
Azure Dynamics Corporation
Unaudited Interim Consolidated Financial Statements

For the three months and nine months ended September 30, 2008 and 2007 (unaudited)

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Azure Dynamics Corporation
Consolidated Balance Sheets
(Stated in Thousands)

As at	September 30 2008 (unaudited)	December 31 2007 (audited)
	\$	\$
ASSETS		
Current		
Cash and cash equivalents	21,207	24,133
Accounts receivable	3,123	590
Contributions receivable	1,228	1,128
Inventory and related prepayments (Note 3)	11,949	10,201
Prepaid expenses	836	702
	38,343	36,754
Restricted cash	1,258	1,172
Property and equipment	6,343	5,746
Intangible assets, net of amortization	8,344	9,283
Goodwill	2,932	2,932
	57,220	55,887
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	4,198	4,275
Customer deposits & deferred revenue	387	166
Current portion of notes payable (Note 4)	40	35
Current portion of obligations under capital leases (Note 5)	91	-
	4,716	4,476
Long-term		
Obligations under capital leases (Note 5)	234	-
Customer deposits & deferred revenue	843	941
Notes payable (Note 4)	2,185	2,064
	3,262	3,005
Shareholders' equity		
Share capital (Note 6)	165,057	140,665
Contributed surplus (Note 6)	6,384	5,605
Deficit	(122,199)	(97,864)
	49,242	48,406
	57,220	55,887

Approved on behalf of the Board:

"signed D. Campbell Deacon" Director
D. Campbell Deacon
"signed James C. Gouin" Director
James C. Gouin

Azure Dynamics Corporation
Consolidated Statements of Operations, Comprehensive Loss, and Deficit
(Stated in Thousands)

	For the three months ended September 30 (unaudited)		For the nine months ended September 30 (unaudited)	
	2008	2007	2008	2007
	\$	\$	\$	\$
Revenues	1,325	1,534	5,078	2,283
Cost of sales	2,132	1,731	6,214	2,401
Gross Margin	(807)	(197)	(1,136)	(118)
Expenses				
Engineering, research, development and related costs, net	4,832	4,132	15,074	11,949
Selling and marketing	818	940	2,430	2,603
General and administrative	1,798	1,870	5,349	5,864
Total expenses	7,448	6,942	22,853	20,416
Loss from operations	(8,255)	(7,139)	(23,989)	(20,534)
Interest and other income, net	40	156	285	460
Interest expense	(3)	-	(6)	-
Other Expense	-	(1,537)	(561)	(1,748)
Foreign currency gains/(losses)	(91)	66	(64)	(55)
Net loss and comprehensive loss for the period	(8,309)	(8,454)	(24,335)	(21,877)
Deficit, beginning of period	(113,890)	(81,052)	(97,864)	(67,629)
Deficit, end of period	(122,199)	(89,506)	(122,199)	(89,506)
Loss per share - basic	(0.03)	(0.04)	(0.08)	(0.11)
Weighted average number of shares - basic *	316,333	198,276	291,785	198,276

* No fully diluted earnings per share have been disclosed, as these would be anti dilutive.

Azure Dynamics Corporation
Consolidated Statements of Cash Flows
(Stated in Thousands)

	For the three months ended		For the nine months ended	
	September 30		September 30	
	(unaudited)		(unaudited)	
	2008	2007	2008	2007
	\$	\$	\$	\$
Cash flows from operating activities				
Net loss for the period	(8,309)	(8,454)	(24,335)	(21,877)
Adjustments for:				
Amortization of property and equipment and other assets	252	226	699	665
Amortization of intangible assets	347	348	1,063	1,090
Unrealized foreign currency gains/(losses)	64	20	85	(52)
(Gain) / Loss on Disposal of Assets	-	19	-	185
Stock option compensation expense	181	284	633	809
Deferred Share Units compensation expense	93	63	146	63
	<u>(7,372)</u>	<u>(7,494)</u>	<u>(21,709)</u>	<u>(19,117)</u>
Changes in non-cash working capital items	(680)	(2,796)	(4,563)	(480)
Movement due to exchange impact	65	(79)	95	85
Total Cash flows from operating activities	<u>(7,987)</u>	<u>(10,369)</u>	<u>(26,177)</u>	<u>(19,512)</u>
Cash flows from financing activities				
Issuance of common shares (net of costs)	24,394	(88)	24,392	(73)
Principle payments on notes payable	(9)	(8)	(27)	(27)
Proceeds from obligations under capital lease	(10)	-	(20)	-
Movement due to exchange impact	-	(151)	-	(365)
Total Cash flows from financing activities	<u>24,375</u>	<u>(247)</u>	<u>24,345</u>	<u>(465)</u>
Cash flows from investing activities				
Acquisition of property and equipment	(577)	(201)	(961)	(1,042)
Acquisition of other assets	(17)	(27)	(125)	(96)
Changes in Restricted Cash	-	(201)	-	(426)
Total Cash flows from investing activities	<u>(594)</u>	<u>(429)</u>	<u>(1,086)</u>	<u>(1,564)</u>
Increase (decrease) in cash and cash equivalents	15,794	(11,045)	(2,918)	(21,541)
Exchange impact on cash held in foreign currency	(15)	50	(8)	201
Cash and cash equivalents, beginning of period	5,428	16,847	24,133	27,192
Cash and cash equivalents, end of period	<u>21,207</u>	<u>5,852</u>	<u>21,207</u>	<u>5,852</u>
Non cash investing and financing activities:				
Vehicles and equipment acquired under capital lease	151	-	336	-

The accompanying notes are an integral part of these consolidated financial statements.

