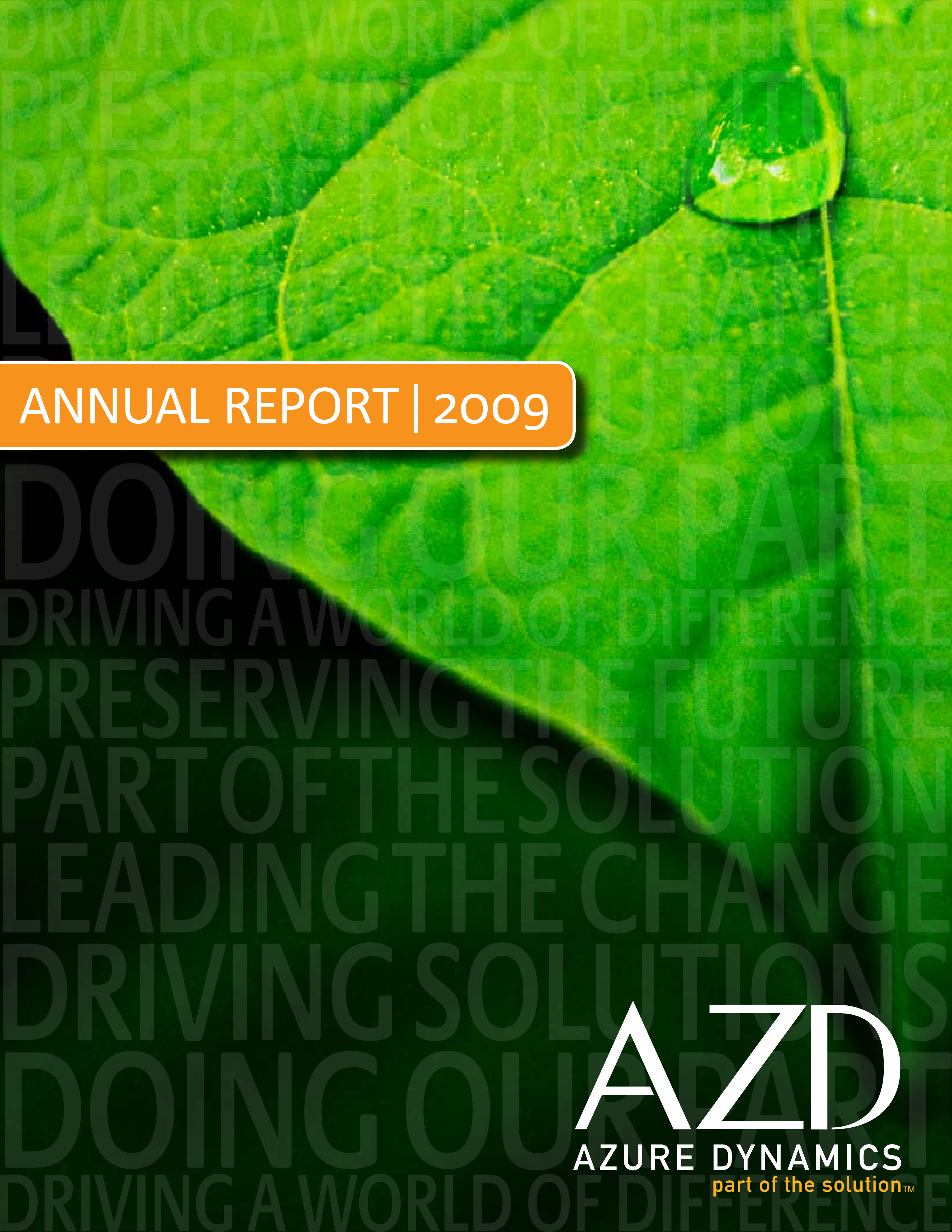
DRIVING A WORLD OF DIFFERENCE
PRESERVING THE FUTURE
PART OF THE SOLUTION
LEADING THE CHANGE
DRIVING SOLUTIONS
ANNUAL REPORT | 2009
DOING OUR PART
DRIVING A WORLD OF DIFFERENCE
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DOING OUR PART
DRIVING A WORLD OF DIFFERENCE
AZD
AZURE DYNAMICS
part of the solution™

SCOTT HARRISON, CEO
AZURE DYNAMICS CORPORATION

Azure Dynamics Corporation (TSX: AZD)(OTX: AZDDF) is a world leader in the development and production of hybrid electric and electric components and powertrain systems for commercial vehicles. Azure is strategically targeting the commercial delivery vehicle and shuttle bus markets and is currently working internationally with various partners and customers. The Company is committed to providing customers and partners with innovative, cost-efficient, and environmentally-friendly energy management solutions. For more information please visit www.azuredynamics.com.

