

**Three months and six months ended June 30, 2007 compared to the three months and six months ended June 30, 2006 and the year ended December 31, 2006**

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## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

**Three months and six months ended June 30, 2007 compared to the three months and six months ended June 30, 2006**

*This "Management's Discussion and Analysis" has been prepared as of August 14, 2007 and should be read in conjunction with the unaudited consolidated financial statements of Azure Dynamics Corporation ("Azure" or the "Company") for the three months and six months ended June 30, 2007 and the audited consolidated financial statements of the Company for the year ended December 31, 2006.*

### **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 beliefs 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 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 market.

Target markets include urban delivery, postal, courier 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 vehicle industry to assemble products to its specifications which are then distributed via existing industry channels to the customer.

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Azure seeks to closely align its product development and sales efforts with recognised industry partners (Original Equipment Manufacturer's, 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 arrangements with Ford Motor Company ("Ford") and StarTrans (a business division of Supreme Corporation) which have facilitated a concentration of the Company's efforts around its core programs for series-hybrid (G1) and parallel-hybrid (P1) delivery vans and shuttle buses. In addition, the Company's third area of focus is referred to as Electric Power Products, the Company has preliminary 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. Furthermore, in 2007, the Company entered into a supply agreement with Electro Autos Eficaces of Mexico ("EAE") for electric drive systems and components.

During the quarter under review the Company initiated organizational and infrastructure changes to take full advantage of the opportunities now available to it in its core programs. D. Campbell Deacon, retiring Chief Executive Officer, became Chairman of the Board. On April 17, 2007 Scott T. Harrison was appointed Chief Executive Officer and joined the Azure Board. Scott Harrison has extensive production and supply chain experience with both new and established products in the automotive industry and has the appropriate skills to successfully manage the transition of the Company from research and development to commercial production. On May 14, 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. Thomas N. Davidson, outgoing Chairman, and Roberto Quarta, Director, did not seek re-election to the Board at the Annual General Meeting of the Shareholders held on June 12, 2007.

On May 7, 2007 the Company announced that it will establish a new corporate head office and development center in the heartland of the North American automotive industry. The new location will be selected to ensure the Company can leverage its relationship with Ford and capitalize on the significant opportunities in the mid-sized truck market. The Kenilworth facility in the UK as well as the Executive and Marketing office in Toronto were closed in May and July 2007 respectively. Upon completion of these changes the Company will operate offices and facilities in Boston (engineering, sales and service); Vancouver (engineering, sales and service); Mississauga/Toronto (service) and Detroit/Windsor (development and corporate).

In continuation of the repositioning of the executive and management team of Azure, effective August 20, 2007 David E. Deacon, Executive Vice President and Deputy Chairman, and Gregory P. Francis, President and Chief Operating Officer, will resign their positions. David Deacon will continue to serve as a non-executive Director of the Board and Greg Francis will support the Company's strategic development in an advisory capacity. Guy Pearson, Vice President, Engineering (Vancouver) resigned with effect from July 9, 2007. His responsibilities have been assumed by Ricardo Espinosa, Vice-President, Engineering (Boston). On August 13, 2007 the Company appointed Curt Huston as Chief Operating Officer. Curt will enhance Azure's ability to build a best-in-class supply chain by attracting industry talent and building the necessary supply chain processes

The executive and senior management team of Azure is now comprised of the following:

Scott Harrison – Chief Executive Officer;  
Daniel Renzella – Chief Financial Officer;  
Ronald Iacobelli – Chief Technology Officer;  
Curt Huston – Chief Operating Officer;  
Mark Federle – Senior Vice-President, Sales;  
Mike Elwood – Vice-President, Marketing;  
Ricardo Espinosa – Vice-President, Engineering;  
Steven Glaser – Vice-President, Corporate Affairs;

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Rajan Johal – Vice-President, Operations;  
Dean McGrew – Vice-President, Business Development.

The facilities and management reorganization described above are expected to provide annual cost savings in excess of \$3.0 million. The cost savings are related to both fixed costs for facilities and people as well as in variable costs, such as travel. The savings are expected to be approximately \$0.5 million in the current year, net of exit and set up costs.