For the three months and nine months ended September 30, 2008 and 2007 (unaudited)

1. Nature of Operations and Basis of Presentation

Azure Dynamics Corporation (the "Company") or ("ADC") is incorporated under the laws of Alberta, Canada. On January 1, 2008, the Company transitioned from a development stage enterprise which typically devotes most of its efforts to activities such as raising capital, research and development, recruiting and training personnel, developing markets and starting up production, to a profit oriented enterprise as the Company is starting to realize revenues on certain product lines that were previously in development stage. The Company is primarily involved in the development and supply of electric and hybrid electric powertrains and vehicle control systems for commercial vehicles in North America.

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (GAAP) on a going concern basis which presumes the realization of assets and discharge of liabilities in the normal course of business for the foreseeable future. While the Company has derived limited revenue from the sale of vehicles and components to third parties, its ability to continue operations is uncertain and dependent upon the successful completion of technical development of the technology, obtaining additional financing and achieving profitable operations. The outcome of these matters cannot be predicted at this time. These consolidated financial statements do not include any adjustments to the assets and liabilities that might be necessary should the Company be unable to continue in business.

2. Significant Accounting Policies

The interim consolidated financial statements of the Company have been prepared by management in accordance with Canadian generally accepted accounting principles (GAAP) on a basis consistent with those followed in the most recent audited financial statements. These interim consolidated financial statements do not include all of the information and notes required by GAAP for annual financial statements and therefore, should be read in conjunction with the audited consolidated financial statements and notes included in the Company's audited financial statements for the year ended December 31, 2007. The preparation of consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. The consolidated financial statements have, in management's opinion, been properly prepared using careful judgment with reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

(a) Consolidation

The consolidated financial statements include the accounts of the Company and of its wholly owned subsidiaries since the date of acquisition. The Company has four wholly owned subsidiaries; Azure Dynamics Inc., which is incorporated under the Canada Business Corporations Act ("CBCA"); Azure Dynamics Corporation of America (inactive) and Azure Dynamics Incorporated, both of which are incorporated under the laws of the state of Delaware, U.S.A.; and Azure Dynamics Limited, which is incorporated under the laws of England and Wales. Investments in joint ventures are accounted for using the proportional consolidation method. All transactions within the subsidiaries have been eliminated upon consolidation.

(b) Revenue recognition

The Company recognizes revenues on the sales of products at the point of shipment, provided that the Company has evidence of an arrangement, the fee is fixed and determinable, title and risk of loss have passed to the customer, and collection is reasonably assured.

For the three months and nine months ended September 30, 2008 and 2007 (unaudited)

2. Significant Accounting Policies (b) (con't)

In addition, the Company recognizes revenues on long term engineering contracts within these product lines 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.

The Company also recognizes revenues related to a technology and software licensing agreement (see note 7). The agreement provided for non-refundable payments which are being recognized in revenue on a straight-line basis over the period of the license agreement.

Customer deposits and deferred revenue primarily represent fees paid by customers in advance of products being shipped, contract revenue recognized, and the license agreement referred to in note 7.

(c) Research and development costs

Research costs are expensed in the year incurred. Development costs are expensed in the year incurred unless the Company believes a development project meets generally accepted criteria for deferral and amortization. No development costs have been deferred to date.

Reimbursements of eligible costs pursuant to government assistance programs are recorded as a reduction of research and development costs when the related costs have been incurred. Claims not settled by the balance sheet date are recorded as "Contributions receivable" on the consolidated balance sheets. The determination of the amount of the claim, and hence the receivable amount, requires management to make calculations based on its interpretation of eligible expenditures in accordance with the terms of the programs. The reimbursement claims submitted by the Company are subject to review by the relevant government agencies. Although the Company has used its best judgment and understanding of the related program agreements in determining the receivable amount, it is possible that the amounts could increase or decrease by a material amount in the near term dependent on the review and audit by the government agency.

The government assistance programs typically incorporate repayment provisions that are contingent upon future trigger-events. In these cases, a repayment liability is recorded when the event occurs or it is considered more likely than not that the event will occur. With respect to repayments in the form of future royalty payments based on revenue levels achieved, the liability will be recorded as the related revenues are recognized by the Company.

(d) Investment tax credits

The benefits of investment tax credits for scientific research and development expenditures are recognized in the year the qualifying expenditure is made provided there is reasonable assurance of recoverability. The investment tax credit reduces the carrying cost of expenditures for capital assets and research and development expense. Since becoming a public company, the Company is no longer eligible to receive cash refunds from the investment tax credit program – all past investment tax credits receivable in cash have been collected. Furthermore, investment tax credits earned are being carried forward to reduce future federal taxes payable. These investment tax credits have not been recorded as their ultimate utilization is uncertain.

For the three months and nine months ended September 30, 2008 and 2007 (unaudited)

2. Significant Accounting Policies (con't)

(e) Cash and cash equivalents

The Company considers bank balances (including temporary bank overdrafts) and all highly liquid instruments purchased with an original maturity of three months or less to be cash equivalents.

