

Year ended December 31, 2006 and 2005

MANAGEMENT'S DISCUSSION AND ANALYSIS

Year Ended December 31, 2006 ("2006") compared to the Year Ended December 31, 2005 ("2005")

This "Management's Discussion and Analysis" has been prepared as of March 21, 2007 and should be read in conjunction with the audited consolidated financial statements of the Company for the year ended December 31, 2006 (the "Financial Statements").

Forward-Looking Statements

This MD&A contains forward-looking statements related to Azure's financial and other projections, expected future plans, events, financial and operating results, objectives and performance, as well as underlying assumptions, all of which involve risks and uncertainties. When used in this MD&A, the words "believe", "anticipate", "intend", "estimate", "expect", "project" and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain such words. These statements reflect management's current belief and are based on information currently available to Azure's management and are subject to certain risks, uncertainties and assumptions. Actual results may differ materially from management expectations as projected in such forward-looking statements for a variety of reasons and no assurances can be given as to actual future results, performance or prospects. Factors that may cause such differences include, but are not limited to, the early stage of development of the Company; a lack of product revenues and a history of losses; the need for additional financing; uncertainty as to commercial viability; uncertainty as to product development and commercialization milestones being met; uncertainty as to the market for the Company's products and unproved acceptance of the Company's technology; competition; uncertainty as to target markets; dependence upon third parties; changes in environmental policies; uncertainty as to patent and proprietary rights; availability of management and key personnel; available regulatory approvals and conflicts of interest by directors and officers of the Company. More detailed information about these and other factors that could affect Azure's operations or financial results are included in Azure's filings with Canadian securities regulatory authorities. Azure does not assume any obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law. Because of these risks, uncertainties and assumptions, readers should not place undue emphasis on Azure's forward-looking statements.

Business Strategy of the Company and Overall Performance

Azure Dynamics Corporation ("Azure" or the "Company") has developed proprietary hybrid vehicle technology for the light to heavy duty commercial vehicle category (the "Technology"). Azure has expertise in the areas of vehicle controls software, power electronics, electric machine design, vehicle systems engineering and vehicle integration. The principal business of Azure is the supply of hybrid electric vehicle ("HEV") and electric vehicle ("EV") control and powertrain systems. The Company also has an established portfolio of proprietary component products that compliment its core technical skills and makes use of an extensive industry supplier base to offer complete powertrain solutions to its target market.

Target markets include urban delivery, postal, courier, taxi and shuttle-bus applications. Over the past five years, the Company has primarily been engaged in the development and testing of its Technology. Certain of the Company's products are now generating commercial revenues while other products are in the development stage. In production, Azure does not intend to be the ultimate manufacturer of components or assembler of powertrain systems. Rather, the Company uses the supply capacity that exists within the commercial and military vehicle industries to assemble products to its specifications which are then distributed via existing industry channels to the customer.

Azure's strategy is to closely align product development and sales efforts with industry partners (Original Equipment Manufacturer's, component suppliers, and customers). By aligning with industry leaders, Azure can gain access to product development support and established distribution networks thereby accelerating the penetration of its hybrid-electric products into the commercial vehicle markets. During 2006, the Company

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concluded arrangements with Ford Motor Company ("Ford") and StarTrans (a business division of Supreme Corporation) that provide industry alignment and have therefore facilitated a concentration of the Company's efforts around its core programs for series (G1) and parallel (P1) delivery vans and shuttle busses.

G1 (series hybrid) production:

The G1 product is now commercially available in delivery van and shuttle bus form. This product is specifically designed for inner-city use and is highly suitable for urban delivery vans and shuttle busses which both have a demanding drive-cycle. As the product is essentially through the development stage, Azure's focus is on sales growth and the infrastructure required to support the execution of sales orders. Key partners in the G1 series production include Workhorse Custom Chassis (part of the International Group) for the chassis platform, Product Concepts Inc. ("PCI") of Union City, Indiana for the hybrid chassis modification, StarTrans for the shuttle bus modification and distribution channels, and Purolator Courier Ltd. as the lead customer for commercial delivery vans.

During the year, a total of 40 production G1 series hybrid electric powered chassis were built. Thirty of these units were fitted with delivery van bodies under the terms of the agreement with Purolator. These units are being placed into delivery service in March and April 2007 bringing the total fleet of Azure vehicles in operation by Purolator to 49 units. The remaining 10 hybrid chassis are being used to build hybrid shuttle busses.

