years and expire on October 1, 2009.