(f) Inventory and related prepayments

Inventory is comprised of product, spare parts, product components and materials held for resale or use in the Company's product development activities or customer projects and include prepayments made for components on order. Work in progress inventory is comprised of material, labour and a portion of overhead costs relating to in-progress customer and internal orders. Inventory is valued at the lower of cost or net realizable value.

(g) Accrued warranty liabilities

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.

(h) Guarantees – Letter of Credit (“LOC”)

In February 2003, the CICA issued Accounting Guideline 14 (AcG-14), Disclosure of Guarantees, which identifies disclosure requirements for certain guarantees. The Company has entered into several Letters of Credit (LOC) with varying financial institutions whereby if certain obligations are not fulfilled by the Company, the beneficiaries of the Letter of Credit, may draw down on the LOC at these financial institutions. The Company recognizes the various letters of credit at its face value in the form of restricted cash. All foreign denominated LOCs are measured at the prevailing foreign exchange rate as at period end.

(i) Property and equipment

Property and equipment assets are recorded at cost, less accumulated amortization. Amortization is provided on a straight-line basis over the estimated useful lives of the assets as follows:

Workshop equipment	5 years	Office furniture and equipment	5 years
Computer software	2 to 3 years	Automotive	3 to 5 years
Computer hardware	3 years	Leasehold improvements	1 to 12 years
Tooling	3 to 5 years		

The building (see note 4) is amortized on a 3% declining balance methodology.

The Company tests long-lived assets for recoverability when events or changes in circumstances indicate that their carrying amount may not be recoverable. Circumstances which could trigger a review include, but are not limited to: significant decreases in the market price of the asset; significant adverse changes in the business climate or legal factors; the accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of the asset; current period cash flow or operating losses combined with a history of losses or a forecast of continuing losses associated with the use of the asset; and a current expectation that the asset will more likely than not be sold or disposed of significantly before the end of its previously estimated useful life.

For the three months and nine months ended September 30, 2008 and 2007 (unaudited)

2. Significant Accounting Policies (i) (con't)

Recoverability is assessed based on the carrying amount of the asset and the sum of the undiscounted cash flows expected to result from the use and the eventual disposal of the asset or asset group. An impairment loss is recognized when the carrying amount is not recoverable and exceeds the fair value of the asset or asset group. The impairment loss is measured as the amount by which the carrying amount exceeds fair value.

(j) Intangible assets

Intangible assets include the fair value of identifiable intangible assets acquired in a purchase business combination. The customer order backlog asset is amortized as the underlying orders are executed. Amortization of the product technology asset is provided on a straight-line basis over the estimated useful life of ten years. The costs of acquiring and applying for patents, trademarks and licensed technology are capitalized and amortized on a straight-line basis over their estimated useful lives of five years. The costs of acquiring and applying for patents, trademarks and licensed technology costs do not necessarily reflect present or future values and the ultimate amount recoverable will be dependent upon the successful development and commercialization of products based on these intellectual properties. Management reviews the intellectual properties for impairment whenever events or changes in circumstances indicate that full recoverability is questionable. Management measures any potential impairment by comparing the carrying value to the undiscounted amounts of expected future cash flows.

(k) Goodwill

Goodwill represents the excess of purchase price over the fair value of identifiable assets acquired in a purchase business combination. Goodwill is not amortized but is subject to annual fair value impairment tests or is adjusted if changes in circumstances indicate that the carrying value may not be recoverable.

(l) Financial instruments

The Company carries a number of financial instruments. Unless otherwise indicated, it is management's opinion that the Company is not exposed to significant interest, currency or credit risks arising from these financial instruments. The fair values of these financial instruments approximate their carrying values, unless otherwise noted. As of 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 has determined that currently, there is no current material impact on the consolidated financial statements.

(m) Foreign currency translation

Monetary assets and liabilities of integrated operations that are not denominated in Canadian Dollars are translated at the rate of exchange prevailing at the period end, while revenues and expenses are translated at average rates of exchange during the period. Exchange gains and losses arising on the translation of the accounts are included in consolidated earnings. Non-monetary items are translated at historical exchange rates. All of the Company's foreign subsidiaries' operations are considered to be integrated.

For the three and nine months ended September 30, 2008, a foreign exchange loss of \$91,000 and \$64,000 was recognized in the consolidated earnings respectively (2007 – foreign exchange gain of \$66,000 and an exchange loss of \$55,000 respectively).

For the three months and nine months ended September 30, 2008 and 2007 (unaudited)

2. Significant Accounting Policies (con't)

(n) Future income taxes

Income taxes are accounted for using the liability method of tax allocation. Future income taxes are recognized for the future income tax consequences attributable to differences between the carrying values of assets and liabilities and their respective income tax bases. Future income tax assets and liabilities are measured using substantively enacted income tax rates expected to apply to taxable income in the years in which temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in rates is included in earnings in the period that includes the enactment date. Future income tax assets are recorded in the consolidated financial statements if realization is considered more likely than not.

(o) Stock based compensation

The Company grants stock options to officers, directors, employees and consultants pursuant to a stock option plan described in Note 6. 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. The forfeiture of stock options are accounted for as they occur.

(p) Deferred share unit ("DSU") compensation

The Company has a Deferred Share Unit Plan ("DSU Plan") under which it may grant deferred share units ("DSU") to non-executive directors and selected employees pursuant to the DSU Plan described in Note 6. Under the DSU Plan, non-executive directors and selected employees may elect to receive their retainer or bonus compensation in DSU's. The number of DSU's issued is calculated based on the amount owing and the trading price of the Company's common shares at the time of the election. As the number of DSU's issued is fixed and the Company has the right to settle the DSU's in cash or in the delivery of shares, this amount is reflected in contributed surplus in the period in which the DSU's are granted. For DSU's issued on a performance-based measure, these DSU's typically have vesting terms over 2 years.