The Company considers the Shuttle bus application to be ideal for the adoption of its G1 technology as they typically operate in high-usage, high-mileage drive cycles and can be eligible for capital subsidies. On August 17, 2006 the Company announced it had signed a supply agreement for the production of hybrid shuttle busses with StarTrans. Under the terms of the agreement, Azure will provide StarTrans with G1 hybrid chassis' on which StarTrans will assemble their shuttle bus body at its manufacturing facilities in Goshen, Indiana. The first StarTrans G1 shuttle bus (the CitiBus Hybrid Senator HD "CitiBus") was completed in October 2006 and unveiled at the North American Buscon trade show in Chicago. The CitiBus product line will be compliant with the United States' Buy-America program and, after testing, will also be eligible for the Federal Transit Administrations funding for bus purchases. The first nine customer units are scheduled for delivery in the first half of 2007 which is also when on-line production capacity is anticipated to be established at StarTrans. Azure has signed up twelve StarTrans bus distributors across North America and therefore has access to a distributor network covering approximately 70% of the targeted shuttle bus market in the US and Canada.

P1 (parallel hybrid) development:

The agreement to develop a parallel hybrid powertrain on the Ford chassis platform, announced on October 5, 2006, is significant for the Company in that it provides Azure with an avenue to achieve rapid penetration of the volume market for commercial vehicles in North America. The P1 product is expected to have wider application than the G1 series product and is intended to address the broader, higher-volume markets.

During 2006, the Company completed a number of concept P1 parallel hybrid vehicles for commercial and military applications. As a result of the Ford agreement, Azure's commercial P1 development program is now focused on the Ford E-350 and E-450 commercial vehicle chassis. Ford is providing technical support to the program and therefore the Company expects that the process to integrate the hybrid system with the engine and transmission will be facilitated. All applicable design and testing experience from Azure's existing P1 program, including the practical experience gained from the prototypes built over the past year, has been carried over to the Ford platform. The Company is currently evaluating and testing next-generation prototypes. Demonstration prototypes will be scheduled for customer in-service trials in mid-2007. Thereafter, a quantity of pre-production units for lead customers is anticipated to be built commencing in late-2007 with full production commencing in 2008. It is intended, subject to formal agreement, to distribute the hybridized chassis through Ford's distribution channels.

During the year, the Company substantially completed two funded military programs, the AM General High Mobility Multipurpose Wheeled Vehicle ("HMMWV") integrated with a third generation Auxiliary Power

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Distribution System ("APDS") and a ground-support aviation APDS developed for the US Air Force. Both of these programs will require minimal future support from Azure.

With the G1 and P1 products/programs, it is Management's view that the Company can make significant inroads into its addressable market thereby building a sustainable business. As the effort required to successfully commercialize these products will likely absorb Azure's engineering and operational resources for the foreseeable future, the Company is curtailing all other activities that are not associated with production programs. The discussion of other product development provided below therefore provides historical context of other activities that occurred in 2006 as well as highlights some development activities that have the potential to become production programs in the future.

Other product development:

During 2006, the Company advanced the development of two product lines that have the potential to develop into major revenue sources – the P2 parallel hybrid system and the Low Emission Electric Power system ("LEEP").

The P2 parallel hybrid system is suitable for larger delivery vans and busses (Class 7 and 8). The Company updated its existing design and built second-generation prototypes. Two delivery trucks were delivered to the Charmer-Sunbelt Group ("Charmer-Sunbelt") in October 2006 and are being evaluated in-service. The Company will only actively pursue the development of the P2 system when development program partners and engineering resources are identified and available.

The LEEP product (formerly referred to as Under-The-Hood) was developed as a result of Azure's participation in several military programs. Essentially the term LEEP covers all systems whereby clean electric power is generated off the vehicles power sources to be used in auxiliary and export power applications. Azure signed a Memorandum of Understanding with Kidron, a division of VT Specialized Vehicles Corporation, on September 12, 2006 for the branding, marketing and sale of Azure's LEEP systems throughout the North American refrigerated truck body segment. Kidron has committed to provide a base vehicle to Azure by mid-March 2007. After a short conceptual evaluation of the base vehicle and proposed LEEP system, it is expected that formal contracts will be concluded and the application program will commence. As the development cycle is expected to be relatively short, the LEEP system could be in production by the second-half of 2007.