**G1 (series hybrid) production:**

Purolator Courier Ltd has completed the introduction of 30 new G1 hybrid delivery vans into their 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.

During the quarter the Company continued the final-stage development of the G1 shuttle bus design. The initial nine customer units have progressed from the cab-chassis stage to be fitted with shuttle bus bodies manufactured and installed by StarTrans. After final assembly and evaluation at Azure's Boston facility the first two shuttle buses were delivered in June 2007. The remaining buses are expected to be delivered in July and August 2007. A larger production run of shuttle busses is in the set-up phase with deliveries anticipated in 2007 and early 2008. Also during the quarter, the Company delivered a shuttle bus that commenced durability testing at Altoona (the process required to qualify for federal capital subsidies in public transit applications).

**P1 (parallel hybrid) development:**

Azure's commercial P1 development program is focused on the Ford E-350 and E-450 commercial vehicle chassis. The program has advanced through the initial requirements and concept phases and is now in the detailed design phase which includes the building, testing and optimizing of additional prototypes. The second prototype truck was completed in June and will be set up for hot weather testing in Arizona commencing in July. These internal prototypes will form the design basis of the demonstration prototypes which are scheduled for customer in-service trials in the latter half of 2007. Thereafter, a quantity of pre-production units for lead customers is anticipated to be built commencing in early 2008 with full production expected to commence in mid 2008.

On May 15, 2007 the Company announced that it had entered into an agreement with FedEx Express, a subsidiary of FedEx Corporation, for a P1 E-450 demonstration vehicle and subsequently 20 pre-production vehicles (the latter to be delivered by May 2008). On August 14, 2007 the Company announced a further order for 105 P1 E-450 vehicles for delivery to Purolator Courier Ltd by the end of 2008. Based on these initial orders, the Company can now commence the supply chain and assembly-line procurement activities required to establish the production process. To this end, the Company announced on August 2, 2007 that it has selected Utilimaster Corporation as the primary assembly and integration partner for the hybridized E-series chassis.

**Electric Power Products and other production:**

Electric Power Products consists of Azure's LEEP and electric drive components. The product name LEEP (Low Emission Electric Power) 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. Azure and Kidron are developing the first LEEP application for use in the North American refrigerated truck body market. Kidron uses cold-plate refrigeration technology whereby the cold-plate is cooled by plugging into the grid. The LEEP system enables the vehicles power train to maintain cooling of the refrigerated cold-plate while driving, thereby extending the delivery range. The LEEP system also has the potential to replace the ancillary motors/generators used in the other method of cooling refrigerated trucks, thereby providing capital cost and fuel savings as well as reductions in noise and emissions. Azure has

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completed the build of a prototype of the LEEP system based on a refrigerated truck body provided by Kidron. The first customer demonstration unit is in progress. The Company is targeting to launch pre-production volumes of this product before the end of 2007.

On April 9, 2007 the Company announced it had signed a supply agreement with EAE. 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; the converted vehicle was unveiled at the International Electric Vehicle Forum on May 8, 2007 in Mexico City. The balance of the 1,000 vehicles is expected to be converted 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 P2 parallel hybrid system, delivered to the Charmer-Sunbelt Group ("Charmer-Sunbelt") in October 2006, continues to be evaluated in-service. Azure will only actively pursue the development of the P2 system when development program partners and engineering resources are available.

The total number of employees increased from 112 at the end of fiscal 2006 to 122 at June 30, 2007. The Company occupies facilities in Vancouver (18,000 square feet) and Boston (77,000 square feet). The Company has also established a service and support center in Mississauga, Canada. The Company considers that, with the addition of the Detroit/Windsor facility, 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.

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.

