

Years ended December 31, 2007 and 2006

MANAGEMENT'S DISCUSSION AND ANALYSIS

Year Ended December 31, 2007 ("2007") compared to the Year Ended December 31, 2006 ("2006")

This "Management's Discussion and Analysis" has been prepared as of March 25, 2008 and should be read in conjunction with the audited consolidated financial statements of Azure Dynamics Corporation ("Azure" or the "Company") for the year ended December 31, 2007 (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

The Company has developed proprietary electric and hybrid electric drive 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 markets.

Target markets include hybrid electric delivery vans and shuttle buses, as well as electric drive applications. Over the past six 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. The Company uses the supply capacity that exists within the commercial vehicle industry to assemble products to its specifications which are then distributed via existing industry channels to the customer.

Azure seeks to closely align its product development and sales efforts with recognised industry partners (original equipment manufacturers, component suppliers, and customers) thereby gaining access to product development support and established distribution networks which can help accelerate the penetration of its electric and hybrid-electric products into the commercial vehicle markets. The Company has concluded

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arrangements with Ford Motor Company ("Ford"), StarTrans (a business division of Supreme Corporation) and Utilimaster Corporation ("Utilimaster"), which has facilitated a concentration of the Company's efforts around its core programs for parallel-hybrid (P1) delivery vans and shuttle buses. In addition, the Company's other area of focus is referred to as Electric Drive Solutions. During the current year the Company concluded arrangements with Kidron, a division of VT Specialized Vehicles Corporation, for the branding, marketing and sale of Azure's LEEP (Low Emission Electric Power) systems throughout the North American refrigerated truck body segment. During the current year, the Company also announced a supply agreement with Electro Autos Eficaces of Mexico ("EAE") for electric drive systems and components.

Management and the Board, after consideration of customer, industry, and market trends and other relevant factors, have implemented several organizational and infrastructure changes in the current year to take full advantage of the opportunities now available to it in its core programs. In April 2007 Scott T. Harrison was appointed Chief Executive Officer and joined the Azure Board. D. Campbell Deacon, retiring Chief Executive Officer, became Chairman of the Board and Thomas N. Davidson, outgoing Chairman, retired from the Board at the Annual Meeting of the Company in June 2007. Mr. Harrison was appointed CEO to ensure that the Company had the appropriate skills to successfully manage the transition from research and development to commercial production. Mr. Harrison has extensive production and supply chain experience with both new and established products in the automotive industry. In May 2007 the Company appointed James J. Padilla, former President and Chief Operating Officer of Ford to its Board of Directors thereby further enhancing the industry profile of the Board. Mr. Padilla replaced Roberto Quarta, who did not seek re-election to the Board. Additionally, Wu Tzu Chien also did not seek re-election to the board. In continuation of the repositioning of the executive and management team, David E. Deacon, Executive Vice President and Deputy Chairman, and Gregory P. Francis, President and Chief Operating Officer, resigned their positions in August 2007 and the Company appointed Curt A. Huston as Chief Operating Officer. Subsequent to the year end, the Company appointed Ryan S. Carr as Chief Financial Officer, replacing Daniel P. Renzella who resigned his position. Mark Federle, Senior Vice President, Sales and Steven Glaser, Vice President Corporate Affairs also resigned their positions subsequent to the year end.

The executive team of Azure is now comprised of the following:

Scott Harrison – Chief Executive Officer;
Ryan Carr – Chief Financial Officer;
Ronald Iacobelli – Chief Technology Officer;
Curt Huston – Chief Operating Officer;

In May 2007 the Company announced that it would establish a new corporate head office and development center in the heartland of the North American automotive industry. In September 2007 the Company finalized those arrangements and announced that it has established its new corporate headquarters in Oak Park, Michigan, in the greater Detroit area. The facility is strategically located in an area that is expected to meet all of the Company's ongoing business development and production needs and is in close proximity to the Company's key industry partners, including Ford Motor Company. The State of Michigan has granted Azure a tax credit potentially valued at more than US\$1.7 million over the next seven years. The city of Oak Park has also proposed an 11-year local tax abatement potentially worth an estimated US\$55,400.

The Kenilworth facility in the UK as well as the Executive and Marketing office in Toronto, were closed in May and July 2007 respectively. The Company does not expect that there will be any material changes to employee counts at its other facilities. The Company will maintain its electric drive solutions business unit and component engineering and design facility in Boston, MA. The bulk of its hybrid and hybrid-electric systems engineering and technology development team will remain at its facility in Vancouver, B.C. The Company will also maintain its service facility in Mississauga, Ontario to support major customers in the Toronto area. In November 2007, the Company announced a significant milestone; its Canadian facility in Vancouver, B.C. became certified to the ISO 9001:2000 Quality Management System standard. The certification of compliance to ISO 9001:2000 recognizes that the policies, practices and procedures of the Company ensure consistent quality in the products and services that are provided to the customer. The process of becoming certified to

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ISO 9001:2000 consists of a stringent evaluation process including the development of a quality management system, a formalized review of the related documentation, a pre-audit, an initial assessment and the clearance of all non-conformances, all of which are intended to identify corrective actions that eliminate non-conformance to the quality management standard. Azure Dynamics received its ISO 9001:2000 certificate of registration from BSI Management Systems. The Company's Boston MA facility has been certified to ISO 9001:2000 since October of 2003. ISO 9001 is accepted worldwide as the inclusive international standard that defines quality.