During the year the Company continued the development work on the contract to supply power electronics and drive systems to DRS Sustainment Systems, Inc. ("DRS") for integration into a HMMWV Chemical Biological Protective Shelter ("CBPS-M2") system. Azure developed advanced power electronics for the CBPS-M2 contract, such as inverters, converters and under-the-hood export power components which DRS integrated into the CBPS-M2. Work on this program was halted late in the year upon receiving a stop work notice from DRS. Azure was subsequently advised that their portion of the contract was terminated as a result of the U.S. Government's decision to abandon the HMMWV in favour of more heavily armoured vehicle platforms. Prior to the year end, the Company reached an agreement on its contract claim with DRS. The claim was settled at CDN\$5.7 million (US\$4.9 million) which represents the value of Azure's contribution to the CBPS-M2 program in 2006 as well as related contract closure matters. Azure has already received CDN\$2.5 million in cash through contract progress billings in 2006 and the balance of the cash (\$3.2 million) is expected to be received in early 2007 upon execution of contracts. The Company has no additional obligations under this contract.

Azure continued its collaboration with Smith Electric Vehicles ("Smith"), part of the Tanfield Group of companies in England, to update Smith's electric vehicle offering based on powertrain technology supplied by Azure. Initial deliveries of product have been made under the terms of the supply agreement entered into in 2005 but volume levels have been disappointing and Smith has shifted its market focus to new products outside the scope of the supply agreement with Azure. The Company has a number of products to serve the electric vehicle market and will continue to pursue market opportunities in conjunction with suitable industry

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partners.

Azure and GKN, a tier 1 supplier to the automotive industry with operations worldwide, built a proof-of-concept hybrid Ford Transit Van in 2006 which is being used as a research and marketing tool in the United Kingdom.

In the execution of its strategy, the Company is actively seeking to establish strategic industry relationships. It is the Company's intent to have recognised industry OEM partners and lead customers for each of its production or development programs (as is the case for G1 and P1). By aligning itself with organisations like Ford or StarTrans the Company gains a higher profile for its products in the respective market categories and access to established distribution networks within those markets. It is also Management's view that gaining access to a Corporate-level industry partner can help accelerate the commercialization of its Technology and also enhance the execution of the commercialization process. Therefore, a strategic committee of the Board of Directors was formed during the year and is tasked with finding suitable strategic partners and with leveraging the strategic value of the Company's asset base. By gaining access to one or more industry partners the Company believes it can:

- accelerate and/or expand market penetration of the Company's Technology and products, not only within its target markets but also in the markets served by potential partners;
- provide procurement, logistics and production-related expertise and infrastructure; these skills are not inherent in the Company's core competencies but are essential to achieve rapid and reliable delivery of quality products to customers;
- provide an after-market service network that can help assure customer satisfaction, mitigate warranty expenses, and effectively capture value from the service business.

Evaluation of the Company's options is ongoing, and the committee and its advisors are engaged in discussions with various parties.

The 2006 financing initiatives, resulting in net \$31.9 million in new financings, combined with monies raised in 2005 have enabled the Company to move forward with its development and commercialization activities. The total number of employees increased from 109 at the end of fiscal 2005 to 112 at December 31, 2006. The Company occupies facilities in Vancouver (18,000 square feet), Boston (77,000 square feet) and Kenilworth, England (5,000 square feet). The Company has also established a service and support center in Mississauga, Canada. The Company considers that its various facilities are suitable to meet the foreseeable requirements for engineering, workshop, test, and administrative accommodations. Additional test and workshop equipment has been acquired to enable the execution of program development and customer deliverables and the Company has implemented an enterprise resource planning ("ERP") system to support all its operations.

CRITICAL ACCOUNTING ESTIMATES

The consolidated financial statements are prepared in accordance with Canadian GAAP, which require management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements. The Company has identified the policies below as critical to the business operations and an understanding of the results of the business operations. The application of these and other accounting policies are described in note 2 to the consolidated financial statements. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the date of the statements, and the reported amounts of revenue and expenses during the reporting period. There can be no assurance that actual results will not differ from those estimates.

Revenue Recognition

Certain product lines within Solectria (acquired in January 2005 - see note 3 to the Financial Statements) are no longer considered development stage. Therefore the Company recognizes revenues on the sales of those products at the point of shipment, provided that the Company has evidence of an arrangement, the fee is fixed and determinable, delivery has occurred, title and risk of loss have passed to the customer, and collectability is reasonably assured.

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In addition, the Company recognizes revenues on long term engineering contracts 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.

Warranty Provision

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. Should these estimates prove to be incorrect, the Company may incur costs different from those provided for in the warranty provisions.

