

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

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

**Three months and nine months ended September 30, 2007 compared to the three months and nine months ended September 30, 2006**

*This "Management's Discussion and Analysis" has been prepared as of November 7, 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 nine months ended September 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 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 market.

Target markets include urban delivery, postal, courier and shuttle-bus 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. 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"), StarTrans (a business division of Supreme Corporation) and Utilimaster Corporation ("Utilimaster"), 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 Drive Solutions. During the current quarter 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. The Company had previously announced a supply agreement with Electro Autos Efficaces of Mexico ("EAE") for electric drive systems and components.

During the previous quarter, the Company initiated organizational and infrastructure changes to take full advantage of the opportunities now available to it in its core programs. The Company also announced that it would establish a new corporate head office and development center in the heartland of the North American automotive industry. In the current quarter, the Company finalized those arrangements and announced on September 19, 2007 that it has established its new corporate headquarters in Oak Park, Michigan, in the greater Detroit area. The facility is located in a strategic location 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 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 worth an estimated US\$55,400.

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 facility in Boston, Mass., and 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 a service facility in Mississauga, Ontario to support major customers in the Toronto area.

On October 23, 2007 the Company announced that it had closed the equity offering that it had announced previously. The Company received gross proceeds of \$30 million and intends to use these funds for ongoing development programs, further commercialization activities in operations, selling and marketing efforts and for working capital.

**G1 (series hybrid) production:**

Purolator Courier continued to operate their fleet of Azure's G1 hybrid delivery vans which totals 49 vehicles located in Montreal, Ottawa, Toronto and Vancouver.

During the quarter the company continued its G1 shuttle bus production and completed six hybrid buses for customers. This brings the total to eight customer buses completed with the final one expected to be completed early in the fourth quarter of 2007. All of the completed buses are expected to be in service by November. 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 will then be fitted with shuttle bus bodies manufactured and installed by Startrans. Shuttle buses are expected to be complete for deliveries in late 2007 and into 2008. Subsequent to the quarter end, the Company completed the durability testing of a shuttle bus at Altoona. Completion of this test is required 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

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chassis. Three prototype 2008 E-450 hybrid vehicles were completed in the quarter with production intent hardware. Hot weather validation testing was also completed on one of these prototypes at Arizona Proving Grounds. A new belt starter-generator system was also developed and commissioned in the quarter. The Purolator and FedEx demonstration vehicles have been completed and are currently undergoing internal testing. Build planning and long-lead parts orders are underway for the pre-production lead customers vehicles which are expected to commence in early 2008.

The Company had previously announced that it had concluded agreements with the initial two lead customers for the P1 program, Purolator Courier Ltd. and FedEx Express, and also that it had selected Utilimaster as the primary assembly and integration partner for the hybridized E-series chassis. During the current quarter, the Company concluded an agreement for a third P1 lead customer. On August 28, 2007 it was announced that the Company had signed a commercial development and cooperation agreement with this customer. 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.

**Electric Drive Solutions and other production:**

Electric Drive Solutions consists of Azure's 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 an MOU with Kidron to develop the first LEEP application. On October 10, 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. Azure's LEEP system uses the vehicle powertrain to generate clean electric power for a range of auxiliary and export power applications. The LEEP system delivers improvements in fuel utilization and emission levels by allowing the vehicle to power auxiliary loads with the engine off. The LEEP system has a wide range of applications beyond refrigeration including utility and telecom.

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 stored energy is used to maintain refrigeration temperatures. The LEEP system also allows the vehicle to operate in engine off mode while still maintaining the desired temperature in the refrigeration unit. Furthermore, by allowing the system to operate with the engine off, the LEEP system provides a solution for increasing anti-idle regulations across North America. Lastly, the LEEP system has the potential to replace the ancillary motors/generators used in the other method of cooling refrigerated trucks, thereby reducing initial capital cost, fuel consumption, noise and emissions. The Company anticipates initial deliveries under this supply agreement will commence in the fourth quarter of 2007.

In the second quarter, 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 in May 2007 in Mexico City. Subsequent to the current quarter end, the Company received the initial purchase order release under this supply agreement for 200 systems and expects to commence delivery against that release in the fourth quarter of 2007. The balance of the 1,000 vehicles is expected to be converted over the following 18 months.

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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, the first two of which were delivered to the Charmer-Sunbelt Group ("Charmer-Sunbelt") in the fourth quarter of 2006, continue to be used in-service. The Company has stated in the past that it would only actively pursue the further development and commercialization of the P2 system when suitable development program partners were identified and engineering resources were available. During the current quarter, the Company progressed discussions with a potential program partner for the development and commercialization of the P2 system and is currently formalizing the terms of the agreement.