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. Key partners in the G1 series production include Workhorse Custom Chassis (part of Navistar International Corporation) for the chassis platform, Productive Concepts Inc. ("PCI") of Union City, Indiana for the hybrid chassis modification, and StarTrans for the shuttle bus modification and distribution channels.

Purolator Courier Ltd ("Purolator") completed the introduction of 30 new G1 hybrid delivery vans into their Canadian fleet operations in the first part of 2007. Their combined fleet of Azure hybrid vehicles now totals 49, with vehicles deployed in Montreal, Ottawa, Toronto and Vancouver. These vehicles have now accumulated more than a half million miles in service. Additional deliveries to Purolator on their current contract are expected to commence in the second half of 2008 and will be built on the Ford P1 platform.

Much of the remaining activity in the year for the G1 product was focussed on the Shuttle Bus application. The Company finalized the development of the G1 shuttle bus in the first half of the year. The initial nine customer units were completed in the second half of the year. In August, the Company commenced a larger production run of shuttle buses which resulted in the first hybrid cab-chassis being completed in October 2007, which was fitted with a shuttle bus body manufactured and installed by StarTrans.

The Company has since completed the assembly of 35 additional cab-chassis. The remainder of the total build of 59 cab chassis are expected to be completed in the first half of 2008. In the fourth quarter of 2007, the Company completed the durability testing of a shuttle bus at Altoona. Completion of this test is required for the product to be eligible for funding programs administered by the Federal Transit Administration (FTA) in the United States. Azure has signed agreements with various StarTrans bus distributors across North America and therefore has access to a distributor network for the targeted shuttle bus market in the US and Canada.

The Company incurred \$4.0 million (2006 – \$8.5 million) in gross research and development expenses for the year ended December 31, 2007 related to these projects. The Company has completed the majority of development of the G1 product line and expects to finalize development of the product throughout 2008. During 2007, the Company recognized approximately \$1.8 million in revenue on sale of 9 shuttle buses, which were launched into production in the year.

P1 (parallel hybrid) development:

The agreement to develop a parallel hybrid powertrain on the Ford chassis platform, announced in October 2006, is significant for the Company in that it provides Azure with an avenue to achieve rapid penetration of a higher 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.

As a result of this agreement, Azure's commercial P1 development program is now focused on the Ford E-350 and E-450 commercial vehicle chassis. During the year, the Company advanced the P1 program through the initial concept phase whereby final production concepts were evaluated in detail to ensure that the most fuel efficient and robust design was utilized. The selected concept underwent detailed design work which included the building, testing and optimization of more prototypes; which led to the initial demonstration prototypes which were completed and delivered to customers for in-service trials in the latter half of 2007 and early 2008.

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In May 2007 the Company announced that it had entered into agreements with FedEx Express, a subsidiary of FedEx Corporation, for a P1 E-450 demonstration vehicle and subsequently 20 pre-production vehicles. The demonstration vehicle was delivered to FedEx in November 2007 and the pre-production vehicles are expected to be delivered in the first half of 2008. In August 2007 the Company announced a further order for 105 P1 E-450 vehicles for delivery to Purolator by the end of 2008. A demonstration vehicle was delivered to Purolator in February of 2008 and is currently being evaluated in service. Based on these initial orders, the Company commenced the supply chain and assembly-line procurement activities required to establish the production process for the P1 product. To this end, the Company announced in August 2007 that it had selected Utilimaster Corporation as the primary assembly and integration partner for the hybridized E-series chassis. During the third quarter of 2007, the Company concluded an agreement for a third P1 lead customer. The Company signed a commercial development and cooperation agreement with this customer, whereby Azure will deliver a gasoline parallel hybrid electric Ford E-450 based vehicle for industry viability validation, testing and demonstration within the Company's North American fleet. The parallel hybrid electric demonstration vehicle will be used to verify the fuel economy improvements, emissions reductions and maintenance cost savings that can be achieved using Azure's patented technology. Successful completion of the program will result in the company becoming a lead customer for Azure's hybrid technology on the Ford E-450 chassis with a minimum commitment of 10 percent of their fleet replacement purchases per annum. Azure completed and delivered the demonstration unit to this customer in February 2008. In the fourth quarter of 2007, the Company announced it had signed a commercial development and cooperation agreement with a fourth lead customer, Florida Power and Light ("FPL"), a wholly owned subsidiary of FPL Group (NYSE: FPL). Azure will deliver a gasoline parallel hybrid electric Ford E-450 based vehicle for industry viability validation, testing and demonstration within the FPL fleet. FPL currently runs a fleet of approximately 3,400 vehicles. The demonstration unit is expected to be delivered to FPL in the April 2008 timeframe. The assembly of pre-production units for these lead customers has commenced with full production expected to commence in the second half of 2008.

