

AZURE DYNAMICS CORPORATION

ANNUAL REPORT 2003



AZURE

D Y N A M I C S

May 2004

It is a pleasure to present the 2003 Annual Report for Azure Dynamics Corporation. Azure has made significant progress during the year towards its stated objective of becoming a world leader in developing hybrid electric systems for light and medium duty commercial vehicles.

2003 Highlights:

Commercialization

- April 2003 – entered into an agreement to in-service test five retrofitted Canada Post delivery vans utilizing Azure’s hybrid electric powertrains. The vans will be utilized in regular Canada Post delivery routes and two additional vans will undergo laboratory testing to validate their performance. This program, which is sponsored in part by EnCana Corporation, is in the build and post-build test phase;
- April 2003 – entered into an agreement with London Taxis International (“LTI”) to re-power three London taxis with Azure’s hybrid powertrain to demonstrate the commercial viability and performance advantages of the hybrid system in a taxi application. This program, which is sponsored in part by the Energy Savings Trust, an United Kingdom government entity, is in the build stage;
- April and November 2003 – the Company was contracted to conduct a feasibility study with respect to hybrid powertrains in military applications funded by the Canadian Department of National Defence; the project is in the final-reporting stage;
- May 2003 – entered into an agreement with LTI, to co-operate in the development and production of electric and hybrid electric delivery vehicles incorporating Azure’s powertrain technology. This program, which is sponsored in part by the Energy Savings Trust, is in the pre-build phase;
- September 2003 – the Company entered into a supply agreement with Purolator Courier Ltd. pursuant to which the Company will deliver 30 preproduction hybrid vehicles to Purolator and thereafter, subject to achievement of certain performance standards and other contract provisions, up to 400 hybrid electric powered chassis per annum over a five-year period. This program is in the confirmation prototype phase;
- October 2003 – the Company entered into an agreement with the United States Postal Service whereby Azure will develop a prototype gas hybrid electric powertrain for their carrier route vehicle as well as a prototype diesel hybrid electric powertrain for their two-ton step van. These two programs are in the initial design, planning and engineering prototype phase.

Funding

- July 2003 – the Company completed a secured convertible debenture financing raising gross proceeds of \$2.2 million to provide it with funds for immediate liquidity and working capital requirements. In December 2003 all issued and outstanding convertible debentures were converted into common shares;
- December 2003 – the Company completed a private placement generating gross proceeds of \$10.7 million.

Subsequent Developments - 2004

- In February 2004 Azure moved to a new facility in Vancouver which was previously occupied by an automotive-related company and is ideally suited for Azure's engineering and testing operations. The space meets Azure's five-year growth requirements;
- In February 2004 the Company announced a demonstration agreement with Leyland Product Development and Zebra Batteries, whereby the parties, in cooperation with Renault Trucks UK, are developing an electric van for demonstration and marketing purposes;
- Management considered it prudent to supplement the Company's cash reserves to facilitate the achievement of certain milestones in a timely manner and thus completed an additional financing on March 10, 2004 raising gross proceeds of \$4.2 million;
- In May 2004 Mr. Roberto Quarta joined the Board of Directors. He has had a distinguished international career in industry over many years. His intimate involvement in running businesses around the world will be of immense strategic value to Azure as the Company continues to expand its international customer base.

I wish to recognize the exceptional efforts by the Azure team during 2003. The contributions of and the accomplishments by our employees and our management in these challenging times bodes well for Azure in its ongoing progress towards commercialization.

Our Board of Directors contributed in many different ways in helping management overcome the technical, commercial and financial challenges that we faced during 2003.

The compelling economic and environmental benefits of Azure's technology are leading the commercial transportation sector which the Company is operating in to make fleet changes and improvements of a substantive nature.

I thank you, the shareholders, for your ongoing support for an exciting Company that can make a significant contribution to the environment we live in while concurrently producing economic benefits for its customers.

Respectfully submitted on behalf of the Board of Directors,



D. Campbell Deacon
Deputy Chairman and Chief Executive Officer

Year Ended December 31, 2003 ("2003") compared to the Year Ended December 31, 2002 ("2002")

This "Management's Discussion and Analysis" has been prepared as of March 11, 2004 and should be read in conjunction with the audited consolidated financial statements of the Company for the year ended December 31, 2003.

Business Strategy of the Company and Overview of Operations

Azure Dynamics Corporation ("Azure" or the "Company") has developed proprietary hybrid vehicle technology for the light to medium duty commercial vehicle category. The principal business of Azure is the development, and ultimate commercialization of its core technology, Hybrid Electric Vehicle ("HEV") control systems. The Company is a development stage enterprise – it is involved in the development and testing of its technology; commercial sales of its first product is targeted to commence at the end of 2004.

In simple terms, Azure's HEV has an electric motor, an energy storage system (batteries), and an additional energy source, such as a small internal combustion engine/generator. A key feature is that it regenerates braking energy to charge the batteries, thereby extending vehicle range. Azure's strategy is to deploy its HEV control systems technology into viable powertrain products for the light to medium duty commercial vehicle markets, focusing initially on urban delivery, postal, courier, taxi and shuttle-bus applications. Azure has selected these markets as they include some of the least efficient drive cycles that use a disproportionate amount of energy when compared to more typical drive-cycles, such as passenger vehicles, and hence are also the most significant polluters. The Hybrid technology benefits from some of the inherent inefficiencies in the nature of the drive-cycle of these applications and eliminates other inefficiencies thereby achieving fuel and maintenance cost reductions, as well as reductions in the harmful emissions that contribute towards health and environmental issues. For example, the short trip, stop-start nature of these applications enable the HEV to regenerate power by capturing braking energy that is then reapplied to recharging the battery and thereby extending operational capacity of the vehicle. Azure's HEV system allows the combustion engine to operate at those times when it is at its most efficient, with an electric-assist or full-electric mode at times when it is not efficient, thereby reducing fuel consumption, emission output and noise levels.

In the execution of its strategy, Azure can be considered as a design, engineering, and customer support operation. Azure's designed products will be assembled using components manufactured, and where necessary adapted to the specific powertrain application, by recognised industry suppliers. The assembly process itself will be performed by the specialist automotive assembly and manufacturing operations that currently serve the Original Equipment Manufacturers or their own niche markets. Thus, it is an important part of Azure's strategy to be aligned with partners who are recognized suppliers to the industry in order to achieve its goals. Azure has established component supply arrangements with companies such as Ford, Mototron (Motorola), Siemens, ZF Sachs and Hawker Batteries although the final determination of production components is still subject to the outcome of product development and supplier negotiations.

Azure is developing two powertrain platforms – G1 for vehicles in the medium-duty weight range 7,500 to 14,000 lbs gross vehicle weight, and G2r for vehicles in the light-duty weight range 5,000 to 7,500 lbs gross vehicle weight. Within each platform, Azure will develop product best-suited to customer applications applying its Series Hybrid, Series-Parallel Hybrid, or Electric technology. During 2003, Azure continued to focus its efforts on the practical demonstration of its technology in customer-specific applications in order to secure customer support for the Company's development program. As a result, Azure secured its first commercial contract with Purolator Courier Ltd, Canada's largest courier company, in September 2003. The contract with Purolator could lead to annual volumes of up to 400 hybrid powertrains per annum, subject to the satisfaction of certain conditions. The first of 30 preproduction vehicles are targeted for delivery by the end of 2004.

In addition to the contract with Purolator, the Company has entered into the following customer arrangements:

- April 2003 – a program to in-service test five retrofitted Canada Post delivery vans utilizing Azure's G1 hybrid electric powertrains. The vans will be utilized in regular Canada Post delivery routes and two more vans will undergo laboratory testing to validate their performance. This program is sponsored in part by EnCana Corporation;
- April 2003 – a program to re-power three London taxis with Azure's G2r hybrid powertrain to demonstrate the commercial viability and performance advantages of the hybrid system in a taxi application. This program with London Taxi International ("LTI") is sponsored in part by the Energy Savings Trust, an United Kingdom government entity;
- April and November 2003 – a feasibility study with respect to hybrid powertrains in military applications (G1 weight class) funded by the Canadian Department of National Defence;
- May 2003 – a second program with LTI, to co-operate in the development and production of electric and hybrid electric delivery vehicles incorporating Azure's G1 powertrain technology. This program is sponsored in part by the Energy Savings Trust;
- October 2003 – a program with the United States Postal Service whereby Azure will test and retrofit two vehicles incorporating Azure's G1 and G2r powertrains.

Subsequent to the year end, the Company also announced a demonstration agreement with Leyland Product Development and Zebra Batteries, whereby the parties, in cooperation with a European truck manufacturer, are developing an electric van for demonstration and marketing purposes.

The Hybrid Electric industry achieved a higher profile during 2003 as many industry analysts, manufacturers, and government organizations publicly recognised hybrid technology as a viable short-term alternative to the traditional combustion engine vehicle and as a platform upon which fuel cell technology can be launched in the longer term. Despite this overall endorsement of hybrid technology, the economic conditions for technology companies in general continued to be difficult for most of the 2003 year. Against this background, Azure continued to achieve commercialization milestones that helped attract potential investor enthusiasm but little by way of their financial support. Therefore, out of necessity, Azure completed a \$2.2 million secured convertible debenture financing in July 2003 to safeguard its ongoing viability. It was not until late 2003, when it became apparent to Azure that the climate for fund raising was improving for development companies, that Azure was successful in securing a sizable financing – a \$10.7 million private placement of common shares that closed December 1, 2003. Together with other sources of funds, the financing now allows Azure to progress its commercialization plans at a more rapid pace in 2004.

Operating Results, Cash Flows and Financial Condition

Statement of Operations Discussion

For the year ended December 31, 2003, the Company incurred a net loss of \$3,832,824 (\$0.08) per share compared to a net loss of \$5,284,536 (\$0.13 per share) in 2002. Since inception, the Company has incurred a total loss of \$14,100,974. As the Company currently has no commercial revenues it mainly incurs costs to progress its development and commercialization plans. In the difficult market conditions of 2002 and 2003 the Company adopted a strategy of exercising tight constraint over development and overhead costs and solicited customer and sponsorship contributions to progress its key projects. Contributions from customers, sponsors and government funding (which are recorded as an offset to research and development expenses) are the most significant reason why the 2003 deficit was lower than 2002, despite more activity on the development front; contributions in 2003 approximated \$2.3 million, some \$1.5 million higher than in 2002.