(q) Earnings per share

Basic earnings per common share are computed by dividing earnings by the weighted average number of common shares outstanding for the period. Diluted per share amounts reflect the potential dilution that could occur if securities or other contracts to issue common shares were exercised or converted to common shares. The treasury stock method is used to determine the dilutive effect of stock options, DSU's and other dilutive instruments.

(r) Use of estimates

The preparation of consolidated financial statements requires the Company's management to make estimates and assumptions that affect the amounts reported in these consolidated financial statements and notes thereto. Significant areas requiring management to make estimates include inventory valuation, product warranty obligations, revenue recognition and recoverability of intangibles and goodwill. Actual results could differ from those estimates.

For the three months and nine months ended September 30, 2008 and 2007 (unaudited)

2. Significant Accounting Policies (con't)

(s) Comparative figures

Certain comparative figures have been restated to be consistent with current year financial statement and footnote presentation.

(t) Recent accounting pronouncements

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

Goodwill and Intangibles assets

In February 2008, the CICA issued Section 3064 "Goodwill and intangible assets", replacing Section 3062, "Goodwill and other intangible assets". The new section will be applicable to financial statements relating to fiscal years beginning on or after October 1, 2008. Accordingly, the Company will adopt the new standards for its fiscal year beginning January 1, 2009. It establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill are unchanged from the standards included in the previous Section 3062. The Company is currently evaluating the impact of the adoption of this new Section on its consolidated financial statements.

3. Inventory

The Company measures its inventories at the lower of cost or net realizable value. Typical costs captured in inventory include the cost of labour, materials and overhead.

As at September 30, 2008, the Company had the following inventory levels:

(Stated in thousands of dollars)	September 30, 2008		December 31, 2007	
Raw Materials	\$	4,593	\$	3,494
WIP		689		2,172
Finished Goods		8,108		5,395
Total Inventory		13,390		11,061
Less: reserve for obsolescence		1,441		860
Net inventory	\$	11,949	\$	10,201

For the three and nine months ended September 30, 2008, the Company recognized \$2.1 million and \$6.2 million respectively (2007 – \$1.7 million and \$2.4 million respectively) in cost of sales. Furthermore, the Company recognized approximately \$1.4 million (2007 – \$0.9 million) in its provision for inventory obsolescence. Inventory items provided for reflect management's belief that there is no future recovery for inventory that was purchased in previous periods. Moreover, there were no circumstances or events that would lead to the reversal of write downs from previous periods. As at September 30, 2008, no inventories were pledged as security for liabilities

For the three months and nine months ended September 30, 2008 and 2007 (unaudited)

4. Investment in Real Estate Joint Venture

The Company's US subsidiary, Azure Dynamics Incorporated (formerly Solectria) owns a 50% interest in ND Solectria LLC, a joint venture partnership with NDNE Real Estate, Inc., a real estate development corporation. The investment in the real estate joint venture, which is accounted for using the proportional consolidation method, was formed for the purpose of holding property located in Woburn, Massachusetts. On October 1, 2001, the Company entered into a lease agreement for the Woburn property. The Company provided a security deposit of US\$400,000 (Cdn\$426,000) and made guarantees of an additional US\$600,000 (Cdn\$639,000) that is in the form of a letter of credit, which is collateralized by certain cash equivalents. NDNE Real Estate, Inc. maintains the unilateral right to sell the property during the lease term and manages the property. The Company is entitled to 50% of earnings of ND Solectria LLC. For the three and nine months ended September 30, 2008 the Company's interest in earnings from the real estate joint venture amounted to \$46,000 and \$143,000 respectively (2007 – \$52,000 and \$160,000 respectively).

The Company's 50% proportional interest in ND Solectria LLC is included in the consolidated balance sheets as follows:

(Stated in thousands of dollars)

	<u>Sept 30, 2008</u>	<u>December 31, 2007</u>
Cash and equivalents	\$ 307	\$ 286
Accounts receivable	8	11
Property and equipment	2,560	2,999
Prepaid expenses	9	12
Total assets	<u>\$ 2,884</u>	<u>\$ 3,308</u>
Accounts payable and accrued liabilities	\$ 294	\$ 270
Note payable – current	40	35
Note payable – long term	2,185	2,064
Shareholders' equity	365	939
Total liabilities and shareholders' equity	<u>\$ 2,884</u>	<u>\$ 3,308</u>

The note payable is the Company's proportionate share of a mortgage on the Boston property owned by ND Solectria LLC. The note 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. As both parties are jointly and severally liable for repayment of the note payable, the maximum exposure to loss as a result of its involvement with this entity is \$4.5 million. The principle repayments over the next five years payable by the joint venture are approximately as follows: 2008-\$37,000, 2009-\$160,000, 2010-\$171,000, 2011-\$4,082,000.