The Company incurred \$3.6 million (2006 - \$1.4 million) in research and development expenses for the year ended December 31, 2007 related to internally funded P1 projects. The Company anticipates further costs for product development will be incurred in 2008 in order to complete and validate this product. No costs have been deferred or capitalized and no sales revenue has been earned from these projects.

Electric Drive Solutions and other production

Electric Drive Solutions consists of Azure's Low Emission Electric Power (LEEP) and electric drive components. The product name LEEP refers to all systems whereby clean electric power is generated off the vehicles' power train to supply a range of auxiliary systems (i.e. pumps, refrigeration, etc.) and export power applications. The Company had previously announced a Memorandum of Understanding (MOU) with Kidron to develop the first LEEP application. In October 2007 the Company announced that it had finalized the supply agreement with Kidron. The supply agreement encompasses branding, marketing and sale of Azure's LEEP systems throughout the North American refrigerated truck body market. The agreement structure has Azure providing Kidron with LEEP systems for integration into their cold plate refrigerated truck and truck body units. Kidron will market this product through its direct sales force and distribution channels across North America. The LEEP system delivers improvements in fuel utilization and emission levels by optimizing the energy management between the engine and an energy storage system. The LEEP system has a wide range of applications beyond refrigeration including utility and telecom applications.

The LEEP system developed for Kidron stores energy in the cold plate refrigeration system when the engine is running. When the engine is off, the cold plate is used to maintain refrigeration temperatures in the box. By allowing the system to operate with the engine off, the LEEP system combined with cold plates provides a solution for increasingly strict anti-idle regulations across North America. The LEEP system has the potential to replace the ancillary motors/generators used in the other method of cooling refrigerated trucks, thereby reducing, fuel consumption, noise and emissions. The Company anticipates initial deliveries under this supply agreement will commence early in 2008.

The Company incurred \$0.1 million in research and development expenses for the year ended December 31, 2007 related to internally funded LEEP projects. The Company anticipates further costs for product

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development will be incurred in 2008 as it addresses the various LEEP variants (i.e. telecom and utility). As at December 31, 2007, no costs have been deferred or capitalized and no sales revenue has been earned from these projects.

In the second quarter of 2007, the Company announced it had signed a supply agreement with Electro Autos Eficaces (EAE) of Mexico. The initial agreement is for 1,000 drive systems for integration into the Nissan Tsuru platform, which is commonly used in the municipal fleet of Mexico City. The Tsurus are being converted from gasoline powered vehicles to electric vehicles. Azure designed and completed the first vehicle integration during the second quarter of 2007, the converted vehicle was unveiled at the International Electric Vehicle Forum in May 2007 in Mexico City. In the third quarter, the Company received the initial purchase order release under the supply agreement for 200 systems and expects to commence delivery against that release early in 2008. The balance of the 1,000 systems are expected to be delivered over the following 18 months. Azure's scope of supply for the 1,000 drive systems includes the motor, controller, gearbox and DC/DC converters. The agreement also includes the potential for Azure to supply a broad range of electric and hybrid electric drive systems and components for various other vehicle applications in Mexico.

The Company incurred \$0.1 million in research and development expenses for the year ended December 31, 2007 related to internally funded Electric Drive System projects. The Company does not anticipate additional product development (or very minor) in 2008 as the Company is currently in the process of production of electric drive kits for eventual sale to its customers. As at December 31, 2007, no costs have been deferred or capitalized. The Company recorded \$11,500 (2006 - \$nil) in revenues during the year which was related to the converted vehicle unveiled at the International Electric Vehicle Forum in May 2007 in Mexico City.

The P2 parallel hybrid system is suitable for larger delivery vans and buses (Class 7 and 8). The Company delivered the first two of these systems to the Charmer-Sunbelt Group ("Charmer-Sunbelt") in the fourth quarter of 2006, and they continue to be used in-service. The Company has stated in the past that it would only actively pursue further development and commercialization of the P2 system when suitable development program partners were identified and engineering resources were available. During the current year, the Company has progressed discussions with a potential program partner for the development and commercialization of the P2 system.

The Company incurred \$nil (2006 - \$0.1 million) in research and development expenses for the year ended December 31, 2007 related to internally funded P2 projects. The Company anticipates costs for product development will be incurred in 2008 in order to continue development of this product. No costs have been deferred or capitalized and no sales revenue has been earned from these projects.

The 2007 financing initiatives, resulting in net \$27.9 million in new financings, combined with monies raised in 2006 have enabled the Company to move forward with its development and commercialization activities. The total number of employees increased from 112 at the end of fiscal 2006 to 127 at December 31, 2007. The Company leases facilities in Vancouver (18,000 square feet), Boston (77,000 square feet) and Detroit, MI (36,000 square feet), as well as the 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.