Azure Dynamics Corporation
(A Development Stage Enterprise)
Management's Discussion and Analysis

Selected Annual Information:

Years ended	December 31, 2003	December 31, 2002	June 30, 2002
Revenue	\$ 47,383	\$ 51,818	\$ 78,469
Net loss before other items	\$ 3,832,824	\$ 4,826,871	\$ 5,298,532
Net loss before other items per share	\$0.08	\$0.12	\$0.17
Net loss	\$ 3,832,824	\$ 5,284,536	\$ 5,756,197
Net loss per share	\$0.08	\$0.13	\$0.18
Total Assets	\$ 10,626,181	\$ 1,967,864	\$ 3,314,400
Long-term financial liabilities	\$ -	\$ -	\$ 2,575

Selected Quarterly information:

	Q4, 2003 (Oct – Dec)	Q3, 2003 (Jul – Sept)	Q2, 2003 (Apr – Jun)	Q1, 2003 (Jan – Mar)
Revenue	\$ 23,993	\$ 9,540	\$ 7,674	\$ 6,176
Expenses	\$ (1,268,790)	\$ (1,239,669)	\$ (586,857)	\$ (784,891)
Net loss for the period	\$ (1,244,797)	\$ (1,230,129)	\$ (579,183)	\$ (778,715)
Loss per share	\$ (0.02)	\$ (0.03)	\$ (0.01)	\$ (0.02)
Weighted average number of Shares	54,547,058	45,044,375	45,031,042	45,008,264

	Q4, 2002 (Oct – Dec)	Q3, 2002 (Jul – Sept)	Q2, 2002 (Apr – Jun)	Q1, 2002 (Jan – Mar)
Revenue	\$ 7,034	\$ 11,799	\$ 16,592	\$ 16,393
Expenses	\$ (862,066)	\$ (1,085,331)	\$ (1,409,481)	\$ (1,521,811)
Lease termination	\$ -	\$ -	\$ (457,665)	\$ -
Net loss for the period	\$ (855,032)	\$ (1,073,532)	\$ (1,850,554)	\$ (1,505,418)
Loss per share	\$ (0.02)	\$ (0.02)	\$ (0.04)	\$ (0.04)
Weighted average number of Shares	43,682,571	43,555,999	43,308,430	34,328,753

The annual and quarterly results vary significantly in accordance with the cost of program related product development and prototype build activities as offset by contributions by third parties. Ignoring the development costs/contributions, the underlying trend has been a reduction in overhead cost due to cost containment initiatives implemented in 2002, including the elimination of all non-core activities. The Company raised additional capital in December 2003 (supplemented by other government financing arrangements and a further equity financing in March 2004) and has recommenced the process of building the infrastructure required to support its ongoing and future operations; therefore costs are anticipated to grow in 2004 in preparation for the Company's commercial product launch.

Revenue: Revenue for the year ended December 31, 2003 was \$47,383 compared to \$51,818 in 2002. Revenue is mainly comprised of interest income earned on monies placed on short-term investment.

Research and development: Before contributions, the Company expended \$3,441,803 on research and development operations for the year ended December 31, 2003 (\$2,677,441 – 2002). The research and development expenses were reduced by \$2,298,204 (\$832,081 – 2002) of contributions from government assistance programs, customer and sponsorship contributions. Net costs are \$1,143,599 in 2003 compared to \$1,845,360 in 2002.

In 2003 the Company completed the build of a demonstrator prototype for Purolator – a pre-cursor to the Purolator sales contract. Additional prototypes will be built in 2004 with the expectation that the pre-production build of 30 vehicles will commence late 2004. The largest project undertaken in 2003 was the build of the five Canada Post (and two in-house) demonstration vehicles. Design, planning and procurement activities commenced after signing the agreement in April 2003; the procurement of components and the physical build process started in the third quarter of the year; completion of the build and in-service operation is expected by the end of the first quarter in 2004. The initial design work regarding the hybrid London taxis is complete and component procurement and the physical build of the vehicles is in progress and is scheduled for completion in the first half of 2004. Initial design work on the LTI delivery van commenced in the latter stages of 2003; delivery of these demonstration vehicles is scheduled for the second half of 2004. The Company completed Phase 1 of the Canadian Department of Defence report in 2003 and is currently finalizing the Phase 2 report. The electric van being developed in cooperation with Leyland Product Development is expected to be on display in England during March 2004. Finally, the United States Postal Service demonstration vehicles are scheduled for build and delivery in late 2004.

All of the aforementioned programs fall within the development scope of the Companies G1 and G2r powertrain platforms – note 12 to the financial statements details costs incurred to December 31, 2003. The Company plans to spend approximately \$12 million (\$6.5 million net of customer and government contributions) on research and development to advance the development of the products in 2004. The Company will require additional financing to successfully commercialise its products – please refer to 'Liquidity, Capital Resources and Risk Factors' below.

Customer contributions during the year were bolstered by the \$1 million sponsorship from EnCana Corporation which has been applied against the cost of the Canada Post build program. Technology Partnerships Canada ("TPC") contributions were \$948,376 in 2003 compared to \$832,081 in 2002; as a result of the equity financing in December 2003, Azure has qualified under the terms of its agreement with TPC to access up to \$6 million in total out of the maximum \$9 million grant available (of which approximately \$1.8 million has been claimed up to December 2003). The Company is required to make royalty payments to TPC, EnCana and the National Research Council based on future revenues as described in note 13 to its annual financial statements; as the Company has no commercial revenues to date, a royalty liability has not been incurred.

At December 31, 2003, Azure employed eleven research, engineering and technical employees (2002 – fifteen). Since December 2003, Azure has activated its plans to grow its development team and put in place the infrastructure required to support its operations. Subsequent to the year end, in February 2004, the Company moved its Vancouver engineering, test and administrative operations into an 18,000 square foot building that has suitable shop and office accommodations.

Selling and marketing: Selling and marketing costs total \$718,345 for the year ended December 31, 2003, compared to \$772,737 in 2002. Although payroll costs were higher in 2003, overall costs are lower due to the cost saving initiatives implemented in 2002. The headcount remained at two during the year (2002 – two).

General and administrative: General and administrative costs, at \$1,306,474 for the year ended December 31, 2003, are approximately \$359,000 lower than in 2002 (\$1,665,759) due to the aforementioned cost saving initiatives as well as lower overall third party consulting costs associated with the Company's strategic and financing efforts. The headcount at December 31, 2003, including that of the executive office, was five (2002 – five). The total headcount of the Company at December 31, 2003 was eighteen compared to twenty-two as at December 31, 2002.

Rent: Rent for the year ended December 31, 2003 was \$219,392 compared to \$401,230 for 2002. During 2002, the Company entered into a lease termination agreement (see note 4 to the annual financial statements) thereby effectively lowering its rental cost obligations.

Amortization: Amortization of capital (mainly shop, computer and office equipment) and other assets (mainly patents and trade marks) was \$198,684 in 2003 (2002 – \$193,603).

Stock option compensation costs: As a result of a change in the Canadian Institute of Chartered Accountants handbook – section 3870 Stock Based Compensation and Other Stock-based Payments – in the fourth quarter of 2004 the Company elected early adoption of the new requirement to expense officer, director and employee stock option grants. Previously, the Company was required to disclose this information by way of a pro-forma note to the financial statements. Accordingly, the Company has charged \$131,426 to operations in 2003 with a corresponding credit to 'Contributed surplus' on the balance sheet.

Amortization of deferred financing costs and accretion expense on convertible debentures: As explained in notes 2 (l), 2 (n) and 10 (b) (vii) the Company issued secured convertible debentures in July 2003 and hence deferred and amortized issue costs and recorded an accretion expense to recognise the separate recording of the liability and equity component of the debt instrument. The debentures were converted into equity in December 2003, and hence all remaining deferred costs were transferred to 'Share capital' at that time, and no further accretion expenses are applicable.

Balance Sheet Discussion

Cash and cash equivalents: Cash and cash equivalents at December 31, 2003 were \$9,075,219 compared to \$1,030,594 at December 31, 2002. Net cash inflows were approximately \$14.3 million in 2003, including net equity and convertible debt financing (\$12.1 million), customer and sponsorship contributions (\$1.3 million), and TPC contributions (\$0.9 million). Net cash outflows in respect of operations and working capital financing were approximately \$6.2 million.

Accounts receivable: Accounts receivable increased to \$337,794 at December 31, 2003 compared to \$28,253 at December 31, 2002 due to approximately \$245,000 receivable from customers in accordance with development agreements; the balance of the accounts receivable amount is made up of sundries and reimbursable general sales taxes.

Contributions receivable: Contributions receivable at December 31, 2003, of \$780,459 (2002 – \$264,455) represent approximately two and a half quarterly TPC claims waiting reimbursement; the balance in 2002 represented one quarterly claim. During 2003, Azure reached the first upper limit (\$1 million) of the amount it can claim under the TPC agreement without having suitable additional financing arrangements in place and hence suspended recording contributions receivable until it could satisfy the agreement criteria. As a result of the financing arrangements completed in 2003, culminating with the December 2003 equity placement and subsequent conversion of the secured convertible debentures to equity, Azure has demonstrated to the satisfaction of TPC that it has sufficient financing arrangements in place and thereby has gained access to the second level of TPC contributions (an additional \$5 million); accordingly the Company has recommenced recording claims as they become due and payable by TPC.

Employee loans: As at December 31, 2003, employee loans amounted to \$91,727 (2002 – \$259,214); the reduction in the amount of loans outstanding is due to employee repayments. The share purchase loans were granted during fiscal 2001 to facilitate the participation by employees in the public float of the Company and are repayable on April 24, 2004 or at any time during the term – see note 8(i) to the annual financial statements.

Capital assets: Net capital assets were \$162,048 at December 31, 2003 compared to \$276,036 at December 31, 2002; the difference is mainly attributable to amortization.

Other assets: Other assets are comprised of patent and trademark assets as well as a deferred charge representing an unsecured employee loan. The net book value of patent and trademark assets is \$117,279 as at December 31, 2003 compared to \$78,732 at December 31, 2002; the increase is attributable to ongoing efforts to protect the Company's intellectual property. On April 29, 2003 the Company announced that the United States Patent Agency issued patent number 6,555,991 to Azure for its battery management technology. The unsecured employee loan was fully amortized in the year in accordance with the terms of the employment contract.

Accounts payable and accrued liabilities: Accounts payable and accrued liabilities were \$567,692 at December 31, 2003 compared to \$347,313 at December 31, 2002. Liabilities are higher as at December 31, 2003 mainly due to payables in respect of in-progress customer prototype component and build costs.

Share capital and special warrants: Share capital and special warrants at December 31, 2003 amounted to \$24,028,037 compared to \$11,878,905 at December 31, 2002. Azure completed two financings during 2003 – a secured convertible debenture financing in July 2003 that raised net proceeds of \$2,008,905 (issue costs of \$207,095) and a brokered private placement of equity in December 2003 that raised net proceeds of \$9,894,470 (issue costs, including agents commissions, of \$766,023).

In respect of the private placement of equity, on December 1, 2004 the Company issued 25,382,126 common shares, at a price of \$0.42 per share, and 12,691,063 warrants, each warrant exercisable into one common share at a price of \$0.62 until December 1, 2004. The Company also issued 2,325,508 compensation options to agents; each option entitles the holder thereof to purchase one common share at \$0.495 up until December 1, 2004. As a result of the conversion of the debentures into equity, on December 19, 2003 the Company issued 7,386,668 common shares at an effective cost of \$0.30 per share. During the year, the Company issued a further 214,000 common shares in respect of various stock option exercises and shares issued in lieu of annual director's fees for net proceeds of \$67,250. Also, effective November 30, 2003 the outstanding 200,000 special warrants from a financing completed in November 2001 were converted into 200,000 common shares for no additional consideration in accordance with the terms of the warrants.