Inventory Provision

In establishing the appropriate provision for inventory obsolescence, management estimates the likelihood that inventory carrying values will be affected by changes in market demand for the Company's products and by changes in technology, which could make inventory on hand obsolete. The Company performs regular reviews to assess the impact of changes in technology, sales trends and other changes on the carrying value of inventory. Where it is determined that such changes have occurred and will have a negative impact on the value of inventory on hand, appropriate provisions are made. Unforeseen changes in these factors could result in additional inventory provisions being required.

Intangible Assets and Goodwill

As a result of the Solectria acquisition (see note 3 to the Financial Statements), the Company recorded intangible assets and goodwill on the balance sheet. In accordance with Canadian GAAP, the Company does not amortize goodwill. Intangible assets are amortized over periods ranging from 2 to 10 years. At least annually, management reviews the carrying value of intangible assets and goodwill by segment for potential impairment. If circumstances indicate that impairment in the value of these assets has occurred, the impairment is recorded in the earnings of the current period.

Operating Results, Cash Flows and Financial Condition

Selected Annual information (Stated in thousands, except per share amounts)

Years ended	December 31, 2006	December 31, 2005	December 31, 2004
Revenue	\$ 5,771	\$ 4,608	\$ -
Net loss	\$ (23,434)	\$ (21,896)	\$ (8,198)
Net loss per share	\$ (0.14)	\$ (0.15)	\$ (0.10)
Total assets	\$ 56,299	\$ 47,395	\$ 17,813

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Selected Quarterly information (Stated in thousands, except per share amounts)

	Q4, 2006 (Oct – Dec)	Q3, 2006 (Jul – Sep)	Q2, 2006 (Apr – Jun)	Q1, 2006 (Jan – Mar)
Revenue	\$ 3,008	\$ 411	\$ 1,205	\$ 1,147
Gross margin	\$ 967	\$ (166)	\$ 76	\$ 304
Expenses, net	\$ (5,974)	\$ (8,849)	\$ (4,922)	\$ (4,870)
Net loss for the period	\$ (5,007)	\$ (9,015)	\$ (4,846)	\$ (4,566)
Net loss per share	\$ (0.03)	\$ (0.05)	\$ (0.03)	\$ (0.03)
Weighted average number of Shares	166,913	159,206	158,638	156,631

	Q4, 2005 (Oct – Dec)	Q3, 2005 (Jul – Sep)	Q2, 2005 (Apr – Jun)	Q1, 2005 (Jan – Mar)
Revenue	\$ 965	\$ 1,134	\$ 1,525	\$ 984
Gross margin	\$ 56	\$ 154	\$ 272	\$ 291
Expenses, net	\$ (6,796)	\$ (4,788)	\$ (5,872)	\$ (5,213)
Net loss for the period	\$ (6,740)	\$ (4,634)	\$ (5,600)	\$ (4,922)
Net loss per share	\$ (0.04)	\$ (0.03)	\$ (0.04)	\$ (0.04)
Weighted average number of Shares	156,116	146,291	141,203	124,892

Results of Operations

For the year ended December 31, 2006, the Company incurred a net loss of \$23.4 million (\$0.14 per share) compared to a net loss of \$21.9 million (\$0.15 per share) in the prior year. The Company has continued to invest in the commercialization of its technology. As a result, the overall investment in development costs, and the level of support and infrastructure costs are higher. The primary increase in development expenses in the current year is attributable to the G1 program, which absorbed substantial resources during the year as the delivery van and shuttle bus were readied for commercial production. Increases in engineering, development, and operations expense were partially offset by the settlement of the DRS claim. The impact of the DRS claim on net income in the current year totalled \$1.4 million (revenue of \$2.7 million net of cost of sales of \$1.3 million). For the quarter ended December 31, 2006, the Company incurred a net loss of \$5.0 million compared to a net loss of \$6.7 million in the prior year. The decrease in the loss in the quarter is primarily attributable to the settlement of the termination claim with DRS which was agreed at the end of December.

The Company employed a total of 112 employees at December 31, 2006 (2005 – 109) in operations in North America and Europe.

Revenue: Revenue for the year ended December 31, 2006 was \$5.8 million, compared to \$4.6 million in 2005. The revenue in both 2006 and 2005 is attributable to the US operation and is mainly comprised of sales of components, customer engineering contracts (recognised on a percentage of completion basis), and after-sales service support. Early revenues from Canadian and UK operations have been set off against development costs in accordance with Canadian accounting standards. The increase in revenues compared to the prior year is primarily related to the increase in activities on the CPBS program with DRS, including the impact to revenue of the claim detailed above. The increase in DRS revenue was partially offset by lower revenues from other funded engineering as these programs tapered off in 2006 as the Company concluded

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these projects and turned its focus to its core production programs. After considering direct and applicable indirect costs of sales, the gross margin contribution from revenue in the current year was \$1.2 million compared to \$0.8 million in the prior year (gross margin as percentage of sales was 20 % in 2006 versus 17% in 2005). The increase in gross margin contribution in the current year is primarily a result of the increase in revenues and the DRS settlement. Revenue for the quarter ended December 31, 2006 was \$3.0 million (gross margin of \$1.0 million), compared to \$1.0 million (gross margin of \$0.1 million) in 2005. The increase in revenue and gross margin in the current quarter is primarily attributable to the DRS settlement.