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Operating Results, Cash Flows and Financial Condition

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

Years ended	December 31, 2007	December 31, 2006	December 31, 2005
Revenue	\$ 2,801	\$ 5,771	\$ 4,608
Net loss	\$ (30,235)	\$ (23,434)	\$ (21,896)
Net loss per share	\$ (0.14)	\$ (0.14)	\$ (0.15)
Total assets	\$ 55,887	\$ 56,299	\$ 47,395

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

	Q4, 2007 (Oct - Dec)	Q3, 2007 (Jul - Sep)	Q2, 2007 (Apr - Jun)	Q1, 2007 (Jan - Mar)
Revenue	\$ 518	\$ 1,534	\$ 593	\$ 156
Gross Margin	\$ (179)	\$ (197)	\$ (10)	\$ 89
Expenses, net	\$ (8,179)	\$ (8,257)	\$ (6,906)	\$ (6,596)
Net loss for the period	\$ (8,359)	\$ (8,454)	\$ (6,916)	\$ (6,507)
Net loss per share	\$ (0.03)	\$ (0.04)	\$ 0.03	\$ (0.03)
Weighted average number of shares	259,101	198,276	198,276	198,275

	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)	\$ (0.06)	\$ (0.03)	\$ (0.03)
Weighted average number of shares	166,913	159,206	158,638	156,631

Results of Operations

For the year ended December 31, 2007, the Company incurred a net loss of \$30.2 million (\$0.14 per share) compared to a net loss of \$23.4 million (\$0.14 per share) in the prior year. During the current 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 in operations and customer support were higher by \$3.2 million. The Company also incurred approximately \$2.6 million of expense (recorded as other expense in statement of operations) in the current year which was attributable to the organizational changes relating to senior management and facilities as noted above. Gross margin was also lower in the current year, which is attributable to the lower volume of sales. The primary increase in development expenses in the current year is attributable to the P1 Ford program, which absorbed substantial resources during the year as the initial demonstration units to lead customers were completed and the delivery van was readied for commercial production. The Company incurred a net loss of \$8.4 million (\$0.03 per share) in the fourth quarter of 2007 compared to a net loss of \$5.0 million (\$0.03 per share) in the fourth quarter of the prior year. The higher loss in the current year quarter is related to the higher level of activities in product development and operations as noted above in addition to \$0.9 million of the \$2.6 million in other expenses related to the organizational changes which were recorded in the fourth quarter. Gross margin was also lower by \$1.1 million in the current year quarter, which was primarily attributable to the lower level of sales.

For the year ended December 31, 2006, the Company incurred a net loss of \$23.4 million (\$0.14 per share)

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compared to a net loss of \$21.9 million (\$0.15 per share) at December 31, 2005. Throughout 2006, the Company continued to invest in the commercialization of its technology. As a result, the overall investment in development costs, support of vehicles and infrastructure costs were higher. The primary increase in development expenses was 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 totalled \$1.4 million (revenue of \$2.7 million net of cost of sales of \$1.3 million).

There are currently no specific seasonality patterns for the financial results of the Company over the past eight quarters. Variations in revenues, gross margin, expenses and net loss are driven primarily by the timing of development projects which vary on a project by project basis.

Revenue: Revenue for the year ended December 31, 2007 was \$2.8 million, compared to \$5.8 million in 2006. The revenue in both 2007 and 2006 is attributable to the US operation and is mainly comprised of sales of components, customer engineering contracts (recognised on a percentage of completion basis), after-sales service support and the initial nine shuttle buses completed for customers in the year. Early revenues from Canadian and UK operations have been set off against development costs in accordance with Canadian accounting standards. The decrease in revenues compared to the prior year is primarily related to the CPBS program with DRS, which was settled and recorded in the fourth quarter of 2006. The revenue related to this settlement was \$2.7 million. After considering direct and applicable indirect costs of sales, the gross margin contribution from revenue in the current year was negative \$0.3 million compared to \$1.2 million in the prior year (gross margin as percentage of sales was negative 11% in 2007 versus 20% in 2006). The decrease in gross margin contribution in the current year is a result of the decrease in revenues, primarily driven by the DRS settlement, which contributed \$1.4 million of gross margin in 2006. Revenue for the quarter ended December 31, 2007 was \$0.5 million (gross margin of negative \$0.2 million), compared to \$3.0 million (gross margin of \$1.0 million) in the fourth quarter of 2006. The decrease in revenue and gross margin in the current quarter is primarily attributable to the DRS settlement as noted above.

Revenue for the year ended December 31, 2006 was \$5.8 million, compared to \$4.6 million at December 31, 2005. The revenue in both 2006 and 2005 was attributable to the US operation and was mainly comprised of sales of components, customer engineering contracts (recognised on a percentage of completion basis), and after-sales service support. As noted above, certain revenues for development stage programs were set off against development costs in accordance with Canadian accounting standards. The increase in revenues in 2006 was 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 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 2006 was \$1.2 million compared to \$0.8 million in 2005 (gross margin as percentage of sales was 20 % in 2006 versus 17% in 2005). The increase in gross margin contribution in 2006 was primarily a result of the increase in revenues and the DRS settlement.