The total number of employees increased from 112 at the end of fiscal 2006 to 130 at September 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, and as discussed above, a head office in Oak Park, Michigan. The Company considers that its various facilities are suitable to meet the foreseeable requirements for engineering, workshop, test, and administrative accommodations. Additional test and workshop equipment has been acquired to enable the execution of program development and customer deliverables and the Company has implemented an enterprise resource planning ("ERP") system to support all its operations.

### **Critical Accounting Estimates**

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

#### **Revenue Recognition**

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

In addition, the Company has also recognized 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

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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>Q3, 2007</b> <b>(Jul– Sep)</b>	<b>Q2, 2007</b> <b>(Apr– Jun)</b>	<b>Q1, 2007</b> <b>(Jan – Mar)</b>	<b>Q4, 2006</b> <b>(Oct – Dec)</b>
<b>Revenue</b>	\$ 1,534	\$ 593	\$ 156	\$ 3,008
<b>Gross margin</b>	\$ (197)	\$ (10)	\$ 89	\$ 967
<b>Expenses, net</b>	\$ (8,257)	\$ (6,906)	\$ (6,596)	\$ (5,974)
<b>Net loss for the period</b>	\$ (8,454)	\$ (6,916)	\$ (6,507)	\$ (5,007)
<b>Net loss per share</b>	\$ (0.04)	\$ (0.03)	\$ (0.03)	\$ (0.03)
<b>Weighted average number of Shares</b>	198,276	198,276	198,275	166,913

	<b>Q3, 2006</b> <b>(Jul – Sep)</b>	<b>Q2, 2006</b> <b>(Apr – Jun)</b>	<b>Q1, 2006</b> <b>(Jan – Mar)</b>	<b>Q4, 2005</b> <b>(Oct – Dec)</b>
<b>Revenue</b>	\$ 411	\$ 1,205	\$ 1,147	\$ 965
<b>Gross margin</b>	\$ (166)	\$ 76	\$ 304	\$ 56
<b>Expenses, net</b>	\$ (8,849)	\$ (4,922)	\$ (4,870)	\$ (6,796)
<b>Net loss for the period</b>	\$ (9,015)	\$ (4,846)	\$ (4,566)	\$ (6,740)
<b>Net loss per share</b>	\$ (0.06)	\$ (0.03)	\$ (0.03)	\$ (0.04)
<b>Weighted average number of Shares</b>	159,206	158,638	156,631	156,116

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For the quarter ended September 30, 2007, the Company incurred a net loss of \$8.5 million (\$0.04 per share) compared to a net loss of \$9.0 million (\$0.06 per share) in the comparable 2006 quarter. The lower loss in the current quarter is primarily attributable to lower levels of expenditures in product development cost compared to the prior year partially offset by significantly higher other expenses in the current year quarter. The lower product development costs were a result of the prior year quarter including the expensing of higher cost, early production vehicles on the G1 product line, which were shipped at the end of last year. The expenses related to those vehicles totalled approximately \$2.8 million in the prior year quarter. Consistent with companies in the Development Stage, the costs were expensed to development costs as opposed to cost of goods. The lower level of product development costs in the current quarter was partially offset by severance and other costs exit costs associated with the closing of the Toronto headquarters and the changes in senior management. These costs were recorded in the other expenses section of the current quarter financial statements. On a cumulative basis, the Company incurred a net loss of \$21.9 million or \$0.11 per share (2006 - \$18.4 million or \$0.12 per share). The increased net loss on a cumulative basis is primarily attributable to the higher other expenses as noted above in addition to a higher level of operating expenses as activities in operations, product support as well as selling and marketing activities has increased.

Revenue: Revenue for the quarter ended September 30, 2007 was \$1.5 million (2006 - \$0.4 million) and year to date was \$2.3 million (2006 - \$2.8 million). The higher revenue in the current quarter is attributable to the ramp up of deliveries of launched product. A total of six customer shuttle buses were completed in the quarter. Revenue in the prior year quarter primarily related to funded engineering programs, which were essentially completed in the prior year. Engineering resources are now primarily focused on internal development programs that will be launched into production in 2007 and 2008. Revenue in the current quarter also included deliveries of components in addition to after-sale service support. Year to date revenue was lower than the prior year due to higher levels of activities in funded engineering programs in the prior year as noted above. After considering direct and applicable indirect costs of sales, the gross margin contribution from revenue in the quarter was negative \$0.2 million (2006 - negative \$0.2 million) and negative \$0.1 million year to date (2006 - \$0.2 million). Gross margin as a percentage of sales was negative 13% in the quarter (2006 - negative 40%) and negative 5% year to date (2006 - 7%).