The Company's 50% proportional interest in ND Solectria LLC is included in the consolidated statements of operations and deficit as follows:

	<u>Three months ended</u>		<u>Nine months ended</u>	
	<u>Sept 30</u>		<u>Sept 30</u>	
	<u>2008</u>	<u>2007</u>	<u>2008</u>	<u>2007</u>
(Stated in thousands of dollars)				
General and administrative	\$ (85)	\$ (90)	\$ (255)	\$ (281)
Other Expense	39	38	112	121
Net income	<u>\$ 46</u>	<u>\$ 52</u>	<u>\$ 143</u>	<u>\$ 160</u>

For the three months and nine months ended September 30, 2008 and 2007 (unaudited)

4. Investment in Real Estate Joint Venture (con't)

The Company's 50% proportional interest in ND Solectria LLC is included in the consolidated cash flow statement as follows:

(Stated in thousands of dollars)	Three months ended Sept 30		Nine months ended Sept 30	
	2008	2007	2008	2007
Net Income	\$ 46	\$ 52	\$ 143	\$ 160
Amortization	17	17	51	53
Principle payments on note payable	(9)	(8)	(27)	(27)
Changes in short term assets and liabilities	(42)	(91)	(146)	(227)
Net change in cash	12	(31)	21	(41)
Cash & equivalents beginning of period	295	306	286	316
Cash & equivalents end of period	307	275	307	275

5. Obligations Under Capital Lease

The Company has entered into capital leases for vehicles, equipment, and computer equipment for its ongoing operational activities primarily leasing vehicles for the purposes of marketing and research and development. Future minimum annual lease payments, including imputed interest, under capital leases are as follows:

(Stated in thousands of dollars)

Year	Amount
2008	\$ 29
2009	117
2010	101
2011	56
2012	58
2013	22
	383
Less: imputed interest	(58)
Total capital lease obligation	325
Less: current portion of capital lease obligation	(91)
Long term portion of capital lease obligation	\$ 234

Lease terms vary from 3 to 5 years. Furthermore, the imputed interest rates on these leases range from 7% – 23%. The leases are secured by the vehicles and computer equipment under capital lease.

For the three months and nine months ended September 30, 2008 and 2007 (unaudited)

6. Share Capital, Warrants and Stock Options

a) Authorized

Unlimited common shares without par value
Unlimited preferred shares without par value, non cumulative, redeemable, and non voting

b) Issued and outstanding common shares

Issued and Outstanding Common Shares (Amount stated in thousands of dollars)	Number of Common Shares	Amount
Balance, December 31, 2007	279,376,177	140,665
August 2008 private placement (i)	100,000,000	24,392
Balance, September 30, 2008	379,376,177	165,057

- i. On August 27, 2008, the Company completed a private placement of 100,000,000 common shares of the Company at a price of CDN\$0.25 per share, for net proceeds of \$24.4 million after deducting share issue costs of \$0.6 million.

c) Contributed surplus

(amount stated in thousands of dollars)	Amount
Balance, December 31, 2007	\$ 5,605
Stock option compensation expense	633
Deferred share units compensation expense	146
Release to share capital on exercise of stock options	-
Balance, September 30, 2008	\$ 6,384

d) Stock options

The Company has a stock option plan (the "Plan") which authorizes the Board to issue options to insiders, employees and service providers of the Corporation and its subsidiaries. The maximum number of common shares issuable under stock options, together with common shares as may be subject to options pursuant to other share compensation arrangements, shall not exceed 10% of the outstanding common shares. The exercise price shall not be lower than the closing trading price of the common shares on the TSX, on the last trading day prior to the date on which the option is granted. The options have terms ranging from one to seven years and generally vest over periods of up to twenty-four months. As at September 30, 2008 the Company had 17,170,126 stock options outstanding under the Plan.

The stock options are exercisable at a weighted average exercise price of \$0.68 per common share. The stock options expire on various dates between January 1, 2009 and June 2, 2015.

Stock option transactions for the nine months ended September 30, 2008, and the number of stock options outstanding are summarized as follows:

	Number of Optioned Common Shares	Weighted Average Exercise Price \$
Executive Officer, Director, Employee, Consultant Options:		
Balance, December 31, 2007	14,451,626	0.91
Options granted	7,300,000	0.31
Options exercised	-	-
Options forfeited	(3,772,500)	(0.90)
Options expired/cancelled	(809,000)	(0.38)
Balance, September 30, 2008	17,170,126	0.68

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6. Share Capital, Warrants and Stock Options (d) (con't)

As at September 30, 2008 the numbers of optioned common shares outstanding and exercisable are as follows:

Expiry Date	Number Outstanding	Number Exercisable	Exercise Price
January 1, 2009	938,847	938,847	0.65
May 3, 2009	112,000	112,000	0.90
August 12, 2009	240,000	240,000	0.68
September 9, 2011	180,000	180,000	0.53
January 18, 2012	1,308,489	1,308,489	0.86
February 17, 2012	15,790	15,790	0.95
February 24, 2012	760,000	760,000	0.99
May 2, 2012	10,000	10,000	1.05
June 21, 2012	20,000	20,000	0.95
July 4, 2012	50,000	50,000	0.93
July 4, 2012	20,000	20,000	0.94
July 18, 2012	50,000	50,000	0.95
November 16, 2012	10,000	10,000	1.10
December 23, 2012	1,185,000	1,185,000	1.07
January 17, 2013	897,500	897,500	1.11
February 13, 2013	50,000	50,000	1.15
March 23, 2013	35,000	35,000	1.04
May 11, 2013	5,000	5,000	1.30
November 22, 2013	75,000	50,000	0.85
December 10, 2013	1,275,000	975,001	0.87
December 19, 2013	1,642,500	1,095,022	0.83
March 21, 2014	45,000	30,001	0.38
April 17, 2014	500,000	333,334	0.67
May 18, 2014	125,000	83,334	0.68
July 25, 2014	30,000	20,001	0.63
August 21, 2014	300,000	200,000	0.42
September 19, 2014	40,000	26,667	0.53
January 1, 2015	3,630,000	1,210,032	0.38
January 14, 2015	300,000	100,000	0.38
April 1, 2015	70,000	23,337	0.25
April 4, 2015	2,390,000	-	0.26
June 2, 2015	860,000	286,670	0.28
Grand Total	17,170,126	10,321,025	