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

	March 11, 2004	December 31, 2003
Common shares	83,538,252	78,163,836
Warrants, exercisable until December 1, 2004 at \$0.62	12,691,063	12,691,063
Compensation options, exercisable until December 1, 2004 at \$0.495	2,325,508	2,325,508
Stock options issued under the employee Stock Option Plan, with expiry dates ranging up until February 1, 2009 and average exercise price of \$0.50	7,599,228	6,173,000

Liquidity, Capital Resources and Risk Factors

At December 31, 2003 the Company had \$9,075,219 (December 31, 2002 – \$1,030,594) in net cash reserves. The Company invests its cash in highly liquid, highly rated financial instruments such as banker's acceptances and term deposits. Working capital was \$9,687,435 at December 31, 2003 compared to \$979,513 at December 31, 2002; the increase in working capital is primarily due to the financing completed in December 2003 and the accumulation of TPC claims receivable as explained earlier.

The Company has no commercial revenue and is therefore dependant on its financing activities to fund its operations. The prevailing economic climate, and in particular the retraction of general support for the technology sector since 2001, has restricted the Company's ability to raise equity financing. Azure responded by shedding all non-core activities, streamlining operations and slowing down expansion plans, thereby freeing up cash to focus on customer-specific product development efforts that were capable of advancing the Company's product to commercialization and which could also attract customer/third party financial support. The Company has secured customer commitments of approximately \$1.5 million in 2003, and also received \$1 million for a customer project from a sponsor. Based on this experience, the Company believes that it is possible to secure further customer and sponsorship financing for its programs.

The Company also raised over \$12 million net in new financing in 2003, gained access to a further \$5 million of it's available TPC facility, and since the year end has completed an additional financing for net proceeds of approximately \$3.9 million. The Company intends to use it cash resources and available financing arrangements to fund ongoing development activities in 2004 and into 2005. Additional financing will be required in the future, to allow for the uninterrupted development of its products through the commercialization stage of its various products (which is anticipated to continue throughout 2005 and into the early part of 2006). To improve investor liquidity, and hence enhance Azure's attractiveness as an investment vehicle, the Company is considering available listing alternatives. Never the less, 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.

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 May 12, 2003 (this document is available for inspection at www.sedar.com). Management is of the view that, as a result of the recent financing, product and customer developments that risk emphasis in 2004 will be less weighted towards financial risk and more weighted towards the practical risks of implementation, for example, the risk that Azure is delayed in the implementation of customer product requirements specified in development agreements, or the risk of delay to the process of establishing the resources required to support the implementation plans. To better manage all risk factors, the Company has embarked on a system of reporting and measuring progress towards milestones on a regular basis; has developed an organization chart commensurate with its growth plans and is actively recruiting key vacancies; and is implementing an internal control and process system – supported by a computer system that will encompass all existing engineering/support operations and provide a platform for sustainable growth. Management accepts the responsibility of ensuring that the control systems and procedures are established, effective and monitored and is required to report to the Board and its sub-committees on a regular basis.

In conclusion, Azure continued to make progress towards its commercialization goals despite some challenging circumstances in 2003. It is managements' view that the milestones achieved in 2003, and in particular the Purolator contract and equity financing, are stepping stones to the attainment of its 2004 goals and ultimately the emergence of a viable commercial entity that has the potential for healthy investor returns while contributing in a meaningful manner to the resolution of problems associated with environmental pollution.

Azure Dynamics Corporation

(A Development Stage Enterprise)
Consolidated Financial Statements

For the year ended December 31, 2003, six months ended December 31, 2002
and the year ended June 30, 2002

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Auditors' Report

To the Shareholders of Azure Dynamics Corporation

We have audited the consolidated balance sheets of Azure Dynamics Corporation (a development stage enterprise) as at December 31, 2003 and 2002, and June 30, 2002 and the consolidated statements of operations and deficit and cash flows for the year ended December 31, 2003, six months ended December 31, 2002, and the year ended June 30, 2002, respectively. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2003 and 2002, and June 30, 2002 and the results of its operations and its cash flows for the year ended December 31, 2003, the six months ended December 31, 2002, and the year ended June 30, 2002, respectively, in accordance with Canadian generally accepted accounting principles.

BDO Dunwoody LLP

Chartered Accountants

Calgary, Alberta
March 11, 2004

Azure Dynamics Corporation
(A Development Stage Enterprise)
Consolidated Balance Sheets

As at	December 31 2003	December 31 2002	June 30 2002
Assets			
Current			
Cash and cash equivalents (Note 5)	\$ 9,075,219	\$ 1,030,594	\$ 1,896,248
Accounts receivable	337,794	28,253	68,327
Contributions receivable (Note 12)	780,459	264,455	567,626
Prepaid expenses	61,655	13,320	53,961
	<u>10,255,127</u>	1,336,622	2,586,162
Employee loans (Note 8(i))	91,727	259,214	259,214
Property and equipment (Note 6)	162,048	276,036	372,019
Other assets (Note 7)	117,279	95,992	97,005
	<u>\$ 10,626,181</u>	\$ 1,967,864	\$ 3,314,400

Liabilities and Shareholders' Equity

Current

Accounts payable and accrued liabilities	\$ 567,692	\$ 347,313	\$ 442,625
Obligations under capital leases	-	9,796	13,748
	<u>567,692</u>	357,109	456,373

Obligations under capital leases

	-	-	2,575
	<u>567,692</u>	357,109	458,948

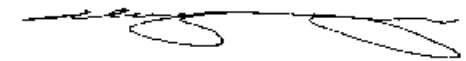
Shareholders' equity

Share capital (Note 10(b))	23,991,665	11,788,905	11,195,038
Special warrants (Note 10(c))	-	90,000	-
Contributed surplus (Note 10(c)(viii and ix))	167,798	-	-
Deficit	(14,100,974)	(10,268,150)	(8,339,586)
	<u>10,058,489</u>	1,610,755	2,855,452
	<u>\$ 10,626,181</u>	\$ 1,967,864	\$ 3,314,400

Approved on behalf of the Board:



D. Campbell Deacon, Director



Dennis A. Sharp, Director

Azure Dynamics Corporation
(A Development Stage Enterprise)
Consolidated Statements of Operations and Deficit

	Years ended December 31		Six months ended December 31		Year ended June 30	Cumulative Since Inception
	2003	2002	2002	2002	2002	
	(Unaudited)					
Revenue						
Contract sales	\$ -	\$ -	\$ -	\$ -	\$ -	258,066
Other	47,383	51,818	18,833	78,469	78,469	186,551
	47,383	51,818	18,833	78,469	78,469	444,617
Cost of contract sales	-	-	-	-	-	101,073
	47,383	51,818	18,833	78,469	78,469	343,544
Expenses						
Research and development, net (Note 12)	1,143,599	1,845,360	690,574	2,395,838	2,395,838	5,632,710
Selling and marketing	718,345	772,737	320,904	756,341	756,341	1,977,775
General and administrative	1,306,474	1,665,759	708,432	1,652,848	1,652,848	4,575,247
Rent	219,392	401,230	117,239	408,913	408,913	943,534
Amortization of capital and other assets	198,684	193,603	110,248	163,061	163,061	563,874
Stock option compensation costs	131,426	-	-	-	-	131,426
Amortization of deferred financing costs	88,143	-	-	-	-	88,143
Accretion expense on convertible debentures	74,144	-	-	-	-	74,144
	3,880,207	4,878,689	1,947,397	5,377,001	5,377,001	13,986,853
Net loss for the period before other items	(3,832,824)	(4,826,871)	(1,928,564)	(5,298,532)	(5,298,532)	(13,643,309)
Lease termination (Note 4)	-	457,665	-	457,665	457,665	457,665
Net loss for the period	(3,832,824)	(5,284,536)	(1,928,564)	(5,756,197)	(5,756,197)	(14,100,974)
Deficit, beginning of period	(10,268,150)	(4,983,614)	(8,339,586)	(2,583,389)	(2,583,389)	-
Deficit, end of period	\$ (14,100,974)	\$ (10,268,150)	\$ (10,268,150)	\$ (8,339,586)	\$ (8,339,586)	\$ (14,100,974)
Earnings per share – basic *	(0.08)	(0.13)	(0.04)	(0.18)	(0.18)	
Weighted average number of shares – basic	47,425,079	41,381,502	43,682,571	31,691,179	31,691,179	

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

Azure Dynamics Corporation
(A Development Stage Enterprise)
Consolidated Statements of Cash Flows

	Years ended December 31	Six months ended December 31	Year ended June 30	Cumulative Since Inception
	2003	2002	2002	2002
Cash flows from operating activities		(unaudited)		
Net loss for the period	\$ (3,832,824)	\$ (5,284,536)	\$ (1,928,564)	\$ (5,756,197)
Adjustments for:				
Amortization of capital and other assets	198,684	193,603	110,248	163,061
Lease termination (Note 4)	-	457,665	-	457,665
Common shares issued in exchange for services	25,000	-	-	50,000
Stock option compensation expenses	131,426	-	-	131,426
Accretion expenses of convertible debenture	74,144	-	-	74,144
Amortization of deferred financing costs	88,143	-	-	88,143
Changes in non-cash working capital items (Note 14)	(653,050)	(669,504)	288,574	(467,823)
	(3,968,477)	(5,302,772)	(1,529,742)	(5,603,294)
Cash flows from financing activities				
Issuance of common shares (net of costs)	9,952,940	5,876,987	593,867	5,078,120
Issuance of special warrants (net of costs)	-	-	90,000	-
Convertible debentures funds received (net of costs)	2,008,905	-	-	2,008,905
Changes in related party advances	-	-	-	14,156
Repayment of obligations under capital lease	(9,797)	(12,321)	(6,527)	(10,993)
Repayment of long term debt	-	-	-	(50,000)
	11,952,048	5,864,666	677,340	5,081,283
Cash flows from investing activities				
Acquisition of capital assets	(45,516)	(138,408)	605	(392,616)
Acquisition of subsidiary	-	-	-	(249,610)
Acquisition of intellectual properties	(60,467)	(59,604)	(13,857)	(62,864)
Changes in loans to employees	167,037	14,287	-	14,287
	61,054	(183,725)	(13,252)	(441,193)
Increase (decrease) in cash and cash equivalents	8,044,625	378,169	(865,654)	(963,204)
Cash and cash equivalents, beginning of period	1,030,594	652,425	1,896,248	2,859,452
Cash and cash equivalents, end of period	\$ 9,075,219	\$ 1,030,594	\$ 1,030,594	\$ 1,896,248
				\$ 9,075,219

Azure Dynamics Corporation
(A Development Stage Enterprise)
Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

1. Nature of Operations and Basis of Presentation

Azure Dynamics Corporation ("the Company") ("ADC") is incorporated under the laws of Alberta. The Company was party to a reverse takeover transaction ("RTO") between ADC (the deemed acquiree) and Azure Dynamics Inc. ("ADI") (the deemed acquirer), effective April 24, 2001. The corporate structure is currently that ADI is the wholly owned subsidiary of ADC. ADI is incorporated under the laws of Canada. On December 31, 2002, in order to harmonize its financial reporting requirements with internal operations and its industry sector, management made application to change the reporting year-end for the consolidated entities to December 31 from June 30.