Engineering, research, development and related costs, net: Before contributions, the Company expended \$17.8 million on engineering, research and development operations in 2007, including \$10.0 million in respect of product development costs (2006 - \$10.8 million). The expenses were reduced by \$1.1 million (2006 - \$4.2 million) in respect of Technology Partnerships Canada ("TPC") contributions. For the quarter, the Company expended \$5.0 million (2006 - \$5.1 million) on engineering, research and development operations and \$2.7 million (2006 - \$2.7 million) in product development. Throughout 2006, contributions related to TPC was \$1.2 million. The remainder of \$3.0 million was related to customer contributions. At December 31, 2007, Azure employed 102 research, engineering, operations and technical personnel (2006 - 86). Engineers and technical personnel are either working on revenue contracts and sales orders, on servicing vehicles or products in the field, or on core product development programs. In the former case, revenues are recognised as product is delivered or in accordance with the percentage of completion methodology in the case of contracts in progress. For product development and other unabsorbed overheads, the direct costs and related overheads, net of customer or government contributions, are expensed. Product development expenses of \$10.0 million (2006 - \$10.8 million) in the year included the start up costs of the G1 production launch, the P1

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system development, and costs related to the development and enhancement of system components.

As at December 31, 2006, before customer and government contributions, the Company expended \$17.6 million on engineering, research and development operations, compared to \$13.2 million in 2005, including \$10.8 million which was directly attributable to product development (2005 - \$6.4 million). The most significant product development expenditure was in respect of the Company's G1 platform, which totalled \$8.0 million in 2006 (2005 - \$4.9 million). The G1 series hybrid platform was launched commercially in 2006 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. As noted above 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 2005. Contributions from government agencies were lower compared to 2005 as less of the work undertaken was eligible for support under the terms of the programs. 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 Corporation and Natural Resources Canada ("NRCan") based on future revenues in respect of specified products. For the year ended December 31, 2007, the Company made royalty payments of \$16,500 each to both EnCana Corporation and Natural Resources Canada. No royalty payments were made to TPC during 2007. For years ending December 31, 2006 and December 31, 2005, no royalty payments were made.

Selling and marketing: Selling and marketing costs were \$3.7 million in the year compared to \$3.2 million in 2006. Selling and marketing costs in the fourth quarter were \$1.1 million, compared to \$0.9 million in the fourth quarter of 2006. The increase in the fourth quarter and in the current year is primarily related to a higher level of activities in advertising, product demonstrations and related expenses to grow the order book for launched products and to sign up lead customers for products in development. The headcount at December 31, 2007 was 9 employees (2006 - 8).

As at December 31, 2006, 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).

General and administrative: General and administrative costs were \$7.8 million in the year compared to \$8.4 million in 2006. General and administrative costs in the fourth quarter were \$1.9 million, compared to \$2.8 million in the fourth quarter of 2006. The decrease in the current quarter and in the current year are primarily attributable to higher advisory and legal fees related to strategic initiatives and higher non-cash expenses related to stock option compensation incurred in 2006. Headcount at December 31, 2007 was 17 (2006 - 18).

As at December 31, 2006, 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 2005 as the intangible assets were attributable to the Solectria acquisition, effective on January 31, 2005. Headcount at December 31, 2006 was 18 (2005 - 18).

Amortization: Amortization of property, equipment and other assets was \$0.9 million in the year and \$0.3 million in the fourth quarter compared to \$0.8 million for the year and \$0.2 million in the fourth quarter in 2006. Property and equipment primarily consists of workshop equipment, tooling, computer hardware and software. The Company purchased assets with a value of \$1.4 million in the year (2006 - \$0.9 million) and \$0.3 million in the fourth quarter (2006 - \$0.1 million). Other assets are primarily the cost of patents and trademarks. In addition, the intangible assets acquired as a result of the US acquisition noted above have been amortized by \$1.4 million in the year (2006 - \$1.7 million) and \$0.3 million in the fourth quarter (2006 - \$0.6 million). Amortization of property, equipment and other assets are allocated to the relevant cost categories on the Statement of Operations. The increase in intangible asset amortization in the prior year and in the prior year fourth quarter is related to higher levels on acquired backlog recorded as revenues in the prior year. The higher acquired backlog revenues primarily relate to the DRS settlement recorded in the fourth quarter of 2006 as noted above.

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As at December 31, 2006, amortization of property and equipment and other assets was \$0.8 million compared to \$0.7 million in 2005. The Company purchased assets with a value of \$0.8 million in 2006 (\$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.

Other expenses: Other expenses totalled \$2.6 million year to date (2006 - \$Nil) and \$0.9 million in the fourth quarter (2006 - \$Nil). These expenses primarily relate to severance costs for UK personnel in respect to the closure of the UK facility and severance costs related to senior management changes paid in respect to the Company's contractual obligations under employment arrangements.

For the year ended December 31, 2005, other expenses were nil.

Foreign currency losses: Foreign currency losses totalled \$82,000 (2006 - loss of \$89,000, 2005 - gain of \$22,000) for the year and \$28,000 in the fourth quarter (2006 - loss of \$82,000). These were mainly unrealised losses in respect of foreign currency cash balances which reversed out subsequent to the quarter and year end.