Engineering, research, development and related costs, net: Before contributions, the Company expended \$4.4 million on engineering, research and development operations in the quarter (2006 - \$7.1 million), including \$2.6 million in respect of product development costs (2006 - \$5.6 million). The expenses were reduced by \$0.3 million (2006 - \$0.7 million) in respect of government and customer contributions. The higher level of product development expenses in the prior year quarter are related to the G1 program expenditures discussed above. On a cumulative basis, the Company expended \$12.8 million (2006 - \$12.5 million) in respect of engineering, research and development operations, including \$7.4 million in respect of product development costs (2006 - \$8.2 million). Contributions of government and customers was \$0.9 million year to date (2006 - \$1.4 million). At September 30, 2007, Azure employed 103 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 \$2.6 million (2006 - \$5.6 million) in the quarter and \$7.4 million (2006 - \$8.2 million) year to date 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 third quarter of 2007 compared to \$0.7 in the third quarter of 2006. All of the contributions in the quarter are associated with Technology Partnerships Canada ("TPC") (2006 - \$0.3 million) as the Company recorded no customer contributions against product development expense (2006 - \$0.4 million). On a cumulative basis, government contributions were \$0.9

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million in the current year compared to \$0.9 million of government contributions and \$0.5 of customer contributions in the prior year.

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

*Selling and marketing:* Selling and marketing costs were \$0.9 million in the third quarter and \$2.6 million year to date compared to \$0.7 million in the quarter and \$2.3 million year to date in the prior year. 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 September 30, 2007 was 9 (2006 – 8).

*General and administrative:* General and administrative costs were \$1.9 million in the quarter and \$5.9 million year to date compared to \$1.8 million in the quarter and \$5.5 million year to date in the prior year. The increase is primarily related to higher costs for non cash expenses such as compensation related to deferred share units and stock options. The headcount at September 30, 2007 was 18 (2006 – 20).

*Amortization:* Amortization of property, equipment and other assets was \$0.2 million in the third quarter and \$0.7 million year to date compared to \$0.2 million in the third quarter and \$0.6 through nine months of 2006. Property and equipment primarily consists of workshop equipment, tooling, computer hardware and software. The Company purchased assets with a value of \$0.2 million in the quarter (2006 - \$0.1 million) and \$1.1 million year to date (2006 - \$0.8 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 \$0.3 million in the quarter (2006 - \$0.4 million) and \$1.1 million year to date (2006 - \$1.2 million). Amortization of property, equipment and other assets are allocated to the relevant cost categories on the Statement of Operations.

*Other expenses:* Other expenses totalled \$1.5 million in the quarter (2006 – \$Nil) and \$1.7 million year to date (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.

*Foreign currency gains/losses:* Foreign currency gains totalled \$66,000 in the quarter (2006 – loss of \$3,000). On a cumulative basis, foreign currency losses were \$55,000 (2006 – loss of \$7,000). These were mainly unrealised gains and 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 September 30, 2007 were \$5.9 million compared to \$27.2 million at December 31, 2006 and \$3.8 million at September 30, 2006. Net cash outflows were approximately \$11.0 million in the quarter and \$21.5 million year to date compared to net cash outflows of \$6.9 million in the third quarter and \$17.0 million through nine months of 2006. The increase in cash outflows of \$4.2 million in the quarter is mainly attributable to the increase in non cash working capital in the current quarter of \$2.9 million compared to an decrease of \$1.3 million in the prior year quarter in addition to the increase in restricted cash of \$0.2 million related to the security deposit related to the new facility in Michigan. The increase in non cash working capital is primarily related to the increase in inventory for G1 product expected to be completed for deliveries late in 2007 and in the first half of 2008. The increase in cash outflows of \$4.6 million year to date compared to the prior year is primarily a result of the increased net loss (higher by \$3.5 million), lower proceeds from the exercise of stock options (lower by \$1.5 million) and an increase in restricted cash of \$0.4 million..

*Accounts receivable:* Accounts receivable at September 30, 2007 were \$0.7 million compared to \$3.4 million

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at December 31, 2006 and \$0.8 million at September 30, 2006. The decrease in the current quarter compared to the year ended December 31, 2006 is primarily related to the DRS receivable of \$3.0 million, which was included in the year end balance and collected in the second quarter of the current year.