e) Stock compensation expense

The fair value of each performance share and stock option is determined at each issue or grant date using the Black-Scholes model with the following assumptions: risk free interest rate - 5% (2007 - 5%), expected life - 4 years (2007 - 4 years), expected dividend yield - nil (2007 - nil), and expected volatility - 44% (2007 - 44%). The Company recorded a net compensation expense charge of \$0.2 million to consolidated earnings for the current quarter (2007 - \$0.3 million) and year to date, \$0.6 million (2007 - \$0.8 million), with a corresponding credit to contributed surplus. The amount released from contributed surplus and added to share capital was \$Nil in the current quarter as no options were exercised (2007 - \$Nil) and for year to date \$Nil (2007 - \$4,000).

For the three months and nine months ended September 30, 2008 and 2007 (unaudited)

6. Share Capital, Warrants and Stock Options (cont'd)

f) Deferred Share Unit Plan

The Company has a Deferred Share Unit Plan ("DSU Plan") under which it may grant deferred share units ("DSUs") to non-executive directors and selected employees. The maximum number of common shares issuable from the Company's treasury to participants under this DSU plan shall not exceed is 3,900,000 common shares at any one time. Under the DSU Plan, non-executive directors can elect to receive a portion of their retainer fees in DSUs and selected employees can elect to receive up to 100% of their annual performance bonus in DSUs. Such elections must be made in advance of the determination of bonuses in the case of selected employees, and prior to the year in which the non-executive directors' retainers will be earned in accordance with plan provisions. The DSU Plan also provides the Corporate Governance and Compensation Committee the authority to make discretionary grants of DSUs to non-executive directors as an additional component of their compensation and to selected employees as part of their annual remuneration. Once a non executive director or selected employee ceases employment, by way of termination, resignation, retirement, disability or death, the Company can, in its sole discretion, either settle the obligation in cash equal to the number of DSUs held by the person multiplied by the previous five day weighted average trading price of the Company's common shares, or in common shares on a one for one basis for each DSU held by the person. The DSUs issued pursuant to the DSU Plan, together with all of the Company's other previously established security based compensation arrangements, may not result at any time in the aggregate number of common shares reserved for issuance from the Company's treasury to insiders exceeding 10% of the outstanding issue or the issuance to insiders from the Company's treasury, within a one year period, of an aggregate number of common shares exceeding 10% of the outstanding issue. The DSU Plan is an unfunded plan and any obligations of the Company under the DSU Plan are unsecured. The DSU plan was effective on May 8, 2007.

As of September 30, 2008 there were 2,905,605 DSUs outstanding (2007 – 2,124,727). Compensation expenses related to DSUs for the three and nine months ended September 30, 2008 were approximately \$93,000 and \$146,000 respectively (2007 – \$63,000 for both the three and nine months period).

7. Related Party Transactions

In November 2003, Solectria entered into a Transfer of Technology and Software Licensing Agreement ("TTA Agreement") with STK. Under the terms of the agreement, the Company transferred specified technology to STK and granted an exclusive license to use and manufacture the technology. 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), revenues from the TTA Agreement are being recognized on a straight-line basis over the period of the license agreement. As of September 30, 2008, the Company has deferred revenue associated with the TTA Agreement in the amount of \$0.8 million (2007 – \$0.9 million). For the three and nine months ended September 30, 2008, 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 and \$45,000 respectively (2007 - \$14,000 and \$46,000 respectively).

For the three months and nine months ended September 30, 2008 and 2007 (unaudited)

8. Capital risk management

The Company's objectives when managing capital is to maintain its ability to continue as a going concern in order to provide returns for shareholders and benefits for other stakeholders. The Company includes, long term debt and equity, comprising of issued common shares, contributed surplus, and deficit in the definition of capital. The following table represents Azure's current capital structure as at September 30, 2008:

<u>(Stated in thousands of dollars)</u>	September 30, 2008	December 31, 2007
Share Capital	165,057	140,665
Contributed Surplus	6,384	5,605
Deficit	(121,199)	(97,864)
Total Capital Structure	<u>49,242</u>	<u>48,406</u>

The Company's primary responsibilities with respect to its capital management are to ensure that it has sufficient cash resources to fund its research and development to pursue its commercialization efforts and to maintain its ongoing operations. To secure the additional capital necessary to pursue these objectives, the Company may attempt to raise additional funds through the issuance of debt, equity and warrants or by securing strategic partners.

Due to the stage of development the Company is currently in; as well as the various stages the Company's products are in, the Company may face difficulty in managing its capital resources and obtaining financing except through raising capital through the issuance of equity. It is the result of the Company's ability to raise financing through equity that has created the cash balances as at September 30, 2008.