Balance Sheet Discussion

Cash and cash equivalents: Cash and cash equivalents at December 31, 2007 were \$24.1 million compared to \$27.2 million at December 31, 2006 and \$5.9 million at September 30, 2007. Net cash outflows were approximately \$3.3 million in the year compared to net cash inflows of \$6.5 million for the prior year. The increase in cash outflows of \$9.8 million in the current year is primarily attributable to the increased net loss (\$6.9 million higher after adjusting for non cash items), a lower level of net equity financings (\$4.0 million lower in the current year), an increase in capital expenditures (\$0.5 million higher in the current year), and an increase in restricted cash of \$0.5 million, partially offset by a decrease in non cash working capital of \$2.4 million. In the fourth quarter, the Company's cash and cash equivalents increased by \$18.2 million compared to an increase of \$23.4 million in the fourth quarter of 2006. The decrease in cash inflows in the current year quarter of \$5.2 million is primarily a result of the higher net loss (\$3.0 million higher in the current year after adjusting for non cash items) and a lower level of net equity financings (\$2.5 million lower in the fourth quarter of the current year), partially offset by a decrease in non cash working capital of \$1.3 million and asset expenditures of approximately \$1.0 million.

As at December 31, 2006, cash and cash equivalents was \$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 2006 was 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).

Accounts receivable: Accounts receivable at December 31, 2007 were \$0.6 million compared to \$3.4 million at December 31, 2006 and \$0.7 million at September 30, 2007. The decrease in the current year compared to the year ended December 31, 2006 is primarily related to the DRS receivable of \$3.2 million, which was included in the 2006 yearend balance and collected in the second quarter of the current year.

As at December 31, 2006 accounts receivable was \$3.4 million compared to \$1.0 million at December 31, 2005. The increase in 2006 compared to 2005 was mainly attributable to the receivable associated with the DRS settlement as noted above.

Contributions receivable: Contributions receivable were \$1.1 million at December 31, 2007 (\$1.3 million at December 31, 2006, \$0.9 million at September 30, 2007). The increase in the current year end compared to the balance at the end of the third quarter is related to an additional quarter of TPC claims included in the yearend balance.

Cost reimbursement claims are subject to review by TPC. During 2007, TPC initiated a review of all 2007 claims made; in particular the G2 program. The Company is confident that the claims will be settled in 2008

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as all claims were based on the G1 product. Furthermore, the Company is seeking an extension of the TPC program from March 31, 2007 to June 30, 2008 as it wraps up the G1 program. The Company anticipates that it will be able to claim a total of \$7.1 million of the available \$9.0 million of funding from TPC. As of December 31, 2007, the Company has claimed approximately \$7.0 million from the TPC program.

As at December 31, 2006 contributions receivable was \$1.3 million compared to \$0.6 million at December 31, 2005. The higher balance was attributable to customer contributions receivable of \$0.6 million at December 31, 2006 (2005 – \$nil).

Inventory and related prepayments: Inventory and related prepayments were \$10.2 million at December 31, 2007 compared to \$3.8 million at December 31, 2006 and \$7.9 million at September 30, 2007. The higher inventory amount at December 31, 2007 compared to the prior year end and the third quarter is attributable to additional work-in-process inventory related to the G1 Shuttle Bus product to support future orders and deliveries as discussed above, in addition to an increase in work in process and finished goods related to the initial order for electric drive systems on the EAE program in Mexico City. Deliveries on the EAE program are expected to commence in the first half of 2008.

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

Prepaid expenses: Prepaid expenses at December 31, 2007 were \$0.7 million compared to \$0.8 million at December 31, 2006 and \$0.9 million at September 30, 2007.

As at December 31, 2006 prepaid expenses was \$0.8 million compared to \$1.0 million at December 31, 2005.

Property and equipment: Net property and equipment was \$5.7 million at December 31, 2007 compared to \$5.6 million at December 31, 2006 and \$5.8 million at September 30, 2007. The increase compared to the prior year end is related to capital purchases of additional workshop equipment, test equipment and computer software offset by additional 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 \$3.0 million at December 31, 2007 (2006 - \$3.1 million).

As at December 31, 2006, net property and equipment was \$5.6 million compared to \$5.6 million at December 31, 2005. The impact of property and equipment additions of \$0.8 million in 2006 was offset by \$0.8 million of amortization. As noted above, 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 (2005 - \$3.2 million).

Goodwill and other intangibles: The Company accounted for the acquisition of Azure Dynamics Incorporated (its US subsidiary) using the purchase method, and in accordance with Canadian accounting standards, allocated the purchase price to identifiable assets, including intangibles. 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 technology (\$12.5 million) as at-acquisition intangible assets. Intangible assets were \$9.3 million at December 31, 2007 (\$10.5 million at December 31, 2006 and \$9.5 million at September 30, 2007). The lower amount at the end of 2007 is attributable to amortization.

As at December 31, 2006, intangibles assets were \$10.5 million compared to \$12.1 million at December 31, 2005. As noted above, the decrease at the end of 2006 compared to 2005 was attributable to amortization.