The Company is a development stage enterprise, involved in developing adaptive hybrid electric vehicle control systems to be used in commercial vehicle applications. The Company has not yet determined the ultimate economic viability of the products under development. The Company is currently in the process of testing its control systems. All costs incurred to date have been recorded as research and development expense. No commercial revenue has been generated from the sale of its products to date.

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles 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. There are several development stages to be completed before the marketability, if any, of the Company's technology can be determined. While the Company has derived limited revenue from the performance of research and development projects for 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 amounts and liabilities that might be necessary should the Company be unable to continue in business.

2. Significant Accounting Policies

The consolidated financial statements of the Company have been prepared by management in accordance with Canadian generally accepted accounting principles. 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 ADI since July 1, 1999, the date it commenced operations, and the accounts of ADC since the effective RTO date of April 24, 2001.

(b) Revenue recognition

Revenue from contractual projects is to be recognized on a percentage-of-completion basis based on the ratio of actual costs incurred to the estimated total cost to complete the project. Provision for loss on contracts is recorded in the period in which the loss is determined.

Azure Dynamics Corporation
(A Development Stage Enterprise)
Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

2. Significant Accounting Policies (cont'd.)

(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 sales levels achieved, the liability will be recorded as sales are made 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. Since becoming a public company, 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.

(e) Property and equipment

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

The following is a summary of estimated useful lives of the assets:

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

(f) 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.

(g) 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.

Azure Dynamics Corporation
(A Development Stage Enterprise)
Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

2. Significant Accounting Policies (cont'd.)

(h) Foreign currency translation

The Company follows the temporal method of accounting for the translation of foreign currency amounts into Canadian dollars. Under this method monetary assets and liabilities are translated into Canadian dollars at the exchange rate in effect at the balance sheet date. Revenue and expenses are translated at monthly average exchange rates throughout the year. Foreign exchange gains or losses are reflected in the results of operations.

(i) Other assets

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.

(j) 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.

(k) Stock based compensation

The Company grants stock options to officers, directors, employees and consultants pursuant to a stock option plan described in Note 10(d). Prior to December 31, 2002, no compensation was recognized for this plan when stock options were granted. Any consideration received on the exercise of stock options or the purchase of stock was credited to share capital. Effective January 1, 2003, the Company accounts for its stock-based compensation programs using the fair-value method. Under this method, compensation expense related to these programs is recorded in the statement of income over the vesting period. The compensation expense amount is determined 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 are based on management's best estimate of the expected volatility over the term of the stock option as of the date of grant. As such, the amounts reported as compensation expense are subject to measurement uncertainty as the expense amount may vary significantly based on the volatility factor used.

(l) Deferred financing costs

Financing costs relating to the issue of debt instruments are deferred on the balance sheet and are amortized over the terms of the debt instruments.

Azure Dynamics Corporation
(A Development Stage Enterprise)
Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

2. Significant Accounting Policies (cont'd.)

(m) 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 and other dilutive instruments, in accordance with standards approved by the Canadian Institute of Chartered Accountants.

(n) Debt instruments

On the issue of convertible debt instruments, the liability component and the equity component as determined at initial recognition, is presented separately. The Company values the equity component of debt instruments using the 'residual value of equity component' method, whereby the liability component is valued first using the current market rates for comparable instruments, at the time of issuance, and the difference between the proceeds of the debt instrument issued and the fair value of the liability is assigned to the equity component. The liability element is subsequently reported at amortized cost. Accretion of the debt discount is recognized in the income statement over the duration of the debt instrument. The value of the equity conversion option recognized at the time of issuance is not changed in future periods. Upon conversion of convertible debt instruments, the remaining face value of the debt outstanding and the initial value attributed to the equity conversion option is attributed to the shares issued on conversion.

3. Business Combinations

Pursuant to the reverse takeover ("RTO") transaction, effective April 24, 2001, ADC effected a stock consolidation of 1 share for each 10 shares of its issued and outstanding shares resulting in 1,526,269 common shares issued and outstanding to its shareholders, on April 24, 2001. ADC, the legal acquirer, issued 22,944,740 common shares for the acquisition of ADI at a deemed price of \$0.25 per share. The acquisition has been accounted for as a purchase transaction with ADI being the deemed acquirer as the transaction was a reverse takeover. The carrying values of the assets and liabilities of ADC as at the effective date, April 24, 2001, were as follows:

Other current assets	\$ 3,843
Current liabilities	(30,116)
Working capital deficiency	<u>(26,273)</u>
Capital assets	1,700
Note payable to ADI	<u>(250,000)</u>
Net deficiency, attributed to the 1,526,269 common shares issued and outstanding prior to the RTO	<u>\$ (274,573)</u>

The excess of consideration given over the fair value of the net assets has been reflected as a reduction of share capital, representing the cost to ADI of becoming a public company by effecting a RTO.

Azure Dynamics Corporation
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Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

4. Lease Termination

Effective June 30, 2002, the Company entered into a lease termination agreement whereby it was released from the terms and conditions of a five-year property lease agreement for office and facility premises. The premises were never occupied by the Company, and as a result of the lease termination, pre-occupation costs (leasehold improvements and prepaid expenses) were written-off in the year ended June 30, 2002.

A summary of the costs expensed and lease termination exit costs are as follows:

Lease termination payment	\$	205,000
Pre-occupation costs		247,665
Legal costs		5,000
	<u>\$</u>	<u>457,665</u>

In conjunction with the lease termination agreement, the landlords of the property agreed to subscribe for 240,000 common shares of the Company, at a price of \$0.50 per share, for gross proceeds of \$120,000.

5. Cash and Cash Equivalents

	<u>December 31</u> <u>2003</u>	<u>December 31</u> <u>2002</u>	<u>June 30</u> <u>2002</u>
Cash (bank indebtedness) in bank	\$ 8,989,323	\$ 93,643	\$ (62,465)
Short term investments	35,896	886,951	1,908,713
Restricted investment	50,000	50,000	50,000
	<u>\$ 9,075,219</u>	<u>\$ 1,030,594</u>	<u>\$ 1,896,248</u>

The restricted investment is pledged as security with the bank against any overdrafts in the current account.

6. Property and Equipment

	<u>December 31, 2003</u>			
	<u>Cost</u>	<u>Accumulated</u> <u>Amortization</u>	<u>Write-off</u> <u>of assets</u>	<u>Net book</u> <u>Value</u>
Laboratory equipment	\$ 175,634	\$ 126,376	\$ -	\$ 49,258
Computer software	218,510	178,786	-	39,724
Computer hardware (ii)	178,196	130,548	-	47,648
Office furniture and equipment	48,374	24,568	-	23,806
Automotive	13,898	12,286	-	1,612
Leasehold improvements (i)	852	852	-	-
	<u>\$ 635,464</u>	<u>\$ 473,416</u>	<u>\$ -</u>	<u>\$ 162,048</u>

Azure Dynamics Corporation
(A Development Stage Enterprise)
Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

6. Property and Equipment (cont'd.)

	December 31, 2002			
	Cost	Accumulated Amortization	Write-off of assets	Net book Value
Laboratory equipment	\$ 175,634	\$ 66,538	\$ -	\$ 109,096
Computer software	184,254	145,916	-	38,338
Computer hardware (ii)	168,360	76,488	-	91,872
Office furniture and equipment	46,949	16,463	-	30,486
Automotive	13,898	7,654	-	6,244
Leasehold improvements (i)	852	852	-	-
	\$ 589,947	\$ 313,911	\$ -	\$ 276,036

	June 30, 2002			
	Cost	Accumulated Amortization	Write-off of assets	Net book Value
Laboratory equipment	\$ 175,634	\$ 48,984	\$ -	\$ 126,650
Computer software	184,254	102,602	-	81,652
Computer hardware (ii)	168,965	48,426	-	120,539
Office furniture and equipment	46,949	12,331	-	34,618
Automotive	13,898	5,338	-	8,560
Leasehold improvements (i)	204,826	9,163	195,663	-
	\$ 794,526	\$ 226,844	\$ 195,663	\$ 372,019

- (i) Pursuant to a lease termination agreement, effective June 30, 2002, the Company has written off leasehold improvements, with a net book value of \$195,663 – refer to Note 4.
- (ii) The cost of assets under lease as at December 31, 2003 was \$nil (\$27,410 less accumulated amortization of \$8,745 at December 31, 2002 and \$4,177 at June 30, 2002).

7. Other Assets

	December 31, 2003		
	Cost	Accumulated Amortization	Net book Value
Patents	\$ 122,400	\$ 30,455	\$ 91,945
Licensed technology	1	-	1
Trademarks	32,059	6,726	25,333
Deferred charge (i)	50,000	50,000	-
	\$ 204,460	\$ 87,181	\$ 117,279

	December 31, 2002		
	Cost	Accumulated Amortization	Net book Value
Patents	\$ 77,715	\$ 12,482	\$ 65,233
Licensed technology	1	-	1
Trademarks	16,278	2,780	13,498
Deferred charge (i)	50,000	32,740	17,260
	\$ 143,994	\$ 48,002	\$ 95,992

Azure Dynamics Corporation
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Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

7. Other Assets (cont'd)

	June 30, 2002		
	Cost	Accumulated Amortization	Net book Value
Patents	\$ 66,900	\$ 5,389	\$ 61,511
Licensed technology	1	-	1
Trademarks	13,236	1,305	11,931
Deferred charge (i)	50,000	26,438	23,562
	<u>\$ 130,137</u>	<u>\$ 33,132</u>	<u>\$ 97,005</u>

- (i) A \$50,000 non-interest bearing unsecured employee loan was advanced during the year ended June 30, 2000. The loan has been forgiven over a four year period in accordance with the terms of the employment contract.