The Company is subject to externally imposed capital requirements through letters of credit ("LOC") that the Company maintains through various financial institutions. These LOCs are performance guarantees as referenced in note 2(h) and may be drawn upon by the beneficiaries of the LOC in the event the Company fails to perform its obligations as agreed upon with the beneficiaries. Certain LOCs have been collateralized through treasury bills. Furthermore, all LOCs have been classified as restricted cash on the consolidated financial statements. There has been no change with respect to overall capital risk management strategy during the quarter ended September 30, 2008.

9. Financial Instruments

The Company is exposed to a variety of financial risks arising from financial instruments related to changes in foreign currency exchange rates, collection of accounts receivable, settlement of liabilities and management of cash and cash equivalents.

The Board of Directors has the overall responsibility for the establishment and oversight of the Company's risk management framework and establishes and monitors risk management policies to identify and analyze the risks faced by the Company; set appropriate risk limits and controls; and to monitor risks and adherence to market conditions and the Company's activities.

The Company has made the following classifications for its financial instruments:

- Cash and cash equivalents and restricted cash are classified as "Assets held for trading" and are measured at fair value at the end of each period with any resulting gains or losses recognized in operations;

For the three months and nine months ended September 30, 2008 and 2007 (unaudited)

9. Financial Instruments (con't)

- Accounts receivable and contributions receivable are classified as “Loans and receivables” and are recorded at amortized cost, which upon their initial measurement is equal to their fair value. Subsequent measurement of trade receivables is at amortized cost, which usually corresponds to the amount initially recorded less any allowance for doubtful accounts.
- Accounts payable and accrued liabilities and notes payable are classified as “Other financial liabilities” and are measured at amortized cost.

Included in accounts receivable on the face of the balance sheet are amounts of \$0.1 million (2007 – \$0.1 million), representing sales tax receivable.

Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist of cash and cash equivalents, restricted cash, accounts receivable and contributions receivable. The Company maintains cash and cash equivalents and restricted cash with various high credit quality financial institutions located in Canada, the United States and the United Kingdom.

As previously mentioned under note 8; the Company has entered into various LOCs of which certain LOCs have been collateralized by treasury bills.

Financial assets that are either past due or impaired:

The Company's accounts receivable consist mainly of various customers in the hybrid or electric automotive industry. The Company's contribution receivable consists of a receivable due from Technology Partnerships Canada (TPC) only. Credit risk from accounts receivable encompasses the default risk of these customers due to the size of their organizations and the conditions in which they operate in. In respect to TPC, there is limited credit risk as the Company has been successful in submitting claims to TPC in which TPC has approved and subsequently paid. Furthermore, TPC is a Canadian government sponsored initiative. Although the TPC program no longer funds new projects, the TPC program is still in effect maintaining existing projects. Currently, there is a delay in payment due to a contract amendment with TPC; however, the Company does not anticipate any difficulty in the collection of amounts due.

Prior to accepting new customers, the Company assesses the risk of default associated with a particular company.

Management does not believe that there is significant credit risk arising from any of the Company's other customers. The maximum exposure to loss arising from accounts receivable is equal to their total carrying amounts. As at September 30, 2008, the Company has provisioned for uncollectible accounts receivable for approximately \$0.1 million (2007 – \$0.1 million). No other provisions have been made.

For the three months and nine months ended September 30, 2008 and 2007 (unaudited)

9. Financial Instruments (con't)

The following table provides information regarding the aging of financial assets:

	Current	31 – 60 days	61 – 90 days	91 days +	Carrying value on the balance sheet \$
Accounts Receivable	16%	9%	15%	60%	3,204
Provision for non-collection	-	-	-	100%	(81)
Net Accounts receivable	17%	9%	15%	59%	3,123
Contributions Receivable	8%	-	-	92%	1,228

The definition of items that are past due is determined by reference to terms agreed with individual customers. Of the 91 days+ balance at September 30, 2008, this relates primarily to two customers in which there are currently outstanding issues of performance in respect to upgrades that the Company needs to resolve prior to payment of these amounts. However, despite the time lapsed on the outstanding balances, none of the amounts outstanding have been challenged by the respective customers and the Company continues to conduct business with them on an ongoing basis. Accordingly, management has no reason to believe that this balance is not fully collectible in the future.

The Company reviews financial assets past due on an ongoing basis with the objective of identifying potential matters which could delay the collection of funds at an early stage. Once items are identified as being past due, contact is made with the respective company to determine the reason for the delay in payment and to establish an agreement to rectify the breach of contractual terms.

Collateral and other credit enhancements obtained:

As at September 30, 2008, the Company did not hold any collateral or other credit enhancements such as letters of credit that would enhance the Company's ability to collect any outstanding debts (i.e. accounts receivable, contributions receivable) owed to the Company.

Foreign Currency Exchange Risk

Foreign currency exchange risk is the risk that the fair value of financial instruments or future cash flows will fluctuate as a result of changes in foreign exchange rates. The Company substantially holds its cash in Canadian dollars; however, is starting to have a greater operating presence in the United States which requires settlement of future operating expenses in that denomination. The Company had no forward exchange rate contracts in place as at or during the six months ended September 30, 2008.

Liquidity Risk

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company's approach is to ensure that it has sufficient liquidity to meet its liabilities when due.

Aside from the note payable, the Company does not have any borrowings or debt facilities and settles its financial obligations out of cash and cash equivalents. The ability to do this relies on the Company being able to successfully rely on external financing as well as collection of its outstanding accounts receivable and contribution receivables.