Engineering, research, development and related costs, net: Before customer and government contributions, the Company expended \$17.6 million on engineering, research and development operations in the year, compared to \$13.2 million in 2005, including \$10.8 million which is directly attributable to product development (2005 - \$6.4 million). The most significant product development expenditure has been in respect of the Company's G1 platform, which totalled \$8.0 million in the year (2005 - \$4.9 million). The G1 series hybrid platform was launched commercially in the year with the build of 40 hybrid chassis for use in delivery van and shuttle bus applications. Engineering and development costs were reduced by \$4.2 million (2005 - \$1.7 million) in respect of government and customer contributions in the year. The level of contributions is comparatively higher in 2006 as the Company recognised \$3.0 million of customer contributions related to G1 product compared to \$0.4 million in the prior year. Contributions from government agencies were lower compared to the prior year as less of the work undertaken was eligible for support under the terms of the programs. The Company expended \$5.1 million before contributions in the fourth quarter of 2006 (2005 - \$3.4 million), of which \$2.7 million was directly attributable to product development (2005 - \$1.5 million). Customer and government contributions were \$2.8 million in the quarter (2005 - \$0.2 million) primarily due to the G1 program as noted above.

At December 31, 2006, Azure employed 86 research, engineering, operations and technical employees (2005 - 82).

The Company is required to make royalty payments to Technology Partnerships Canada ("TPC"), EnCana and the National Research Council based on future revenues in respect of specified products.

Selling and marketing: Selling and marketing costs were \$3.2 million in the year compared to \$3.4 million in 2005. The headcount at December 31, 2006 was eight employees (2005 - nine). Selling and marketing costs in the fourth quarter were \$0.9 million, compared to \$1.1 million in the fourth quarter of 2005. The decrease in the fourth quarter and in the year is headcount related (salaries and other compensation costs).

General and administrative: General and administrative costs were \$8.4 million in the year compared to \$8.2 million in 2005. The increase is primarily attributable to the amortization of intangible assets which were expensed for a full twelve months in 2006, but for only eleven months in the prior year as the intangible assets were attributable to the Solectria acquisition, effective on January 31, 2005. Headcount at December 31, 2006 was 18 (2005 - 18). General and administrative costs in the fourth quarter were \$2.8 million, compared to \$2.6 million in the fourth quarter of 2005. The increase in the current quarter is primarily attributable to advisory fees related to strategic initiatives and an increase in audit and tax related fees.

Amortization: Amortization of property and equipment and other assets was \$0.8 million in the year compared to \$0.7 million in 2005. The Company purchased assets with a value of \$0.8 million in the year (\$0.9 million - 2005) mainly in respect of leasehold improvements, tooling, work-shop equipment and computer hardware/software. Intangible assets acquired as a result of the US acquisition have been amortized by \$1.8 million in the year (2005 - \$1.6 million). The increase in the intangible asset amortization is as noted above.

Foreign currency gains and losses: Foreign currency losses in the year and in the fourth quarter totalled \$89,000 and \$82,000 respectively compared to a gain of \$22,000 for the prior year and a loss of \$17,000 for the fourth quarter of 2005. The currency gains and losses are mainly un-realised gains or losses in respect of foreign currency cash balances held at the financial period end.