MESSAGE TO SHAREHOLDERS

JUNE 8, 2010

Dear Shareholder:

Americans collectively breathed a huge sigh of relief at midnight, December 31, 2009. It was the end of a very difficult decade for the economy, for businesses and for individuals, and the beginning of what most experts believe will be a time of clawing back and regaining lost ground.

SCOTT HARRISON,
CHIEF EXECUTIVE OFFICER,
AZURE DYNAMICS CORPORATION

Fortunately, despite the difficulties of the past several years, it has actually been a good period for Azure Dynamics, one in which instead of losing ground we gained ground through our focus on commercialization, our continued development and refinement of industry-leading technologies, and the addition of a variety of well recognized customers to our family and well respected partners to our team.

As a result, we are a stronger, more disciplined company today than we were a decade or even a year ago with outstanding potential in an increasingly important and growing market segment. Led by our experienced and extremely competent people we have refocused the company and are developing what I have come to call 'eloquently engineered' technology to meet our customers' needs. Azure is truly becoming Part of the Solution.

So exactly what steps did we take to move Azure forward in 2009?

Following are just a few:

We started the year by reducing our cost base by 25% and sharpening our focus on the products and technologies that hold the most immediate potential for the company. We reduced our head count and our discretionary expenses and took actions to offset component price increases and share development costs with our partners. For example, by the end of 2010 we will have reduced the Balance Hybrid Electric Bill of Materials by 40%. This is indicative of our product development approach—develop a robust technology that meets commercial customer needs, then identify opportunities to reduce costs.

Also in January, we announced a five-year lithium-ion battery supply agreement with Johnson Controls-Saft (JC-S), a global industry leader in automotive power solutions. This agreement assures a consistent supply of high powered battery packs with a cost structure that will appeal to our current and potential customers. Availability of superior battery products is critical to many of the commercial vehicle contracts we are now winning.

In September we expanded our partnership with Ford Motor Company when we were awarded the coveted contract to provide the electric drive train for the 2010 North American "Truck of the Year" Ford Transit Connect. Azure's proprietary Force Drive battery electric drive train will power the Transit Connect Electric, the first electric commercial van to come to market from a major OEM. The first pre-production Transit Connect Electrics will be delivered during the fourth quarter of this year with full production to begin in April, 2011. (In May, 2010, we took another exciting step in the Transit Connect Electric project when Ford announced it had selected Azure to provide the Force Drive product for the European version of the Transit Connect which will go on sale in Europe, also in April, 2011.)

Importantly from a financial perspective we improved our cash position significantly in 2009, first with a successful private placement offering of $10 million in August, then with our $30 million offering of common shares in December. We're confident these two actions will provide the operating cash we need until sales revenues hit a continuous and predictable flow.

Despite the unquestionably tough overall economy that dominated 2009, Azure benefited from an ever increasing national focus on the environment and clean air, as well as from federal and state stimulus funding that enabled customers to hold down their purchase costs for our vehicles. As a result of that and our own aggressive sales efforts, 2009 was Azure's best sales year ever with 566 products sold to 80 new and repeat customers. Revenues for the year were 23% ahead of 2008 with fourth quarter revenues up 72% versus the year earlier period. That's the kind of trend we like to see.

A number of customers favored us with repeat business in 2009. This is especially gratifying because it says that our products are delivering on their promise in the marketplace. Included among the repeat buyers were Fed Ex Express, Purolator Courier, AT&T and the U.S. Post Office. Key new customers included Canada Post and Schwann Food as well as a number of states and municipalities which placed orders for Azure's increasingly popular Balance Hybrid Electric shuttle buses.

We also continued to add to our partnership base. In addition to Ford, Johnson Controls-Saft, Utilimaster and Kidron, we inked new agreements with Collins Bus, manufacturer of the only hybrid electric Type A (short) school bus on the market today, as well as with AM General. In addition we added 19 new Ford dealerships during the year to bring our total Ford sales and service network to nearly 50 dealerships giving us an ability to reach new customers across North America and to conveniently service their vehicles when necessary.