For the three months and nine months ended September 30, 2008 and 2007 (unaudited)

9. Financial Instruments (con't)

The Company manages liquidity risk through ongoing review of accounts receivable balances and following up of amounts past due and the management of its cash and cash equivalents at its financial institution where the cash is held in an investment savings account.

As at September 30, 2008, the Company's accounts payable and accrued liabilities were approximately \$4.2 million (2007 - \$4.3 million) of which fall due for payment within twelve months of the balance sheet date.

Market Risk

Market risk is the risk that changes in market prices such as foreign exchange rates, commodity prices and interest rates will affect the Company's net earnings or the value of financial instruments. The objective of market risk management is to mitigate exposures within acceptable limits, while maximizing returns. As at September 30, 2008, the Company did not utilize any forward exchange contracts to mitigate any of the risks as mentioned above. Furthermore, the Company is not materially affected by commodity prices or interest rates.

The Company has completed a sensitivity analysis to estimate the impact on net loss for the period which a +/- 5% change in foreign exchange rates and assumes that changes in foreign currency exchange rates do not cause foreign currency exchange rates in other countries to alter.

(Stated in thousands of dollars)	Estimated impact on net loss
Change of +/-5% in US\$ foreign exchange rate	+ / - \$240

Limitations of sensitivity analysis:

The above table demonstrates the effect of a change in foreign exchange rates in isolation. In reality, there may be other contributing factors that will materially alter the estimated outcome. Furthermore, the financial position of the Company may vary at the time that a change in foreign currency exchange rates occurs, again, causing the impact on the Company's results to differ materially from the estimated outcome shown above.

10. Commitments

As of September 30, 2008, the Company has committed to lease payments for premises, equipment and entered into purchase orders for inventory and goods/services requiring payments in future periods as follows:

(Stated in thousands of dollars)		
2008	\$	6,496
2009		2,122
2010		1,280
2011		1,249
2012		1,316
2013		1,088
	\$	13,551

Approximately \$8.3 million (USD\$7.8 million) of this total is attributable to the US operation and is US dollar denominated, and thus, is subject to currency risk.

For the three months and nine months ended September 30, 2008 and 2007 (unaudited)

10. Commitments (con't)

- (a) Azure Dynamics Incorporated leases its operating facility in Woburn, Massachusetts under a non-cancellable lease agreement. Through a joint venture agreement, the Company has a 50% interest in the lessor, ND Solectria LLC (Note 4). The lease agreement provides for a minimum monthly rental payment plus certain operating costs. The Company's lease agreement contains escalation clauses and expires in September 2016.

In May, 2004 Azure Dynamics Inc. entered into a lease for a facility in Burnaby, British Columbia, which supports engineering and operations activities. The lease is for a 5 year term, concluding on April 20, 2009.

- (b) Pursuant to a contractual agreement with Natural Resources Canada (NRCan), 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. For the quarter ended September 30, 2008, the Company has made no payments (2007 – \$Nil) to NRCan. Cumulative to September 30, 2008, the Company has made total payments of \$16,500 to NRCan.
- (c) 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.
- (d) Pursuant to an 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. For the quarter ended September 30, 2008, the Company has made no payments (2007 – \$Nil) to EnCana Corporation. Cumulative to September 30, 2008, the Company has made total payments of \$16,500 to EnCana Corporation.
- (e) 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 one year compensation, and the immediate vesting of all options previously granted in the event of termination without cause and in some cases in the event of termination due to a change in the control of the Company.
- (f) The Company has entered into purchase orders for the supply of materials to support anticipated future sales of its products. Gross commitments entered into as at September 30, 2008 were \$6.9 million in which \$6.1 million are payable in the coming year.

Azure Dynamics Corporation
Notes to the Consolidated Financial Statements

For the three months and nine months ended September 30, 2008 and 2007 (unaudited)

11. Segmented financial information

Management currently organizes and views the Company's activities as one operating segment. A geographic analysis of revenues by customer locations and of assets employed is as follows:

	Revenues		Total Assets		Property, Plant, Equipment and Goodwill
	Three months ended Sep 30, 2008	Nine months ended Sep 30, 2008	September 30, 2008		
<i>(Stated in thousands of dollars)</i>					
Canada	718	718	\$ 35,387	\$	1,672
United Kingdom	nil	63	37		nil
United States	539	4,211	21,796		7,603
Australia	46	45	nil		nil
Norway	16	16	nil		nil
Asia	6	25	nil		nil
Total	\$ 1,325	\$ 5,078	\$ 57,220	\$	9,275
	Three months ended Sep 30, 2007	Nine months ended Sep 30, 2007	December 31, 2007		
<i>(Stated in thousands of dollars)</i>					
Canada	\$ nil	\$ nil	\$ 35,213	\$	1,076
United Kingdom	nil	nil	39		nil
United States	1,515	2,229	20,635		7,602
Asia	19	54	nil		nil
Total	\$ 1,534	\$ 2,283	\$ 55,887	\$	8,678

The percentage of revenues derived from the Company's largest customers is as follows:

	Three months ended September 30		Nine months ended September 30	
	2008	2007	2008	2007
First	54%	44%	36%	49%
Second	5%	44%	14%	29%
Third	4%	6%	12%	6%
Others	37%	6%	38%	16%
Total	100%	100%	100%	100%