8. Related Party Transactions

In addition to the related party transactions described in other notes to the consolidated financial statements, the Company had the following transactions:

- (i) To facilitate officers and employees participation in the ownership of the Company, a director acquired 700,000 shares of the Company at a cost of \$0.50 per share (\$350,000) from BC Research Inc., a principal shareholder. The shares were converted to 980,000 post-RTO shares with an effective cost of \$0.36 per share, and are subject to escrow restrictions as explained in Note 10(c)(i). The officers and employees acquired the shares at the effective cost of \$0.36 and paid by cash – \$76,499 or through share purchase loans funded by the Company – \$273,501. The share purchase loans are repayable on April 24, 2004, bear interest at the Canada Customs and Revenue Agency prescribed rate (3 to 4% in the year ended December 31, 2003) and can be repaid at any time during the term. \$167,037 of loan principal was repaid in the year ended December 31, 2003 (six months ended December 31, 2002 - \$Nil; year ended June 30, 2002 - \$14,287). The outstanding loans are secured by pledges of the applicable shares. Officers of the Company purchased 693,800 of the post-RTO shares. The balance of the employee loans at the respective year ends is as follows:

	December 31 2003	December 31 2002	June 30 2002
<u>Employee Loans</u>			
Share purchase loans	\$ 91,727	\$ 259,214	\$ 259,214

- (ii) During the year ended December 31, 2003 the Company paid \$306,667 to a company controlled by a officer/director for services rendered to the Company in his capacity as an executive officer (six months ended December 31, 2002 - \$115,500; year ended June 30, 2002 - \$241,363). In the year ended June 30, 2002 the Company paid \$14,018 to a company controlled by an executive officer in respect of strategic consulting services.
- (iii) The costs of administrative services provided by BC Research Inc. to the Company during the year ended December 31, 2003 amounted to \$15,712 (six months ended December 31, 2002 - \$7,073; year ended June 30, 2002 - \$29,608).
- (iv) The Company paid \$141,404 in rent to BC Research Inc. for leased premises and equipment during the year ended December 31, 2003 (six months ended December 31, 2002 - \$74,843; year ended June 30, 2002 - \$151,256). The Company paid \$nil in the year ended December 31, 2003 to BC Research Inc. as a fee to gain access to a workshop facility (six months ended December 31, 2002 - \$2,916; year ended June 30, 2002 - \$10,000).

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Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

8. Related Party Transactions (cont'd)

- (v) On January 29, 2002, the Company completed a placement of 10,400,000 Special Warrants, at a price of \$0.50 per Special Warrant, of which 296,443 Special Warrants were issued to parties related to directors and officers of the Company at that time.
- (vi) On November 21, 2002, the Company completed a private placement of 1,300,000 units, at a price of \$0.50 per unit, of which 150,000 units were issued to a party related to a director at that time.
- (vii) Effective July 31, 2003, the Company completed a \$2,216,000 secured convertible debenture financing, \$256,000 of which was issued to parties related to directors at that time.
- (viii) The Company incurred advisory costs of \$30,000 that are payable to a director during the year ended December 31, 2003 (six months ended December 31, 2002 and year ended June 30, 2002 - \$nil)

All the related party transactions have been recorded at the agreed upon exchange amount. The exchange amounts agreed upon reflect the carrying values and approximate fair values of the services rendered.

9. Pension Contributions

After an executive officer or employee has completed one year of service, the Company will contribute up to 5% of the officer's or employee's base salary to a self-directed registered retirement plan. The resultant pension contribution expense is recorded in the period that the services are rendered by the officer or employee. The Company incurred pension contribution expenses for the year ended December 31, 2003 of \$76,450 (six months ended December 31, 2002 - \$37,334; June 30, 2002 - \$23,381).

10. Share Capital, Special Warrants and Stock Options

- (a) Authorized
 - Unlimited common shares without par value
 - Unlimited preferred shares without par value, non cumulative, redeemable, and non voting

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Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

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

(b) Issued and outstanding common shares

	Number of shares		Amount
	Pre RTO	Post RTO	
Balance, June 30, 1999	2	2	\$ 2
Issued to acquire certain intellectual Properties	5,199,998	7,279,998	1
Private placement	1,794,500	2,512,300	1,795
Private placement	2,600,000	3,640,000	650,000
Issued for services	100,000	140,000	25,000
Balance, June 30, 2000	9,694,500	13,572,300	\$ 676,798
Private placement	6,574,600	9,204,440	2,298,231
Issued for services	120,000	168,000	-
Balance before RTO (i)	16,389,100	22,944,740	2,975,029
RTO transaction		1,526,269	(274,573)
Share issue costs on RTO transaction		-	(248,038)
Issued on exercise of options		178,000	44,500
Balance, June 30, 2001		24,649,009	\$ 2,496,918
Private placement (ii)(iv)		8,000,000	3,511,250
Private placement (iii)(iv)		10,400,000	5,000,195
Issued on exercise of options		266,700	66,675
Private placement (v)		240,000	120,000
Balance, June 30, 2002		43,555,709	\$ 11,195,038
Issued on exercise of options		125,333	33,867
Private placement (vi)		1,300,000	560,000
Balance, December 31, 2002		44,981,042	\$ 11,788,905
Issued in lieu of non-executive director fees		50,000	25,000
Issued on exercise of options		164,000	42,250
Equity issue cost recovery		-	16,220
Special warrants converted to shares (vi)		200,000	90,000
Private placement (viii)		25,382,126	9,858,098
Debenture conversion (vii)		7,386,668	2,171,192
Balance, December 31, 2003		78,163,836	\$ 23,991,665

(c) Issued and outstanding special warrants

	Number	Amount
Special A Warrants issued for cash (ii)	8,000,000	\$ 3,600,000
Less special warrants subscription receivable	-	(100,000)
Balance, June 30, 2001	8,000,000	3,500,000
Special A Warrants subscription received (ii)	-	100,000
Special A Warrants issue costs (ii)	-	(88,750)
Special B Warrants issued for cash, net of issuance costs (iii)	10,400,000	5,000,195
Less Special A and B Warrants converted to shares (iv)	(18,400,000)	(8,511,445)
Balance, June 30, 2002	-	-
Special Warrants issued for cash, net of issuance costs (vi)	200,000	90,000
Balance, December 31, 2002	200,000	90,000
Less special warrants converted to shares (vi)	(200,000)	(90,000)
Balance, December 31, 2003	-	\$ -

Azure Dynamics Corporation
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Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

10. Share Capital, Special Warrants and Stock Options (c) (cont'd)

- (i) 14,288,200 common shares were subject to escrow restrictions pursuant to a business combination (Note 3). There are 2,143,230 common shares subject to escrow restrictions as at December 31, 2003 (December 31, 2002 – 6,429,690, June 30, 2002 – 8,572,920). 2,143,230 common shares will be released from escrow restrictions on each subsequent date that is 24, 30, and 36 months from the issue date of April 24, 2001.
- (ii) On June 28, 2001 the Company completed a non-brokered placement of 8,000,000 Special A Warrants at a price of \$0.45 each for net proceeds of \$3,511,250 after deducting issuance costs of \$88,750. Each Special A Warrant entitled the holder to receive, at no additional cost, one common share.
- (iii) On January 29, 2002 the Company completed a non-brokered placement of 10,400,000 Special B Warrants at a price of \$0.50 each for net proceeds of \$5,000,195 after deducting issuance costs of \$199,805. Each Special B Warrant entitled the holder to receive, at no additional cost, one common share.
- (iv) On February 5, 2002 the Company received a receipt for its final prospectus (dated January 31, 2002) from the British Columbia, Alberta, and Ontario Securities Commissions relating to the qualification of 8,000,000 Common Shares issuable upon the exercise of 8,000,000 Special A Warrants and 10,400,000 Common Shares issuable upon the exercise of 10,400,000 Special B Warrants, whereupon the Special A and B Warrants were exercised and converted into common shares.
- (v) Effective June 30, 2002, the Company entered into a private placement subscription agreement for 240,000 common shares of the Company, at a price of \$0.50 per share, for gross proceeds of \$120,000 in conjunction with a lease termination – refer to Note 4.
- (vi) On November 21, 2002, the Company completed a private placement of 1,300,000 units of the Company (the "Unit Financing"), at a price of \$0.50 per unit, for net proceeds of \$560,000 after deducting issue costs estimated at \$90,000. Under the Unit Financing, each unit is comprised of one common share of the Company and one quarter warrant, each whole warrant being exercisable into one common share at \$0.55, until November 30, 2003. These warrants expired unexercised on December 1, 2003.

The Company also completed a private placement of 200,000 Special Warrants of the Company (the "Special Warrant Financing"), at a price of \$0.50 per Special Warrant, for net proceeds of \$90,000 after deducting issue costs estimated at \$10,000. Under the Special Warrant Financing, each Special Warrant is exercisable into one common share of the Company and one Warrant, each Warrant being exercisable into one common share at \$0.55, until November 30, 2003. On November 30, 2003 the Special Warrants were exercised into 200,000 common shares of the Company and 200,000 Warrants; the Warrants, exercisable into common shares at \$0.55, expired unexercised on December 1, 2003.

- (vii) Effective July 31, 2003, the Company completed a \$2,216,000 secured convertible debenture financing. The Debentures were to mature on June 30, 2004 and were secured by all of the property of the Company and 100% of the equity of the Company's operating subsidiary, Azure Dynamics Inc. The Debentures did not bear interest. The Company could repay the Debentures at any time, and at such time each Debenture holder could elect to be repaid in cash or shares. On December 19, 2003 the Company redeemed the Debentures; all the Debenture holders elected to be redeemed by way of conversion, and in accordance with the terms of the Debentures, such conversion took place at a conversion price equal to \$0.30 per share thereby giving the holders 7,386,668 common shares of the Company.

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Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

10. Share Capital, Special Warrants and Stock Options (c) (vii) (cont'd)

As these debentures were considered to be compound financial instruments, the liability component and the equity component, as determined at initial recognition, were presented separately. The Company valued the equity component of these debentures using the 'residual value of equity component' method, whereby the liability component was valued first using the current market rates for comparable instruments, at the time of issuance, and the difference between the proceeds of the debentures issued and the fair value of the liability was assigned to the equity component. The resulting liability and equity values determined using this method, based on an 8% interest rate, was as follows:

Convertible Debentures

Balance, December 31, 2002	\$ -
Issued during the period	2,216,000
Less: equity component	<u>(177,500)</u>
	2,038,500
Accretion on conversion feature for the period	<u>74,144</u>
	2,112,644
Converted to equity during the year	<u>(2,112,644)</u>
Balance, December 31, 2003	\$ -

The Company accreted the equity component of the debentures on a pro rata basis over their term such that the debt would equal the original face value of the debentures upon maturity; an accretion charge to operations of \$74,144 was recorded in the year. Debenture issue costs, amounting to \$207,095, were recorded as deferred costs on the balance sheet; an amortization charge to operations of \$88,143 was recorded in the year. On conversion of the debentures on December 19, 2003, the carrying value of the convertible debenture liability of \$2,112,644 was credited to share capital and the unamortized balance of deferred debenture issue costs of \$118,952 was charged to share issue costs. Upon conversion, the debenture balance outstanding plus the original value of the equity component less the deferred issue costs totalling \$2,171,192 was credited to share capital.