Accounts payable and accrued liabilities: Accounts payable and accrued liabilities were \$4.3 million at December 31, 2007 compared to \$2.8 million at December 31, 2006 and \$4.1 million at September 30, 2007. The higher amount at the current year end compared to the prior year end is primarily attributable to

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increased purchasing levels related to inventory for launched product.

As at December 31, 2006, accounts payable and accrued liabilities was \$2.8 million 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 \$1.1 million at December 31, 2007 compared to \$2.0 million at December 31, 2006 and \$1.3 million at September 30, 2007). The amount is attributable to the US operation and is comprised of customer deposits in respect of work-in-progress of \$0.2 million (\$1.3 million – December 31, 2006) and deferred revenue of \$0.9 million (\$1.0 million – December 31, 2006). The deferred revenue is primarily 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 deposit balances are primarily related to deposits from initial shuttle bus customers. The lower balance at the current year end compared to the prior year end is related to the deposits being reduced as the shuttle buses on which the deposits were paid were completed and delivered to the customers in the year.

As at December 31, 2006, current and long-term deferred revenue and customer deposits was \$2.0 million compared to \$2.6 million at December 31, 2005. The decrease in 2006 versus 2005 is primarily attributable to the completion of programs in 2006 where revenue had previously been deferred or deposits had previously been received.

Notes payable: The note payable is attributable to the US subsidiary 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 amount of \$2.1 million at December 31, 2007 compared to \$2.5 million at December 31, 2006 is attributable to principal repayments.

As at December 31, 2006 notes payable was \$2.5 million compared to \$2.6 million at December 31, 2005. The lower balance in 2006 is attributable to principle repayments made in the year.

Share capital: Share capital at December 31, 2007 was \$140.7 million compared to \$112.8 million at December 31, 2006 and \$112.7 million at September 30, 2007. The increase in share capital at the current year end compared to the prior year and the third quarter is primarily related to the equity financing in October 2007 (net increase to share capital of \$27.8 million).

As at December 31, 2006, share capital was \$112.8 million compared to \$80.7 million at December 31, 2005. The increase in 2006 was primarily due to equity financings (net) totalling \$30.3 million (gross \$31.9 million), The remainder of the increase was due to stock option exercises throughout the year and the re-class of stock compensation from contributed surplus.

The number of common shares, options and deferred share units (“DSU’s”) issued and outstanding is presented in the following table:

	March 25, 2008	December 31, 2007	December 31, 2006
Common shares	279,376,177	279,376,177	198,253,101
Deferred Share Units	2,144,727	2,124,727	Nil
Stock options issued under the Stock Option Plan, with expiry dates ranging up until September 19, 2014 and average exercise price of \$0.91	18,334,126	14,451,626	16,685,003

During the period from December 31, 2007 to March 25, 2008, the Company granted 3,980,000 stock options

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and 20,000 DSUs to employees and board members in accordance with the Company's stock option and DSU plans. In addition, 97,500 employee stock options were cancelled during this period.

Related Party Transactions

In November 2003, Solectria entered into a Transfer of Technology and Software Licensing Agreement ("TTA Agreement") with Singapore Technologies Kinetics ("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. As discussed in note 2(b) of the December 31, 2007 Financial Statements, revenues from the TTA Agreement are being recognized on a straight-line basis over the period of the license agreement. As of December 31, 2007, the Company has deferred revenue associated with the TTA Agreement in the amount of \$0.9 million. During the year ended December 31, 2007, revenues recognized by the Company from the sale of products to STK and its related companies and from certain other contractual arrangements totalled approximately \$65,000 (2006 - \$68,000). As of December 31, 2007, accounts receivable includes \$Nil (2006 - \$11,000) due from STK and customer deposits includes \$Nil (2006 - \$42,000) received from STK.

Liquidity, Capital Resources, and Risk Factors

At December 31, 2007 the Company had \$25.3 million (December 31, 2006 – \$27.9 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 bankers acceptances and term deposits. At December 31, 2007 approximately \$1.2 million of cash was restricted (2006 - \$0.7 million). The restricted cash is related to a security deposit in respect of the facility in Boston (\$0.8 million), a standby letter of credit associated with a customer contract (\$0.2 million), and a standby letter of credit related to the security deposit for the new facility in Oak Park (\$0.2 million). Working capital was \$32.3 million at December 31, 2007 compared to \$32.4 million at December 31, 2006. Working capital in total is comparable to the prior year as lower cash balances at the current year end (lower by \$3.0 million) were offset by higher non cash working capital balances. The higher non cash working capital balances in the current year are primarily attributable to higher inventory balances (\$6.4 million higher as described above), partially offset by lower accounts receivable balances (\$2.8 million lower primarily related to the DRS settlement as described above).

The Company has incurred losses since its inception as it has invested in the development of its Technology. Although the Company is active in a number of revenue-generating programs it also continues to incur product development costs. As a result, the Company has relied on its financing activities to fund its operations. In addition, Azure has in the past, subject to TPC conditions, been eligible to access the grant of up to \$9.0 million available under the terms of the TPC contribution agreement. As at December 31, 2007 the Company had claimed approximately \$7.0 million in accordance with the terms of the TPC agreement. However, based on the current product development plan, it is unlikely, as noted above that the Company will be eligible for the balance of the grant of \$2.0 million.