Much was accomplished in 2009. Much more remains to be done, and despite all the good news we are not naïve about the challenges of the future. We know we still have a long way to go before we become the company we want to be. But there is also much working in our favor.

In addition to the improving economy and the growing emphasis on green, two factors we don't control, Azure as a company is in the best position it's ever been in to take advantage of existing opportunities and to aggressively pursue new ones. We have positioned ourselves to be in the right place with the right technology and the right products at the right time. And we are ready to go.

Our technology is proven. It works. Over 25 million miles on the road says so, as do our repeat and new customers. It's no longer necessary for customers to buy one or two test units to validate Azure technology. We have on-the-road experience from a variety of satisfied customers who are willing to share the data with potential new customers. Our dependability and in-service numbers are beyond just being competitive. They are superlative.

Our relationships are solid. Our partners are growing their business with us and our customers are coming back for more. They're telling other companies about us and our reputation is growing. We are moving from a goal of wanting to be "a" leader in the commercial vehicle industry to one of wanting to be "the" leader in the alternative energy commercial vehicle industry.

Our benefits are real. Fifty percent of all fleet operating costs are in fuel. Our products offer up to 40% improvement in fuel economy. That means we offer a 20% reduction in overall operating costs and no commercial fleet owner can ignore a number like 20%, especially when the government is willing to pitch in as it is today to help reduce the front-end purchase costs. Add to that the public pressure to clean up the environment and you have both real and moral imperatives favoring Azure products.

We are proud of our accomplishments and excited about our potential. We are confident and even bullish about our future, but we will be realistic in the way we approach it. We will be cautiously aggressive and aggressively proactive in taking advantage of existing opportunities and in finding new ones and we will do everything we can to drive our products and our business to the next level.

Bottom line: Azure has reached the point our shareholders have been waiting for, a time when we will be less about making promises and more about keeping them. Our plan is in place. Our technology has been developed and refined. Our customer base is solid. Our partners are the best in industry. Our employees are passionate and dedicated. Our future is bright. We are ready!

Obviously none of this would be possible without the support of our shareholders. We appreciate that support and we appreciate your continued loyalty to Azure. We look forward to making you proud of your company and earning you the kind of return you expect and deserve.

Sincerely,

Scott T. Harrison
Chief Executive Officer

2009 MILESTONES

JANUARY 13

Azure announced a five year supply agreement with Johnson Controls-Saft under which Johnson Controls-Saft will supply the Company with its state-of-the-art lithium-ion hybrid batteries.

JANUARY 25

Azure announced a plan designed to address cost issues while meeting growing demand for its green technology solutions. The plan included a 25% workforce reduction, cuts in discretionary spending, actions to offset component cost increases and a focus on new programs that involve a sharing of development costs.

APRIL 9

Azure announced an exclusive supply agreement with Collins Bus of Kansas to create NEXBUS, the only hybrid electric Type A (short) school bus available in North America.

AUGUST 13

Azure Dynamics closed a private placement offering for gross proceeds of approximately $10,000,000.

OCTOBER 14

Azure and Kidron announced a record 248 unit Low Emission Electric Power (LEEP™) sale to Idealease on behalf of its client, Schwan Food Company.

OCTOBER 30

Azure announced its collaborative effort to deliver the Ford Transit Connect Electric van. Azure will upfit the Transit Connect with its proprietary Force Drive™ pure electric drivetrain.

NOVEMBER 9

Azure announced that FedEx Express purchased fifty-one (51) additional Azure Balance™ Hybrid Electric vans.

DECEMBER 14

Azure announced that Purolator Courier Ltd. ("Purolator") placed an order for an additional 200 Balance™ Hybrid Electric delivery trucks. The 200 unit purchase is Azure's largest revenue order ever. Purolator had already ordered 50 units earlier in the year.

DECEMBER 22

Azure closed its offering of common shares for total gross proceeds to the Company of approximately $30,000,000.

DRIVING FORWARD

2009 was a watershed year for Azure Dynamics: new focus, renewed commitment to streamlined and efficient processes, new partnerships with industry leaders, new customers and returning business from established contracts. But even as we celebrate the triumphs of '09, we're not idling on our past successes. 2010 and beyond sees us stepping into a future for our company full of exciting new developments and triumphs to come.

Hybrid and electric drive technology has moved to the forefront of public consciousness. Governments and industry leaders are getting behind our mission, increasing funding for purchase and development of clean drive technologies—and AZD's trusted, established presence in the field puts us at the front of the pack.