(viii) On December 1, 2003, the Company completed a private placement of 25,382,126 common shares of the Company ("Units"), at a price of \$0.42 per unit, for net proceeds of \$9,894,470 after deducting issue costs of \$766,023. In conjunction with the financing, the Company issued 12,691,063 warrants, each warrant being exercisable into one common share of the Company at \$0.62 until December 1, 2004. The Company also issued 2,325,508 compensation options to agents, each option being exercisable into one common share of the Company at \$0.495 up until December 1, 2004. The Company recorded a charge of \$36,372 to share capital and a corresponding credit to contributed surplus in respect of the deemed issue costs of the warrants and options in accordance with the Canadian Institute of Chartered Accountants handbook section 3870 - Stock-Based Compensation and Other Stock-Based Payments ("Section 3870").

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Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

10. Share Capital, Special Warrants and Stock Options (c) (cont'd)

(ix) Effective January 1, 2003, the Company adopted the revised recommendations in Section 3870 whereby it is required to record a compensation expense charge for options granted (previously, with effect from July 1, 2002, and as permitted by Section 3870, the Company only reported the pro-forma impact of stock options granted to officers, directors and employees and during the period July 1, 2002 to December 31, 2002, reported a pro-forma impact on compensation expense and credit to share capital of \$1,192). The Company's accounting policy is described in note 2(k). The Company recorded a compensation expense charge of \$131,426 during the year with a corresponding credit to contributed surplus (2002 – \$nil). The Company measures compensation costs associated with stock-based compensation using the fair value method and the cost is recognized over the vesting period of the underlying security. 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%, expected life - 5 years, expected dividend yield - nil, and expected volatility - 0.17%.

(d) Stock Options

The Company operates a Stock Option Plan (the "Plan") under which common shares can be reserved for issuance to executive officers and directors, employees and consultants. The exercise price of the options is determined by the Board of Directors estimate of the fair value of the common shares at the grant date. The options have a maximum term of five years and generally vest over a period of twelve to twenty-four months. On May 11, 2003 the Company received shareholders' approval to increase the maximum number of stock options that may be issued under the terms of the stock option plan from 6,461,800 to 6,754,656. At December 31, 2003, 417,656 further options are available for future grant under the Plan.

Azure Dynamics Corporation
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Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

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

Stock option transactions for the respective periods and the number of stock options outstanding are summarized as follows:

	Number of Optioned Common Shares	Weighted Average Exercise Price
Executive Officers, Directors, Employees and Consultant Options:		
Balance, June 30, 2000	-	\$ -
Options attributable to pre RTO	12,000	2.50
Options expired	(12,000)	2.50
Options granted	5,141,000	0.25
Options cancelled	(1,945,000)	0.25
Balance, June 30, 2001	3,196,000	0.25
Options granted	2,526,000	0.63
Options exercised	(266,700)	0.25
Options cancelled	(126,500)	0.28
Options expired	(9,200)	0.25
Balance, June 30, 2002	5,319,600	0.43
Options granted	20,000	0.53
Options exercised	(53,333)	0.30
Options expired	(281,267)	0.36
Balance, December 31, 2002	5,005,000	0.44
Options granted	1,990,000	0.44
Options exercised	(164,000)	0.26
Option cancelled	(75,000)	0.48
Options expired	(583,000)	0.50
Balance, December 31, 2003	6,173,000	0.44
Broker Financial Advisory Options:		
Balance, June 30, 2001 and June 30, 2002	72,000	0.25
Options exercised	(72,000)	0.25
Balance, December 31, 2002 and 2003	-	-
Agent's Compensation Options:		
Options granted	2,325,508	0.495
Balance, December 31, 2003	2,325,508	0.495
Total Options Outstanding, December 31, 2003	8,498,508	\$ 0.45

Azure Dynamics Corporation
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Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

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

Stock options outstanding and exercisable as at December 31, 2003 are as follows:

Expiry date	Number of optioned common shares		Exercise price
	Outstanding	Exercisable	
	#	#	\$
December 1, 2004	2,325,508	2,325,508	0.495
April 25, 2006	2,378,000	2,378,000	0.25
August 20, 2006	282,000	282,000	0.44
November 5, 2006	227,000	227,000	0.45
November 26, 2006	112,000	112,000	0.50
January 22, 2007	50,000	33,333	0.61
February 12, 2007	55,000	36,667	0.61
March 7, 2007	20,000	13,333	0.71
March 11, 2007	1,150,000	766,667	0.73
April 12, 2007	30,000	20,000	0.94
May 1, 2007	145,000	96,667	0.80
January 1, 2008	335,000	253,333	0.50
February 1, 2008	164,000	54,667	0.50
August 25, 2008	475,000	158,333	0.30
September 26, 2008	750,000	250,000	0.48
Total Options	8,498,508	7,007,508	

11. Income Taxes

As at December 31, 2003, the Company has unclaimed scientific research and experimental development expenditures of \$3,524,318 that are available to offset future taxable income. These expenditures are available for indefinite carry forward. The Company also has \$10,456,799 of non-capital tax losses that are available for carry forward to offset future taxable income, and \$1,653,307 of investment tax credits that are available to offset future income taxes payable, that expire as follows:

	Non-Capital Losses	Investment tax credits
2004	591,019	-
2005	212,012	-
2006	1,105,303	-
2007	652,430	29,508
2008	3,537,565	18,534
2009	2,573,530	213,160
2010	1,784,940	109,180
2011	-	719,850
2012	-	365,024
2013	-	198,051
	\$ 10,456,799	\$ 1,653,307

The Company also has net temporary tax differences of \$1,498,601, relating primarily to capital assets and share issue costs, which may be used to offset future taxable income.

The ability of the Company to utilize the losses and other tax balances carried forward in the future is not reasonably assured and therefore has not been recognized in the financial statements. The effective tax rate for the Corporation is approximately 42%. The difference between the effective rate and the actual rate of nil% is attributable to the fact that no future tax asset has been recorded for available loss carry forwards as their ultimate utilization is uncertain.

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

12. Projects Under Development

The Company is commercializing its technology for hybrid electric vehicle control systems for commercial vehicles, such as postal and courier step-vans. Its activities can be categorised into the following categories/projects:

Hybrid Vehicle Energy Management Research

The Company incurs costs with respect to the ongoing refinement and development of adaptive energy management systems for hybrid vehicles – the Company’s core technology.

The Company incurred \$21,411 in research and development expenses for the year ended December 31, 2003 (\$44,667 – six months ended December 31, 2002; \$114,863 – year ended June 30, 2002) related to Hybrid Vehicle Energy Management Research. No costs have been deferred or capitalized and no sales revenue has been earned from this research.

Series Hybrid Electric Vehicle 7,500 – 14,000 lbs GVW (“G1”) Development Project

The Company’s current focus is on development of a series hybrid power train package for a commercial vehicle in the weight class 7,500 – 14,000 lbs GVW (gross vehicle weight) and demonstration of the proprietary smart energy management system. The vehicles in this class typically deliver urban mail and packages and are also used in small shuttle bus applications. The design and engineering (Concept prototype) phase of this project was completed during the year ended June 30, 2002. During 2002/2003 the project progressed through the development and engineering phase (Engineering prototype) and is currently in the confirmation development and testing phase (Confirmation prototype).

The Company incurred \$2,897,003 in research and development expenses for the year ended December 31, 2003 (\$866,088 – six months ended December 31, 2002; \$2,395,838 – year ended June 30, 2002) related to this project. No costs have been deferred or capitalized and no sales revenue has been earned from this project.

Series Hybrid Electric Vehicle 5,000 – 7,500 lbs GVW (“G2r”) Development Project

The Company is also developing a series hybrid power train package for a commercial vehicle in the weight class 5,000 – 7,500 lbs GVW. The vehicles in this class typically deliver urban mail, small packages and are also used in taxi applications. This project is in the design and engineering phase (Concept prototype).

The Company incurred \$523,389 in research and development expenses for the year ended December 31, 2003 (\$44,274 – six months ended December 31, 2002; \$258,081 – year ended June 30, 2002) related to this project. No costs have been deferred or capitalized and no sales revenue has been earned from this project.

Third Party Development Costs

In January 2002, the Company entered into a strategic alliance agreement with Hydro-Québec CapiTech Inc. (“CapiTech”) the terms of which included a \$665,000 payment by the Company to a CapiTech subsidiary for services in respect of the collaborative research and development of technology relating to hybrid electric vehicle components.

Azure Dynamics Corporation
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Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

12. Projects Under Development (cont'd)

Development Cost Contribution Agreements

On March 31, 2002 the Company entered into a \$9 million Research and Development agreement with the Government of Canada, through its Technology Partnerships Canada ("TPC") program. The agreement provides for a 26.6% contribution by TPC towards specified expenditures in respect of the research and development of the G1 and G2r hybrid electric power trains, up to a maximum reimbursement of \$9 million. The Company has claimed reimbursable costs amounting to \$948,376 in the year ended December 31, 2003 (\$264,455 – six months ended December 31, 2002; \$567,626 – year ended June 30, 2002). Reimbursable costs are recorded as a credit to research and development expenses on the income statement; claims not settled by the balance sheet date are recorded as assets (contributions receivable) on the balance sheet. Cost reimbursement claims are subject to review by TPC and to disbursement conditions based on financing amounts to be raised by Azure.

The Company has also received customer and third-party sponsorship contributions amounting to \$1,349,828 in the year ended December 31, 2003 which amount is recorded as a credit to research and development expenses on the income statement. In total, contributions from all sources (including investment tax credits in the past) were \$2,298,204 in the year ended December 31, 2003 (\$264,455 – six months ended December 31, 2002; \$579,501 – year ended June 30, 2002).

13. Commitments

- (a) The Company has committed to lease payments for premises and equipment requiring minimum payments in future periods as follows:

2004	\$	341,000
2005		264,000
2006		180,000
2007		181,000
2008		181,000
2009		60,000
	\$	1,207,000

The commitments include \$42,000 payable to BC Research Inc. for premise and equipment leases.

- (b) Pursuant to a contractual agreement with National Research Council Canada, the Company is required to make royalty payments in the event that the Company successfully commercializes its intellectual properties specified in this agreement. The royalty payments, if any, are calculated at a rate of 1% of yearly gross sales earned from its intellectual properties. The obligation to make royalty payments expires at the earlier of January 2011 or when aggregate royalty payments reach \$296,242.
- (c) Pursuant to a contractual agreement with Technology Partnerships Canada, the Company is required to make royalty payments equal to the greater of 0.28% of yearly gross sales or in accordance with a repayment schedule, with repayment amounts ranging from \$0 to \$1,327,507, 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 2018 or when a cumulative payment ceiling of \$20,532,400 is reached.

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Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

13. Commitments (cont'd)

- (d) Pursuant to a contractual agreement with EnCana Corporation, whereby EnCana sponsored the development of power train product, the Company is required to make royalty payments equal to 1% of gross revenue from sales of the power train product up to a maximum payment of \$1 million.
- (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, ranging from one to two year's compensation, and the immediate vesting of all options previously granted, in the event of termination without cause and in some cases in the event of termination due to a change in the control of the Company.