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**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**

**Statement of Operations Discussion**

*Selected Quarterly information: (stated in thousands except loss per share amounts)*

	<b>Q2, 2007 (Apr – Jun)</b>	<b>Q1, 2007 (Jan – Mar)</b>	<b>Q4, 2006 (Oct – Dec)</b>	<b>Q3, 2006 (Jul – Sep)</b>
<b>Revenue</b>	\$ 593	\$ 156	\$ 3,008	\$ 411
<b>Gross margin</b>	\$ (10)	\$ 89	\$ 967	\$ (166)
<b>Expenses, net</b>	\$ (6,906)	\$ (6,596)	\$ (5,974)	\$ (8,849)
<b>Net loss for the period</b>	\$ (6,916)	\$ (6,507)	\$ (5,007)	\$ (9,015)
<b>Net loss per share</b>	\$ (0.03)	\$ (0.03)	\$ (0.03)	\$ (0.06)
<b>Weighted average number of Shares</b>	198,276	198,275	166,913	159,206

	<b>Q2, 2006 (Apr – Jun)</b>	<b>Q1, 2006 (Jan – Mar)</b>	<b>Q4, 2005 (Oct – Dec)</b>	<b>Q3, 2005 (Jul – Sep)</b>
<b>Revenue</b>	\$ 1,205	\$ 1,147	\$ 965	\$ 1,134
<b>Gross margin</b>	\$ 76	\$ 304	\$ 56	\$ 154
<b>Expenses, net</b>	\$ (4,922)	\$ (4,870)	\$ (6,796)	\$ (4,788)
<b>Net loss for the period</b>	\$ (4,846)	\$ (4,566)	\$ (6,740)	\$ (4,634)
<b>Net loss per share</b>	\$ (0.03)	\$ (0.03)	\$ (0.04)	\$ (0.03)
<b>Weighted average number of Shares</b>	158,638	156,631	156,116	146,291

**Three months and six months ended June 30, 2007 compared to the three months and six months ended June 30, 2006 and the year ended December 31, 2006**

For the quarter ended June 30, 2007, the Company incurred a net loss of \$6.9 million (\$0.03 per share) compared to a net loss of \$4.8 million (\$0.03 per share) in the comparable 2006 quarter. The higher loss in the current quarter is primarily attributable to the lower margins associated with lower volume and the higher level of activities in engineering and operations as the Company progresses the P1 Ford development and incurs final engineering and start up costs associated with the ramp up of G1 production.

Revenue: Revenue for the quarter ended June 30, 2007 was \$0.6 million (2006 – \$1.2 million). The lower revenue is attributable to decreased activities in funded engineering contracts in the Boston operation. The Company substantially completed the funded development programs in 2006 and has now refocused its engineering resources on internal development programs that will be launched into production in 2007 and 2008. Revenue in the current quarter is mainly comprised of the initial two deliveries of shuttle buses to customers in New York, in addition to sales of components and after-sales service support. After considering direct and applicable indirect costs of sales, the gross margin contribution from revenue in the quarter was \$nil (2006 – \$0.1 million). Gross margin as a percentage of sales was nil% (2006 – 6%).

Engineering, research, development and related costs, net: Before contributions, the Company expended \$4.2 million on engineering, research and development operations in the quarter (2006 – \$2.7 million), including \$2.4 million in respect of product development costs (2006 - \$1.3 million). The expenses were reduced by \$0.3 million (2006 – \$0.4 million) in respect of government and customer contributions. At June 30, 2007, Azure employed 97 research, engineering, operations and technical personnel (2006 - 84). 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 \$2.4 million (2006 – \$1.3 million) include the start up costs of the G1 production launch, the P1 system development, and costs related to the development and enhancement of system components.

Customer and government contributions were \$0.3 million in the second quarter of 2007 compared to \$0.4 million in the second quarter of 2006. All of the contributions in the quarter are associated with Technology Partnerships Canada ("TPC") (2006 - \$0.3 million). The Company recorded no customer contributions in the second quarter of 2007 (2006 – \$0.1 million).

The Company is required to make royalty payments to TPC, EnCana Corporation and the National Research Council based on future revenues in respect of specified products.

Selling and marketing: Selling and marketing costs were \$0.9 million in the second quarter of 2007 compared to \$0.8 million in the comparable 2006 quarter. The increase is primarily related to a higher level of activities in advertising, product demonstrations and related travel to grow the order book for launched products and to sign up lead customers for products in development. The selling and marketing headcount at June 30, 2007 was 8 (2006 – 8).

General and administrative: General and administrative costs were \$2.2 million in the quarter compared to \$1.9 million in 2006. The increase is primarily related to the one time exit costs related to the closure of the UK facility. The headcount at June 30, 2007 was 17 (2006 – 20).