The need for the technology we deliver has never been clearer. Dire warnings about the status of global oil reserves, wild increases in fuel costs, a universal new mandate for companies to cut maintenance and fuel costs in a critical period of economic recovery. The world is looking to AZD as a key part of the solution like never before.

The current year has seen a constant stream of exciting new announcements issuing from our offices. New contracts from transport-dependent organizations like CINTAS and the State of Texas, aggressive new funding initiatives from governments like the State of California and others that make it easier than ever for corporations to choose greener transportation options, our partnership with Ford on the Transit Connect Electric, our move into the European market—this is just the beginning.

As we take stock in AZD's exciting achievements in 2009, we're looking forward together to more good news to come.

BEST TECHNOLOGY
BEST VALUE
BEST PARTNERS
BEST TECHNOLOGY
BEST VALUE
BEST PARTNERS
BEST TECHNOLOGY
BEST VALUE
BEST PARTNERS
BEST TECHNOLOGY
BEST VALUE
BEST PARTNERS

PRODUCTS

BALANCE HYBRID™

BEST TECHNOLOGY

BALANCE™ HYBRID

Azure's Balance™ Hybrid Electric drive-train integrated on the Ford E-450 chassis is a powerhouse in the medium duty commercial truck segment where it resides and where Ford is the clear market leader. Azure customers report up to 40% fuel economy improvement, 30% reduction in maintenance costs, and a 30% reduction in greenhouse gas emissions. Current government incentives are encouraging adoption of this environmentally-friendly technology.

BEST PARTNERS

FORD MOTOR COMPANY

Azure's Balance™ Hybrid Electric medium-duty commercial vehicle, a favorite delivery vehicle for a number of major national fleets including FedEx Express, AT&T and Purolator Courier, is built on the Ford E-450 cutaway and strip chassis as is the Balance™ Hybrid Electric shuttle bus.

COLLINS BUS

Collins Bus Corporation is the largest manufacturer of small school buses in North America. AZD's new, exclusive partnership with Collins means that school districts who act on increasing demand for hybrid drivetrain technology will order Type A (14-30 passenger) school buses with AZD's Balance™ Hybrid Electric technology under the hood.

BEST VALUE

As concerns centering on the economy, energy and environment continue, Azure remains 'Part of the Solution' by providing efficient transportation solutions. The new incentive programs in California will help small businesses, small fleets, and large fleet operators overcome the economic barrier to acquisition.

FORCE DRIVE™

BEST TECHNOLOGY

FORCE DRIVE™

AZD's proprietary Force Drive™ System is the high-efficiency, all-electric, zero emission drivetrain powering the 2010 Ford Transit Connect Electric.

In a Force Drive™ powered vehicle, an electric motor propels the vehicle, while smart technology manages batteries and recaptures braking energy to charge the battery pack and increase range. Force Drive™ Systems occupy the same space as traditional drivetrains, making installations and conversions in all types of service vehicles fast and easy.

BEST PARTNERS

FORD MOTOR COMPANY

The high-profile roll-out of the FORD Transit Connect Electric is a major triumph for AZD, with our proprietary Force Drive™ powering these multi-purpose vehicles when they hit the streets in late 2010. Press reviews on this vehicle have been resoundingly positive, and the AZD name and brand has been prominent throughout.

JOHNSON CONTROLS-SAFT

AZD's five year supply agreement with Johnson Controls-Saft means state-of-the-art lithium-ion batteries powering AZD's Force Drive™ pure electric drivetrain in the Ford Transit Connect Electric.

BEST VALUE

Commercial users often travel predictable, short-range routes with frequent stop-and-go driving in urban and suburban environments, therefore a battery electric vehicle makes sense.

For customers seeking sustainable mobility solutions, the Transit Connect Electric with Azure Force Drive™ will provide a zero emissions option.

LEEP™

BEST TECHNOLOGY

LEEP™

AZD's Low Emission Electric Power System (LEEP™) provides reliable, clean auxiliary power to refrigeration trucks, lift trucks and more. The LEEP™ Freeze system in Kidron refrigeration trucks, for example, captures energy from the vehicle's powertrain while the engine is running, and uses this stored energy to maintain perfect refrigeration temperatures when the engine is off.

LEEP™ Systems also power a wide range of applications for other service vehicles like lift trucks, telecom vehicles and a whole field of others. Powering critical service systems with the engine off reduces tailpipe emissions, drastically cuts fuel costs and side-steps problems with increasing anti-idle laws across the continent.