14. Net Changes in Non-Cash Operating Working Capital

	Year ended December 31 2003	Six months ended December 31 2002	Year ended June 30 2002	Cumulative Since Inception
Investment tax credits				
Receivable	\$ -	\$ -	\$ 147,341	\$ -
Accounts receivable	(309,541)	40,073	99,066	(529,567)
Contributions				
Receivable	(516,004)	303,171	(492,401)	(705,234)
Prepaid expenses	(48,335)	40,642	19,039	(61,654)
Accounts payable and accrued liabilities	220,830	(95,312)	(240,868)	511,584
	\$ (653,050)	\$ 288,574	\$ (467,823)	\$ (784,871)

15. Financial Instruments

At December 31, 2003, substantially all of the Company's cash was held at a recognized Canadian national financial institution. As a result, the Company was exposed to all of the risks associated with that institution.

Pursuant to certain agreements with industry partners, the Company is to receive approximately \$800,000 in development cost contributions that are denominated in foreign currencies. As such the Company is exposed to foreign currency exchange risk.

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Notes to Consolidated Financial Statements

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

16. Subsequent Events

- (a) Effective January 1, 2004, the Company issued, subject to shareholders and regulatory approval, stock options as follows:
- (i) 328,847 director options in lieu of the cash payment of annual non-executive director's fees;
 - (ii) 115,380 consultant options in lieu of the cash payment of annual fees to the Company's advisory board members;
 - (iii) 1,103,000 employee options.

The options are exercisable at \$0.65 per share, expire on January 1, 2009, and have vesting terms ranging from twelve to twenty-four months. The Company also issued 42,307 common shares, at \$0.65 per share, in lieu of the cash payment of annual non-executive director's fees.

- (b) On January 16, 2004, the Company announced the appointment of Harbour Financial Inc. to provide investor relations support for a twelve-month period, commencing January 15, 2004, subject to an initial performance review period. The Company issued 250,000 consultant stock options exercisable at \$0.70 per share, subject to satisfaction of the initial performance review period, expiring December 31, 2004.
- (c) Effective February 1, 2004, the Company issued 100,000 employee stock options exercisable at \$0.85 per share, expiring February 1, 2009, with vesting over a twenty-four month period.
- (d) On February 5, 2004, the Company announced the signing of a demonstration agreement with Leyland Product Development ("LPD") and Zebra Batteries ("Zebra") whereby the parties, in cooperation with a European truck manufacturer, agreed to develop an electric van for display, demonstration and marketing purposes.
- (e) On March 11, 2004, the Company announced the completion of a private placement financing of 4,861,110 common shares, at a price of £0.36 (approximately \$0.90), raising net proceeds of approximately \$3.9 million.

Azure Dynamics Corporation
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Supplementary Information

Year ended December 31, 2003, six months ended December 31, 2002, and year ended June 30, 2002

Breakdown of expenses by major category:

	Years ended December 31		Six months ended December 31		Year ended June 30	Cumulative Since Inception
	2003	2002	2002	2002	2002	Inception
	(unaudited)					
Research and Development Expenses						
Salaries & benefits	\$ 1,046,986	\$ 1,472,799	\$ 655,783	\$ 1,473,807	\$ 4,056,727	\$ 4,056,727
Recruitment and relocation	1,977	8,460	-	91,636	93,613	93,613
Consulting fees	174,807	64,599	-	-	174,807	174,807
Outsourced labour	104,675	-	-	-	104,675	104,675
Legal fees	22,774	-	-	-	22,774	22,774
Product development costs	1,914,329	216,073	207,870	502,263	3,230,898	3,230,898
Third party product development	-	665,000	-	665,000	665,000	665,000
Telephone, fax and internet	5,760	8,205	-	-	5,760	5,760
Travel expenses	94,116	158,599	62,150	143,123	336,893	336,893
Miscellaneous costs	76,379	83,706	29,226	99,510	247,948	247,948
	\$ 3,441,803	\$ 2,677,441	\$ 955,029	\$ 2,975,339	\$ 8,939,095	
Less: Government, customer and sponsorship contributions and investment tax credits	2,298,204	832,081	264,455	579,501	3,306,385	
	\$ 1,143,599	\$ 1,845,360	\$ 690,574	\$ 2,395,838	\$ 5,632,710	
Selling and Marketing Expenses						
Salaries & benefits	\$ 543,632	\$ 465,116	\$ 194,179	\$ 403,535	\$ 1,208,746	\$ 1,208,746
Recruitment and relocation	-	14,500	14,500	-	14,500	14,500
Consulting fees	500	10,500	1,000	84,494	156,794	156,794
Marketing/ advertising and PR	33,405	68,924	11,531	80,013	129,102	129,102
Telephone, fax and internet	20,433	20,292	9,047	19,817	49,297	49,297
Travel expenses	119,086	192,463	90,050	168,137	417,105	417,105
Miscellaneous costs	1,289	942	597	345	2,231	2,231
	\$ 718,345	\$ 772,737	\$ 320,904	\$ 756,341	\$ 1,977,775	
General and Administrative Expenses						
Salaries & benefits	\$ 655,930	\$ 714,840	\$ 277,748	\$ 701,641	\$ 1,937,655	\$ 1,937,655
Recruitment and relocation	11,056	72,449	65,349	55,546	163,860	163,860
Consulting fees	164,150	328,793	104,190	319,230	766,568	766,568
Office supplies	10,083	17,566	5,434	30,300	83,642	83,642
Contract services	15,712	14,666	7,073	29,608	89,609	89,609
Travel expenses	123,109	183,734	88,468	158,553	458,886	458,886
Directors' fees	25,000	-	-	-	25,000	25,000
Audit and tax services	32,661	51,425	22,470	36,106	150,052	150,052
Legal fees	70,463	110,091	31,771	137,792	340,984	340,984
Insurance	65,769	39,343	28,719	33,680	157,645	157,645
Regulatory filing and transfer Fees	49,402	10,790	-	-	49,402	49,402
Telephone, fax and internet	48,194	75,718	33,759	78,298	160,251	160,251
Miscellaneous costs	34,945	46,344	43,451	72,094	191,693	191,693
	\$ 1,306,474	\$ 1,665,759	\$ 708,432	\$ 1,652,848	\$ 4,575,247	

DIRECTORS

Thomas N. Davidson, Sr., Chairman of the Board, has been Chairman of Quarry Hill Group, a private investment holding partnership, since 1989, and Chairman of NuTech Precision Metals since 1990. During Mr. Davidson's career, he has been a principal owner of several U.S., Canadian, and European enterprises and a director of numerous Canadian and U.S. companies. He is currently a director of MDC Corporation Inc. (MDZ.A: TSX) and TLC Laser Eye Centres Inc. (TLC: TSX) (TLCV: NASDAQ). He was International President of the Young Presidents Organization, and Past International President of the World Presidents Organization. Mr. Davidson was recognized as Canadian Entrepreneur of the Year in 1979, and Plastic Industry Man of the Year in 1985.

D. Campbell Deacon, Deputy Chairman, is the Chief Executive Officer of the company. From 1994 to 1999 he was the President of UTS Energy Corporation. From 1986 to 1994 he was Chairman and CEO of Deacon Barclays de Zoete Wedd, an international investment banking firm. Mr. Deacon was Vice-Chairman and then Chairman of the Investment Dealers Association of Canada from 1991-1993. Mr. Deacon is currently a director of the following public companies: CPI Plastics Group (CPI: TSX) and UTS Energy Corporation (UTS: TSX).

Nicholas O. Brigstocke, Director, retired in 2001 as Chairman, Equity Capital Markets at Credit Suisse First Boston. He joined Credit Suisse First Boston when CSFB purchased Barclays de Zoete Wedd in January 1998, at which time he was Chairman and Managing Director of BZW's U.K. corporate broking business. Prior to that time, Mr. Brigstocke was head of the Institutional Equity sales team and a member of the Equity Management Committee at BZW. He is currently a non-executive director of Turbo Genset PLC. (TGN: TSX), DDD Group PLC., Bridgewell Ltd. and Healthcare Enterprises Group.

David E. Deacon, Director, is the President and Chief Operating Officer of the Company. Mr. Deacon became the General Manager of Porsche Canada in 1983. He then started Deacon Day Advertising in 1988 with BMW as his major client. He sold it in 1993 to the Interpublic Group, a NYSE listed company. For the next several years, he ran another major Canadian advertising company with Mercedes Benz as its major client before starting Investment Profile Inc., a business specializing in building brands. Mr. Deacon is familiar with corporate affairs and government relations through his long involvement in politics, including a term as President of the Ontario Liberal party.

Robert A. Donaldson, Director, formed a business and law consulting company in 1998 which presently serves as General Counsel to two publicly listed Canadian corporations. He is a member of the board of directors of several Canadian companies – public and private. In 1966 he was called to the bar of Ontario and was appointed Queen's Counsel in January of 1985. Mr. Donaldson has over 30 years experience practicing law as a senior partner with major Canadian law firms. Mr. Donaldson has considerable experience and expertise in the areas of acquisitions and mergers, the raising of capital by way of private placement or prospectus, foreign investment review, biotechnology, the regulation of health, the regulation of Canadian financial institutions, directors' and officers' liability and corporate governance. Mr. Donaldson has chaired or participated in many securities law conferences, written numerous articles on securities law topics and has taught corporate finance and securities regulation and corporate governance as a special lecturer at Osgoode Hall Law School and the University of Western Ontario Law School.

Roberto Quarta, Director, has enjoyed a distinguished international career in industry spanning four decades. Based in London, Mr. Quarta is currently a Partner and the CEO of Clayton Dubilier & Rice, Europe ("CD&R"). CD&R is one of the world's leading private equity firms with investments in over 35 diverse businesses with a total enterprise value in excess of \$18 Billion and revenues of over \$25 Billion. As Partner and CEO, Mr. Quarta is responsible for leading potential acquisitions and actively chairing the fully constituted boards of portfolio companies. Mr. Quarta is also the Non-Executive Chairman of BBA Group plc of the UK, the Chairman & CEO of Italtel Holdings SpA of Italy, and a non-Executive Director of Equant NV.

DIRECTORS – Continued

Dennis A. Sharp, Director, has been the Chairman and Chief Executive Officer of UTS Energy Corporation (UTS: TSX) since 1998. He is a director of several companies including EnCana Corporation (ECA: TSX), and BachTech Enviromet Corporation (YBA: TSX Venture). He has served as a Governor of the Canadian Association of Petroleum Producers (CAPP) from March 1994 to July 1997, Vice Chairman of CAPP from 1995 to 1996 and Chairman from 1996 to 1997. He is a geological engineer and he founded CS Resources Ltd. in 1984, which he led until its acquisition in July 1997 by Pan Canadian Petroleum Ltd. In 1993 CS Resources received the Alberta Science and Technology award for outstanding commercial achievement. In 1997 Mr. Sharp was honoured as one of Canada's Master Entrepreneurs.