Amortization: Amortization of property, equipment and other assets was \$0.2 million in the second quarter of 2007 compared to \$0.2 million in the second quarter of 2006. Property and equipment primarily consists of workshop equipment, tooling, computer hardware and software. The Company purchased assets with a value of \$0.5 million in the quarter (2006 - \$0.4 million). Other assets are primarily the cost of patents and

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trademarks. In addition, the intangible assets acquired as a result of the US acquisition noted above have been amortized by \$0.4 million (2006 - \$0.4 million). Amortization of property, equipment and other assets are allocated to the relevant cost categories on the Statement of Operations.

Foreign currency losses: Foreign currency losses total \$71,000 in the quarter (2006 – gain of \$38,000). These were mainly unrealised losses in respect of foreign currency cash balances which reversed out subsequent to the quarter end.

***Balance Sheet Discussion***

Cash and cash equivalents: Cash and cash equivalents at June 30, 2007 were \$16.8 million compared to \$27.2 million at December 31, 2006 and \$10.7 million at June 30, 2006. Net cash outflows were approximately \$3.9 million in the quarter compared to net cash outflows of \$4.9 million in the second quarter of 2006. The prior year quarter included net equity financing of \$0.7 million compared to \$nil in the second quarter of 2007. Net cash outflows in respect of operations, working capital financing and capital expenditures were approximately \$3.9 million compared to \$5.6 million in the second quarter of 2006. The decrease in cash outflows of \$1.7 million is mainly attributable to the decrease in non cash working capital in the current quarter of \$2.6 million compared to an increase of \$1.1 million in the prior year quarter, partially offset by the \$2.1 million higher loss in the current quarter (\$6.9 million compared to \$4.8 million in the prior year quarter). The decrease in non cash working capital of \$2.6 million in the current quarter was primarily attributable to the collection of the receivable from DRS (\$2.9 million). The other non-cash working capital changes are more fully described below. The higher loss in the current quarter is related to the increase in activity levels as described above.

Accounts receivable: Accounts receivable at June 30, 2007 were \$0.3 million compared to \$3.4 million at December 31, 2006 and \$1.1 million at June 30, 2006. The significant decrease in the current quarter compared to the year ended December 31, 2006 is primarily related to the DRS receivable of \$2.9 million, which was collected in the current quarter. The decrease in accounts receivable compared to the prior year quarter is primarily due to the higher revenue levels in the prior year quarter.

Contributions receivable: Contributions receivable were \$0.6 million at June 30, 2007 (\$1.3 million at December 31, 2006, \$0.6 million at June 30, 2006). The decrease in the current quarter compared to the year end is primarily related to customer contributions of \$0.6 million, which were included in the year end balance, collected during the first quarter.

Inventory and related prepayments: Inventory and related prepayments were \$5.4 million at June 30, 2007 compared to \$3.8 million at December 31, 2006 and \$4.3 million at June 30, 2006. The higher inventory amount at June 30, 2007 compared to the year end and the prior year quarter is attributable to additional work-in-process inventory related to customer orders scheduled to ship in the second quarter of 2007 and additional inventories to support future orders.

Prepaid expenses: Prepaid expenses at June 30, 2007 were \$0.9 million compared to \$0.8 million at December 31, 2006 and \$1.0 million at June 30, 2006.

Property and equipment: Net property and equipment was \$5.9 million at June 30, 2007 compared to \$5.6 million at December 31, 2006 and \$5.8 million at June 30, 2006. The increase compared to the year end is related to capital purchases of additional workshop and test equipment partially offset by additional amortization.

Other assets: Other assets were \$nil at June 30, 2007 and December 31, 2006 (2006 - \$44,000). The balance in the prior year quarter related to a note receivable which was has since been repaid in full.

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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 \$9.9 million at June 30, 2007 (\$10.5 million at December 31, 2006 and \$11.4 million at June 30, 2006). The lower amount in 2007 is attributable to the amortization.

Accounts payable and accrued liabilities: Accounts payable and accrued liabilities were \$3.4 million at June 30, 2007 compared to \$2.8 million at December 31, 2006 and \$3.0 million at June 30, 2006. The higher amount in the current quarter compared to the year end and the prior year is primarily attributable to increased purchasing levels related to inventory for launched product.