Contributions receivable: Contributions receivable were \$0.9 million at September 30, 2007 (\$1.3 million at December 31, 2006, \$0.6 million at September 30, 2006). The decrease in the current quarter compared to the year end is primarily related to customer contributions of \$0.4 million, which were included in the year end balance and collected during the first quarter. This was partially offset by the higher balance of TPC receivables in the current quarter, which includes three quarters of claims compared to two at the year end.

Inventory and related prepayments: Inventory and related prepayments were \$7.9 million at September 30, 2007 compared to \$3.8 million at December 31, 2006 and \$4.3 million at September 30, 2006. The higher inventory amount at September 30, 2007 compared to the year end and the prior year quarter is attributable to additional work-in-process inventory related to G1 product to support future orders and deliveries as discussed above.

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

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

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 \$9.2 million at September 30, 2007 (\$10.2 million at December 31, 2006 and \$10.8 million at September 30, 2006). The lower amount in 2007 is attributable to amortization.

Accounts payable and accrued liabilities: Accounts payable and accrued liabilities were \$4.1 million at September 30, 2007 compared to \$2.8 million at December 31, 2006 and \$4.2 million at September 30, 2006. The higher amount in the current quarter compared to the year end 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 \$1.3 million at September 30, 2007 compared to \$2.0 million at December 31, 2006 and \$1.5 million at September 30, 2006). The amount is attributable to the US operation and is comprised of customer deposits in respect of work-in-progress of \$0.4 million and deferred revenue of \$0.9 million. 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 balance is primarily related to deposits from initial shuttle bus customers. The lower balance in the current quarter compared to the year end is related to lower deposit amounts, which were reduced as the shuttle buses on which the deposits were paid were completed and delivered to the customers in the year.

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 September 30, 2007 compared to \$2.5 million at December 31, 2006 and

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\$2.4 million at September 30, 2006 is attributable to principle repayments.

*Share capital:* Share capital at September 30, 2007 was \$112.7 million compared to \$112.8 million at December 31, 2006 and \$82.4 million at September 30, 2006. The increase in share capital in the current quarter 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 deferred share units ("DSU's") issued and outstanding is presented in the following table:

	November 7, 2007	September 30, 2007	September 30, 2006
Common shares	279,376,177	198,276,177	159,379,983
Deferred Share Units	103,810	103,810	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	14,878,459	14,878,459	12,253,068

During the period from September 30, 2007 to November 7, 2007, the Company issued 81,100,000 common shares upon the completion of an equity offering.

**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 September 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 September 30, 2007, the Company has deferred revenue associated with the TTA Agreement in the amount of \$0.9 million. During the three months ended September 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 \$14,000. As of September 30, 2007, accounts receivable includes \$9,000 due from STK and customer deposits includes \$36,000 received from STK.

**Liquidity, Capital Resources and Risk Factors**

At September 30, 2007 the Company had \$6.8 million (December 31, 2006 - \$27.9, September 30, 2006 - \$4.5 million) in net cash reserves, including restricted cash. 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 September 30, 2007 approximately \$1.0 million of cash was restricted. The restricted cash is related to a security deposit in respect of the facility in Boston (\$0.6 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 \$11.5 million at September 30, 2007 compared to \$32.4 million at December 31, 2006 and \$3.3 million at September 30, 2006. Working capital is \$20.9 million lower compared to the year end primarily due to the lower cash balance (\$21.4 million lower due to the cash outflows described above) as the lower accounts receivable balance (\$2.7 million lower primarily due to the collection of the DRS receivable), the lower contributions receivable balance (\$0.4 million lower due to the collection of the customer contributions as described above), and the higher accounts payable balances (\$1.5 million higher due to increased inventory purchase activity as described above) were

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

essentially offset by the higher inventory balances (\$4.1 million higher due to increased work in process as described above) and the lower customer deposits (\$0.7 million lower as described above). Working capital is \$8.3 million higher compared to the prior year quarter primarily due to the higher cash balance (higher by \$1.9 million), the higher inventory levels (\$3.6 higher as described above) the higher contributions receivable balance of \$0.3 million, 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).

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 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 September 30, 2007 the Company had claimed approximately \$6.7 million in accordance with the terms of the TPC agreement and is therefore eligible for further contributions totalling approximately \$2.3 million.

On October 23, 2007, the Company completed a previously announced equity financing for gross proceeds of approximately \$30.0 million. The Company intends to use its cash resources and available financing arrangements from TPC to fund ongoing product development and for general corporate purposes in 2007 and 2008. 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 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, equipment, and certain short term supplier contracts totalling \$7.7 million over the next five years, are described in note 7 to the September 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

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

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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).