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Balance Sheet Discussion

Cash and cash equivalents: Cash and cash equivalents at December 31, 2006 were \$27.2 million compared to \$20.7 million at December 31, 2005, an increase of \$6.5 million (2005 – increased by \$7.0 million). The increase in the year is primarily derived from net cash inflows from equity financings totalling \$31.9 million (2005 - \$26.3 million), partially offset by \$24.7 million of cash outflows to fund operations (2005 – \$18.3 million). The equity financings included a November 2006 public offering (\$24.5 million in net proceeds), a November 2006 private placement (\$3.3 million in net proceeds), and the November 2006 exercise of over-allotment options associated with the November 2006 public offering (\$2.5 million in net proceeds). The balance of the equity financings in the year are related to the exercise of stock options (\$1.6 million in net proceeds). The \$6.4 million increase in operating cash outflows in 2006 is due to the larger loss from operating activities (by \$1.5 million) and an increase in non-cash working capital (by \$4.9 million). Operating losses are higher in 2006 as the Company advanced its production programs, including the G1 hybrid chassis which launched into production. The increase in non-cash working capital is primarily attributable to the increase in work-in-process inventory for products expected to be delivered in the first half of 2007, and an increase in accounts receivable in respect of the DRS claim which was outstanding at December 31, 2006. Approximately \$0.7 million of the available cash balance is restricted as security for the operating lease in respect of the Boston facility. In the fourth quarter, the Company's cash and cash equivalents increased by \$23.4 million compared to a decrease of \$3.3 million in the fourth quarter of 2005. The increase in the quarter is primarily derived from the November equity financings described above and the lower net loss in the quarter (lower by \$1.7 million), partially offset by the higher non cash working capital related to the DRS settlement.

Accounts receivable: Accounts receivable at December 31, 2006 were \$3.4 million compared to \$1.0 million at December 31, 2005. The increase in the current year is mainly attributable to the receivable associated with the DRS settlement as noted above.

Contributions receivable: Contributions receivable were \$1.3 million at December 31, 2006 (\$0.6 million at December 31, 2005). The higher balance is attributable to customer contributions receivable of \$0.6 million at December 31, 2006 (2005 – \$nil).

Inventory and related prepayments: Inventory and related prepayments was \$3.8 million at December 31, 2006 compared to \$2.7 million at December 31, 2005. The increase of approximately \$1.1 million is primarily attributable to work-in-process inventory in respect of G1 products expected to be delivered in the first half of 2007.

Prepaid expenses: Prepaid expenses at December 31, 2006 were \$0.8 million compared to \$1.0 million at December 31, 2005.

Property and equipment: Net property and equipment was \$5.6 million at December 31, 2006 compared to \$5.6 million at December 31, 2005. The impact of property and equipment additions of \$0.8 million in the year was offset by \$0.8 million of amortization. The premises occupied in Boston are leased from a joint venture ("ND Solectria LLC") established with a Boston real estate development company, in which Azure is a 50% owner. The Company's proportionate share (50%) of the fair market value of the joint venture property and equipment is included within this account and was approximately \$3.1 million at December 31, 2006.

Other assets: Other assets were \$nil at December 31, 2006 (2005 - \$61,000). The balance in the prior year related to a note receivable which was repaid in full in the current year.

Goodwill and other intangibles: The Company accounted for the acquisition of Azure US using the purchase method, and in accordance with Canadian accounting standards, allocated the purchase price to identifiable assets, including intangible assets. The excess of the purchase price consideration over identifiable assets is recorded as goodwill on the balance sheet (\$2.9 million). The Company identified the order book (\$0.9 million) and product technology (\$12.5 million) as at-acquisition intangible assets and has recorded \$2.9

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million of amortization against these assets to December 31, 2006.

Accounts payable and accrued liabilities: Accounts payable and accrued liabilities were \$2.8 million at December 31, 2006 compared to \$3.4 million at December 31, 2005. The comparatively higher balance in 2005 was primarily attributable to several high dollar value invoices for materials that remained unpaid at the 2005 year end.

Customer deposits and deferred revenues: Current and long-term deferred revenue and customer deposits total \$2.0 million at December 31, 2006 (2005 - \$2.6 million). The amount is attributable to the US operation and is comprised of customer deposits in respect of work-in-progress (\$1.3 million) and \$1.0 million in respect of deferred revenue, partially offset by \$0.3 million in unbilled revenues. Approximately \$0.9 million of the deferred revenue is in respect of a payment received from Singapore Technologies Kinetics Ltd. ("STK") for a license agreement for certain technology that expires in 2020. The license agreement fee is being recognised in revenue over the 17-year duration of the agreement. The decrease in the current year is primarily attributable to the completion of programs in the year where revenue had previously been deferred or deposits had previously been received.

Notes payable: The note payable is attributable to the US operation and is the Company's proportionate share of a mortgage on the Boston property owned by ND Solectria LLC, in which the Company has a 50% interest. The note was refinanced in November 2006, is repayable on November 20, 2011, bears interest at a floating rate of the applicable Treasury rate plus 200 basis points and is secured by the mortgaged premises. The lower balance in the year (\$2.5 million at December 31, 2006 compared to \$2.6 million at December 31, 2005) is attributable to principle repayments made in the year.