Customer deposits and deferred revenues: Current and long-term deferred revenue and customer deposits total \$1.8 million at June 30, 2007 compared to \$2.0 million at December 31, 2006 and \$1.9 million at June 30, 2006). The amount is attributable to the US operation and is comprised of customer deposits in respect of work-in-progress of \$0.9 million and deferred revenue of \$0.9 million. 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 deposit balance is primarily related to deposits from initial shuttle bus customers.

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 \$2.3 million at June 30, 2007 compared to \$2.5 million at December 31, 2006 and \$2.4 million at June 30, 2006 is attributable to principle repayments.

Share capital: Share capital at June 30, 2007 was \$112.8 million compared to \$112.8 million at December 31, 2006 and \$82.2 million at June 30, 2006. The increase in share capital in the current quarter and year end compared to the prior year quarter is primarily related to the equity financings in November 2006 (increase to share capital of \$30.3 million).

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

	August 14, 2007	June 30, 2007	June 30, 2006
Common shares	198,276,177	198,276,177	159,139,445
Deferred Share Units ("DSUs")	80,000	Nil	Nil
Stock options issued under the Stock Option Plan, with expiry dates ranging up until May 18, 2014 and average exercise price of \$0.92	15,515,128	15,515,128	12,386,408

There was no share or option activity during the period from June 30, 2007 to August 14, 2007. The Company issued 80,000 DSUs on July 12, 2007.

**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

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cash consideration for the license and transfer of technology, and for the training in the aggregate amount of US\$1.0 million (Cdn\$1.2 million). As discussed in note 2(b) of the June 30, 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 June 30, 2007, the Company has deferred revenue associated with the TTA Agreement in the amount of \$1.0 million. During the three months ended June 30, 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 \$15,000. As of June 30, 2007, accounts receivable includes \$11,000 due from STK and customer deposits includes \$42,000 received from STK.

**Liquidity, Capital Resources and Risk Factors**

At June 30, 2007 the Company had \$17.7 million (December 31, 2006 - \$27.9, June 30, 2006 - \$11.4 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 June 30, 2007 approximately \$0.8 million of cash was restricted. The restricted cash is related to a security deposit in respect of the Boston joint venture property and lease arrangements (\$0.6 million) and a standby letter of credit associated with a contract in the Boston operation (\$0.2 million). Working capital was \$19.6 million at June 30, 2007 compared to \$32.4 million at December 31, 2006 and \$11.5 million at June 30, 2006. Working capital is \$12.8 lower compared to the year end primarily due to the lower cash balance (\$10.3 million lower due to the cash outflows described above), the lower accounts receivable balance (\$3.1 million due to the collection of the DRS receivable) and the lower contributions receivable balance (\$0.7 million lower due to the collection of the customer contributions as described above), partially offset by the higher inventory balances (\$1.6 million higher due to increased work in process as described above) and the higher accounts payable balances (\$0.5 million higher due to increased inventory purchase activity as described above). Working capital is \$8.1 million higher compared to the prior year quarter primarily due to the higher cash balance (higher by \$6.1 million as described above), the higher inventory levels (\$1.1 higher as described above) and the lower short term note payable balances (lower by \$2.2 million due to the current classification of the note payable as long term as the note was refinanced in late 2006), partially offset by the decreases in accounts receivable (\$0.8 million lower) and increases in accounts payable (higher by \$0.3 million) as are more fully 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. 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 June 30, 2007 the Company had claimed approximately \$6.5 million in accordance with the terms of the TPC agreement and is therefore eligible for further contributions totalling approximately \$2.5 million.

The Company intends to use its cash resources and available financing arrangements from TPC 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 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](http://www.sedar.com)). These risks include the practical risks of

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**Three months and six months ended June 30, 2007 compared to the three months and six months ended June 30, 2006 and the year ended December 31, 2006**

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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. 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.

The Company has no long-term contractual purchase obligations. Contractual commitments in respect of leased premises and equipment, totalling \$7.2 million over the next five years, are described in note 7 to the June 30, 2007 financial statements.

### **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 quarterly 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' quarterly 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.

There have been no 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](http://www.sedar.com).