On October 23, 2007, the Company completed an equity financing with gross proceeds of approximately \$30.0 million. The Company intends to use these cash resources for ongoing product development and for general corporate purposes. The Company is now 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

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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 25, 2008 (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). 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 has implemented an internal control and process system supported by an appropriate ERP system that encompasses all existing engineering/support operations. The Company recently completed its ISO certification at its Canadian location in Vancouver, B.C. The Boston, Massachusetts location already conforms to ISO. 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, 2007 the Company had the following contractual obligations and operating lease commitments:

Contractual Obligations	Total	Payments due by period			
		Less than 1 year	1-3 years	4-5 years	After 5 years
Operating leases ⁽¹⁾	9,299	1,204	3,249	2,112	2,734
Purchase obligations ⁽²⁾	7,564	7,564	0	0	0
Total contractual obligations	16,863	8,768	3,249	2,112	2,734

Off-balance sheet arrangements:

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

⁽²⁾ Purchase obligations are agreements to purchase goods or services. Pursuant to a contractual agreement with National Instruments, 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. To date, the Company has made payments in the amount of approximately \$16,500.

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. The Company has made no royalty payments to date.

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. To date, the Company has made payments in the amount of approximately \$16,500.

The Company has entered into employment agreements with certain executive directors and officers. In addition to defining the terms of employment, the agreements entitle the executives to termination payments, of up 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

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Company.

CHANGES IN ACCOUNTING POLICIES

Effective January 1, 2007, the Company adopted Section 1530 – Comprehensive Income, Section 3855 – Financial Instrument Recognition and Measurement, Section 3861 – Financial Instruments Disclosure and Presentation, and Section 3865 – Hedges, in accordance with the transitional provisions in each respective Section. As a result of the adoption of these Sections, the Company determined that currently, there was no current material impact on the consolidated financial statements.

In 2005, due to the acquisition of Solectria in January 2005, the Company 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.

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), in addition to the G1 Shuttle Bus, which was launched into production during 2007, 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 collection is reasonably assured.

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.

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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 Annual 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.

Stock based compensation

The Company grants stock options to officers, directors, employees and consultants pursuant to the Company's stock option plan. The Company accounts for the stock-based compensation using the fair-value method as at the grant date. Under this method, compensation expense related to option grants is recorded in consolidated earnings over the vesting period of the options or, for consultants, as the work is performed. The compensation expense amount is based on the fair value of the option as estimated using the Black-Scholes option pricing model. The assumptions used in calculating the value of the stock options issued include management's best estimate, as of the date of grant, of the expected share price volatility over the term of the stock option and expected option life. As such, the amounts reported as compensation expense are subject to measurement uncertainty as the expense amount may vary significantly based on the assumptions used.

NEW ACCOUNTING PRONOUNCEMENTS AND DEVELOPMENT

Recent accounting pronouncements that have been issued but are not yet effective, and have a potential implication for the Company are as follows:

Financial instruments

Effective January 1, 2008, the Company will be required to adopt two new CICA standards, Section 3862, Financial Instruments Disclosure and Section 3863, Financial Instruments Presentation, which will replace Section 3861 Financial Instruments Disclosure and Presentation. The new disclosure standard increases the emphasis on the risks associated with both recognized and unrecognized financial instruments and how those risks are managed. The new presentation standard carries forward the former presentations requirements. The Company is currently evaluating the implications of these standards.

Capital disclosures

In November 2006, the CICA issued the new handbook Section 1535, "Capital Disclosures," effective for annual and interim periods related to fiscal years beginning on or after October, 1, 2007. This section establishes standards for disclosing information about a Company's capital and how it is managed in order that a user of the financial statements may evaluate the company's objectives, policies, and processes for managed capital. The Company is currently determining the additional disclosures that may be required under this standard.

Inventories

The CICA issued a new section 3031, "Inventories", in March 2007, which is based on International Accounting Standard 2. The new section replaced the existing section 3030, Inventories. Under the new section, inventories are required to be measured at the "lower of cost and net realizable value", which is

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different from the existing guidance of the "lower of cost and market". The new section also allows the reversal of any write-downs previously recognized. The new accounting standard and any consequential amendments will be effective for the Company beginning January 1, 2008. The Company is currently evaluating the implications of the new standard.

Financial statement presentation

CICA Handbook Section 1400, General Standards on Financial Statement Presentation, has been amended to include requirements to assess and disclose an entity's ability to continue as a going concern. The changes are effective for interim and annual financial statements beginning on or after January 1, 2008. The Company does not expect the adoption of these changes to have a material impact on its financial statements.

International financial reporting standards (IFRS)

In 2006, Canada's Accounting Standards Board ratified a strategic plan that will result in Canadian GAAP, as used by public companies, being converged with International Financial Reporting Standards over a transitional period currently expected to be about five years. The precise timing of convergence will depend on an Accounting Standards Board progress review to be undertaken by early 2008. The impact of this transition on the Company's consolidated financial statements has not yet been determined; however, management continues to monitor these regulatory developments.

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

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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.