Share capital: Share capital at December 31, 2006 was \$112.8 million compared to \$80.7 million at December 31, 2005.

The number of common shares, warrants, and options issued and outstanding are presented in the following table:

	March 21, 2007	December 31, 2006	December 31, 2005
Common shares	198,276,177	198,253,101	156,134,272
Stock options issued under the Stock Option Plan, with expiry dates ranging up until December 18, 2013 at a weighted average exercise price of \$0.92	16,661,927	16,685,003	14,030,914

During the period from December 31, 2006 to March 21, 2007, 23,076 options were exercised into common shares.

Related Party Transactions

During the prior year, the Company paid \$315,000 to a private company controlled by the Chief Executive Officer for remuneration in respect of an employment contract. In 2006, the Company paid the remuneration directly to the Chief Executive Officer.

In November 2003, Solectria entered into a Transfer of Technology and Software Licensing Agreement ("TTA Agreement") with STK. Under the terms of the agreement, STK has a non exclusive license to use and manufacture specified technology in specified Asian countries. 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 to the Financial Statements, revenues resulting from the TTA Agreement are being recognized on a straight-line basis over the period of the agreement. As of December 31, 2006, the

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Company has deferred revenue associated with the TTA Agreement in the amount of \$0.9 million. During the year ended December 31, 2006 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 \$68,000 (2005 -\$137,000). As at December 31, 2006 accounts receivable includes \$11,000 due from STK (2005 - \$11,000) and customer deposits includes \$42,000 received from STK (2005 - \$41,000).

Changes in Accounting Policies

Due to the acquisition of Solectria in January 2005, the Company has reviewed its accounting policy notes and either expanded existing policies or adopted new policies in respect of consolidation, foreign currency translation, revenue recognition, inventory, property and equipment, intangibles, goodwill and variable interest entities. None of the resultant changes have impacted transactions previously recorded by the Company. The impacts of changes in policies on the financial statements arising from the review are explained above in this Management's Discussion and Analysis and in the notes to the Financial Statements.

Liquidity, Capital Resources, and Risk Factors

At December 31, 2006 the Company had \$27.9 million (December 31, 2005 – \$21.4 million) in net cash reserves. The Company invests its cash, in accordance with its investments policy, in highly-liquid, highly-rated financial instruments such as banker's acceptances and term deposits. At December 31, 2006 approximately \$0.7 million of cash was restricted as security in respect of the Boston joint venture property and lease arrangements. Working capital was \$32.5 million at December 31, 2006 compared to \$18.5 million at December 31, 2005. The increase in working capital compared to the prior periods is primarily due to higher cash balances (higher by \$6.5 million) and higher non cash working capital balances. Non-cash working capital has increased by approximately \$7.5 million since December 2005. The increase is primarily due to the increases in accounts receivable (due to the DRS claim), contributions receivable (due to the customer receivable from Purolator), inventories (due to the work in process associated with buses to be delivered in early 2007), and decreases in accounts payable (due to the high dollar invoices remaining unpaid at the 2005 year end), deposits and deferred revenue (due to delivery of product in the current year where deposits received had been applied or revenue had already been taken on a percentage of completion basis). The increase was also partially attributable to the refinancing of the note payable related to the Joint Venture owning the Boston facility, in which the Company holds a 50% interest. The entire note payable was classified as short term in the prior year as the note was repayable in November 2006, whereas after the refinancing, only the payments that are due in the next year are classified as short term.

The Company has incurred losses since its inception as it has invested in the development of its Technology. With the acquisition of Solectria, combined with its existing customer base, the Company is now active in a number of revenue generating programs. The Company continues to incur development costs and has relied on its financing activities to fund its operations. For the year ended December 31, 2006 the Company raised approximately \$31.9 million in equity financing, net of issue costs. In addition, Azure is eligible, subject to TPC conditions, to access the maximum grant of up to \$9.0 million available under the terms of the TPC contribution agreement. As at December 31, 2006 the Company had claimed approximately \$5.9 million in accordance with the terms of the TPC agreement and is therefore eligible for further contributions totalling approximately \$3.1 million.

The Company intends to use its cash resources and available financing arrangements to fund ongoing product development and commercialization activities in 2007. The Company is generating revenue and expects the volumes to grow as additional products are brought into production. Additional financing may be required in the future, to allow for the uninterrupted development of its various products through the commercialization stage. The raising of financing to fund operations remains subject to uncertainty and there is no assurance that such financing will be available on commercially reasonable terms.