OFFICERS

Wesley M. Arnold is Vice-President, Operations. Mr. Arnold joined Azure on July 30, 2001 from Western Star Trucks where he spent 9 years. His most recent role at Western Star was that of Manager of Body Engineering. In this role he managed product development of cab and sleeper structures, interiors and systems (including electrical) on heavy class 8 trucks. Other roles at Western Star included project engineering manager, group leader for cab development, and design leader for the Star Light Sleeper program. Mr. Arnold also invented a unique cab-sleeper mounting system for class 8 trucks. For seven years prior to joining Western Star Mr. Arnold gained experience in lightweight structures and systems in the Canadian Aircraft industry. He was employed in stress, structures and design positions at Bristol Aerospace, Boeing de Havilland, and Northwest Industries division of CAE. Mr. Arnold holds a Bachelor of Science in Aerospace Engineering from the University of Michigan as well as diplomas from the Southern Alberta Institute of Technology (AET & MET).

Felicia B. Bortolussi, Secretary, is a corporate finance lawyer with the Calgary office of Heenan Blaikie LLP, where she has been practicing since October 2001. Prior to that, Ms. Bortolussi practiced with a corporate finance boutique law firm in Calgary from 1996 to 2001, and with a full service Bay Street law firm from 1993 to 1995. Ms. Bortolussi has advised both emerging and established companies on corporate commercial and securities law matters ranging from public and private equity and debt financings, corporate reorganizations, securities regulatory compliance, shareholder disputes and corporate governance.

Gregory P. Francis is Senior Vice-President, Finance and Chief Financial Officer. Mr. Francis has over 20 years of experience in international financial management and business operations. Before joining Azure he held the position Vice-President, Operations West at Kinacor – a division of Wajax Limited, a Canadian company listed on the Toronto Stock Exchange. From 1995 to 1998, he served as Corporate Controller for Wajax Limited. Prior to coming to Canada in 1995, Mr. Francis was European Controller of Pepe Group Plc, an international branded clothing company based in London, England. Mr. Francis is a Chartered Accountant and served 7 years in public accounting practice with KPMG in Durban, South Africa and London, England.

Steven Glaser is Vice-President, Corporate Affairs. Mr. Glaser joined Azure in August of 2001 from Seymour Capital, a company he founded in December of 1997 to provide seed investment capital and business development consultation to start-up businesses. Mr. Glaser also managed a small portfolio of private investment funds, trading in the North American equity and option markets. Prior to Seymour Capital, Mr. Glaser spent 8 years with the Royal Bank in various customer service and consulting positions. His last position held was that of Human Resource software consultant. In this role Mr. Glaser gave seminars to Royal Banks corporate clients regarding systems migration. During his tenure with the bank he completed a Bachelor of Administrative Studies degree at York University, graduating in 1996 and a Master of Business Administration degree at Wilfred Laurier University, Waterloo, graduating in 1997.

OFFICERS – continued

Ronald V. Iacobelli is Senior Vice-President, Development and Operations. Mr. Iacobelli joined Azure on April 2, 2001 from Ballard Power Systems where he developed and led a supplier management program. Prior to that, Mr Iacobelli spent 7 years at Ford Motor Company as Supplier Quality Manager, Senior Electrical Systems Engineer and Senior Chassis Systems Engineer. His experience includes exposure to all automotive systems with an emphasis on quality, manufacturing, process development and supplier management. Prior to joining Ford, Mr Iacobelli was a Thermal Station Engineer with Ontario Hydro. He has a Bachelor of Applied Science in Mechanical Engineering from the University of Windsor and holds the P. Eng. designation in Ontario and British Columbia.

Ronald Spranger is Vice-President, Sales and Customer Service. Mr. Spranger joined the company in February 2004 from Ballard Power Systems' Transportation Division where he held the position of Global Sales Manager. Prior to Ballard Power Systems, Mr. Spranger held various sales and engineering positions at Johnson Controls, Robert Bosch Corporation and Sachs Automotive of America. He has extensive experience within the electric and hybrid electric drive systems industry. Mr. Spranger was a former Captain in the German Air Force. He has a Masters of Business Administration degree from Henley Management College, London, United Kingdom, as well as a Masters in Electrical Engineering degree from the University of the German Armed Forces, Munich, Germany.

ADVISORY BOARD

Dr. Nigel P. Fitzpatrick, a founder of Azure Dynamics, whose past roles include being a technical director of Alcan International Ltd. where he started Alupower Canada Ltd (now Fuel Cells Technology Inc. – FCT on TSX Venture Exchange) and was also a board member of Alupower-Chloride Ltd., a joint venture between Alcan and the Hawker Battery Group. Dr. Fitzpatrick, who graduated from Imperial College, is a recognized expert consultant in transportation, climate change, battery and fuels.

Professor Colin Besant is President and Chief Executive Officer of Turbo Genset Inc. Since 1989, he has been Professor of Computer-Aided Manufacture at Imperial College, where he leads a large research section in the field of Advanced Manufacturing Technology supported by such organizations as GEC-Marconi, Rolls-Royce Plc and the United Kingdom Atomic Energy Authority. In the early part of his career he worked on pressurized water reactor design for nuclear submarines for Rolls-Royce and associated companies, following which he joined the UKAEA as a Senior Scientific Officer. He took up his first post at Imperial College in 1963. Professor Besant has been involved in the establishment of a number of high technology companies in the fields of computer-aided design, numerical control and robotics.

Professor C.C. Chan is presently the Honda Chair of Engineering and Head of Department of Electrical & Electronic Engineering of the University of Hong Kong, President of the Hong Kong Institution of Engineers, and President of the World Electric Vehicle Association. Professor Chan was awarded an Honorary Doctor of Science degree and a Fellow of The Institute of Electrical and Electronics Engineers (USA) in 1992 for his prominent contribution to modern electric drives and electric vehicles. He is a Fellow of the Royal Academy of Engineering, UK and the First Academician of the Chinese Academy of Engineering in Hong Kong. He is also a Fellow of the Ukraine Academy of Engineering Sciences, the Hong Kong Academy of Engineering Sciences and the Institution of the Electrical Engineers, UK. He has had 11 years industrial experience and 29 years academic experience. He has been serving as Visiting Professor or Honorary Professor of a number of well known universities around the world, including UC Berkeley in 1989, and MIT in 1995. He served as General Chairman and delivered keynote speeches at a number of leading international conferences. He has published over 200 technical papers and served as Guest Editor of IEEE Transactions. He founded the International Research Centre for Electric Vehicles in 1986 and was elected as one of the three wise men in electric vehicle technology in 1990.

ADVISORY BOARD – continued

Piotr Drozd, Azure's founding Vice-President of technology, has many years of involvement in hybrid electric vehicles which led to the identification of the importance of "smart energy management." Mr. Drozd is experienced in heavy-duty equipment, transit bus technology, hybrid propulsion, energy management and vehicle emissions. He was a project engineer at Ortech Corporation (1990 to 1995) involved in contract research and development in the area of computer-aided engineering. Mr. Drozd was involved in the conceptual phase of the hybrid Orion bus development, the first hybrid vehicle commercially sold in North America, and has been the principal researcher for several projects related to the implementation of hybrid buses in Canada. As a senior engineer at BC Research's (BCR) transportation group (1995 to 2000), Mr. Drozd led the technical development of an intelligent energy management system for hybrid vehicles, which resulted in two U.S. patents granted to BCR/Azure in 1999 and 2001. Mr. Drozd obtained his degree at Warsaw Technical University.

Professor Michel Gou, Professor at the École Polytechnique in Montreal. Professor Gou is past head of the section of Design of Machines of the mechanical department of engineering. He consults to industry and teaches courses on elements of machines and design. His research and consulting relates especially to subjects concerning the car industry (road safety, brakes and combustion). He has been a member of the Research Center on Transport and has directed, for more than twenty years, the road safety team of the Polytechnic School. Professor Gou was involved in the setting up and training of specialists at the Transport Canada Motor Vehicle Test Center in Blainville, Quebec. His many publications include work on conventional and natural gas engines. His consulting company employs more than nine people and he has directed many studies for industry and government.

Dr. Michael Heffring, is a former tenured Associate Professor of Marketing at the University of Calgary teaching marketing strategy courses in the MBA faculty for 10 years, until 1988. Dr. Heffring has also acted as a consultant to numerous companies such as Telus, Petro-Canada, Safeway, and General Motors. In 1980 he started a marketing research company in Calgary which grew to be the largest research company in Alberta. A 50% interest in the company was sold to the Environics Research Group of Toronto, Canada's largest privately held research company. Currently he holds the position of President, Environics West. Dr. Heffring's focus is on integrating customer databases to feed on-line and off-line marketing programs using Customer Relationship Management (CRM) software. He co-founded Ceres Integrated Solutions, in Raleigh, North Carolina. This company specialized in the development of CRM software. Clients included Blockbuster Entertainment, Wal-Mart, JC Penney, Eddie Bauer, Federated Department Stores (Bloomingdales, Bon Marche, etc.), as well as other major US retailers. The company was sold to NCR Corp. in April of 2000. The Ceres CRM software is now the basis for NCR's global CRM solution.

Michael T. McCabe was with Ford Motor Company for 30 years in marketing, sales, production programming, and finance in addition to other activities in the automotive industry. He has devoted more than six years specifically to alternative fuel vehicles. In 2001, Mr. McCabe was Marketing Manager for TH!NK Technologies, the organization within Ford Motor Company that is pioneering development of fuel cell and electric vehicles. His chief focus was to ensure that TH!NK Technologies vehicles and advanced powertrains reflected the requirements of customers by linking TH!NK engineers with the "Voice of the Customer", a process for conducting market research to identify customer demands and integrating those demands into future products. Mr. McCabe has experience in both new and established product lines – launching the new Ford Probe in 1989 and implementing marketing plans for the Ford Thunderbird and Mustang brands. Over the past several years, he has developed the marketing strategy for the Ford Ranger EV and the 2004 Ford Escape hybrid electric sport utility vehicle, as well as defined Ford Motor Company's new TH!NK brand.

ADVISORY BOARD – continued

Edwin O. Riddell is a Director of Enova Systems. Since 1999, Mr. Riddell has been President of CR Transportation Services, a consultant to the electric vehicle industry. From 1991 to 1999, Mr. Riddell was Product Line Manager of the Transportation Business Unit at the Electric Power Research Institute, and from 1985 until 1990, he served with the Transportation Group, Inc. as Vice President, Engineering, working on electric public transportation systems. From 1979 to 1985, he was Vice President, General Manager and COO of Lift-U, Inc., the leading manufacturer of handicapped wheelchair lifts for the transit industry. Mr. Riddell has also worked with Ford, Chrysler, and General Motors in the area of auto design, and has worked as a member of senior management for a number of public transit vehicle manufacturers. Mr. Riddell served as a member of the American Public Transportation Association's (APTA) Member Board of Governors for over 15 years, and has served on APTA's Board of Directors. Mr. Riddell has also been one of the Managing Partners of the U.S. Advanced Battery Consortium.

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