The Company holds substantially all of its cash at a recognized Canadian national financial institution, and as such is exposed to all of the risks associated with that institution. The Company operates in foreign markets and has foreign subsidiaries and is therefore exposed to foreign currency exchange risk. Azure's operations

Year ended December 31, 2006 and 2005

are subject to all of the risks inherent in the establishment of a new business enterprise – please see Risk Factors – Annual Information Form, dated March 21, 2007 (this document and additional information relating to the Company is available for inspection at www.sedar.com). These risks include the practical risks of implementation and execution of its commercialization strategy (for example, the risk that Azure is delayed in the development of customer product requirements specified in development agreements, or is delayed in the process of establishing the infrastructure required to support its commercialization plans). The addition of Solectria Corporation in January 2005 introduced the risks associated with acquisition integration. Management is of the view that the acquisition integration plan has been satisfactorily implemented. To better manage all risk factors, the Company has a system of reporting and measuring progress towards milestones on a regular basis. The Company has an organization structure commensurate with its growth plans and is implementing an internal control and process system supported by an appropriate ERP system that will encompass all existing engineering/support operations. Management accepts the responsibility of ensuring that control systems and procedures are established and are effective and monitored and is required to report to the Board and its sub-committees on a regular basis on such matters.

Contractual Obligations and Off-Balance Sheet Arrangements

Contractual obligations:

As at December 31, 2006 the Company had the following contractual obligations and operating lease commitments:

(Stated in thousands)	Total	Payments due by period			
		Less than 1 year	1-3 years	4-5 years	After 5 years
Contractual Obligations					
Operating leases ⁽¹⁾	6,946	1,449	3,465	2,032	0
Purchase obligations ⁽²⁾	1,086	1,086	0	0	0
Total contractual obligations	8,032	2,535	3,465	2,032	0

⁽¹⁾ See note 15 to the Financial Statements for details of facility operating leases.

⁽²⁾ Purchase obligations are agreements to purchase goods or services that are enforceable and legal

Off-balance sheet arrangements:

Pursuant to a contractual agreement with 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.

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 business revenues or in accordance with a fixed repayment schedule, with repayment amounts ranging from \$0.7 million to \$1.0 million per year starting in 2008 and totalling \$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 2015 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.

Pursuant to a contractual 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.

The Company has entered into employment agreements with certain executive directors and officers. In

Year ended December 31, 2006 and 2005

addition to defining the terms of employment, the agreements entitle the executives to termination payments, ranging from one to two year's 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.

Other MD&A Requirements

Management has designed disclosure controls and procedures to provide reasonable assurance that material information relating to the Company, including its consolidated subsidiaries, is made known to the Chief Executive Officer and the Chief Financial Officer by others within those entities, particularly during the period in which the annual filings of the Company are being prepared, in an accurate and timely manner in order for the Company to comply with its continuous disclosure and financial reporting obligations and in order to safeguard assets. Management has concluded that the Company's disclosure controls and procedures, as of the end of the period covered by the annual filings, are effective in providing reasonable assurance that material information is accumulated and disclosed accurately. Consistent with the concept of reasonable assurance, the Company recognizes that the relative cost of maintaining these controls and procedures should not exceed their expected benefits. As such, the Company's disclosure controls and procedures can only provide reasonable assurance, and not absolute assurance, that the objectives of such controls and procedures are met.

The Corporation's financial reporting procedures and practices have enabled the certification of Azure Dynamics' annual filings in compliance with Multilateral Instrument 52-109 "Certification of Disclosure in Issuers' Annual and Interim Filings". Management has designed such internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements and other annual filings in accordance with Canadian Generally Accepted Accounting Principles, except as noted below.

Given the size of the Company, the evaluation of the design of internal controls over financial reporting for the Company resulted in the identification of the following weaknesses:

Management is aware that due to its relatively small scale of operations there is a lack of segregation of duties due to a limited number of employees dealing with accounting and financial matters. However, management has concluded that considering the employees involved and the control procedures in place, including management and Audit Committee oversight, risks associated with such lack of segregation are not significant enough to justify the expense associated with adding employees to clearly segregate duties.

Management is aware that in-house expertise to deal with complex taxation, accounting and reporting issues may not be sufficient. The Company requires outside assistance and advice on new accounting pronouncements and complex accounting and reporting issues, which is common with companies of a similar size.

There have been no significant changes to the Company's internal control over financial reporting that occurred during the most recent interim period that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Additional Information

Additional information regarding Azure, including its Annual Information Form, can be found on SEDAR at www.sedar.com.