BEST PARTNERS

KIDRON

Our collaboration with Kidron ensures safe transport of fresh, cold product for companies like Foster Farms Dairy.

AZD's LEEP™ Freeze system coupled with Kidron's UltraTemp cold plate technology means reliable, efficient hybrid cooling systems for refrigeration trucks when they need it most.

BEST VALUE

By eliminating the diesel engine that is part of a conventional refrigeration system, UltraTemp with LEEP™ Freeze can save up to a gallon of fuel per hour and maintains set-point temperatures even when the engine is off.

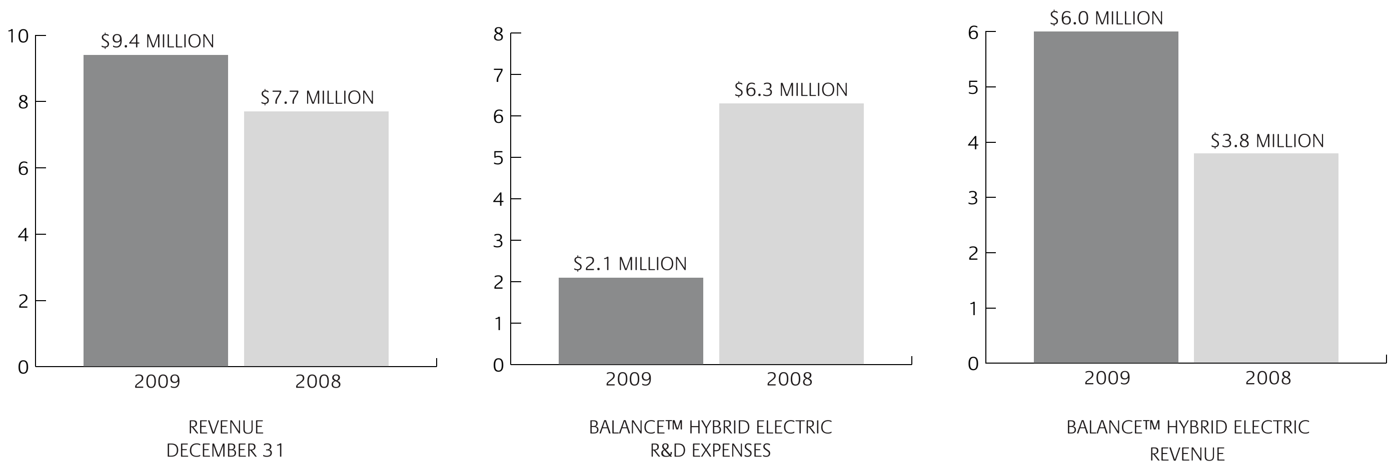
Customers can expect significant cost savings, longer route capabilities, fast temperature recovery, simple maintenance, and reduced emissions.

BEST VALUE

WHEN WE SAY BEST VALUE WE MEAN:

BEST VALUE FOR OUR SHAREHOLDERS

2009 showed a strong improvement in financial results, with a record revenue year and new strategies in place to address cost issues. We have streamlined our workforce, cut discretionary spending and introduced new initiatives to offset increases in our component costs and to share development costs with our technology partners. These Best Value decisions bring results. A good example—AZD projects a 40% reduction in the Bill of Materials for our Balance Hybrid Electric Systems by year-end 2010. And with new and returning clients like AT&T, FedEx, Purolator, Metro Mobility, City of Toronto, and the United States Postal Service, AZD's market reach is growing.



BEST VALUE FOR OUR CUSTOMERS

AZD offers strong value to new and returning customers. Qualifying for green initiatives like federal tax credits and California's Hybrid Voucher Incentive Program makes choosing AZD technology smarter than ever. And our customers can't ignore the bottom line: with savings up to 40% in fuel costs, up to 30% reduction in maintenance costs and up to 20% overall reduction in vehicle operating costs.

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Cover image by: Sean McGrath

MANAGEMENT'S DISCUSSION & ANALYSIS

MANAGEMENT'S DISCUSSION AND ANALYSIS

Year Ended December 31, 2009 ("2009") compared to the Year Ended December 31, 2008 ("2008")

This "Management's Discussion and Analysis" has been prepared as of March 24,2010 and should be read in conjunction with the audited consolidated financial statements of Azure Dynamics Corporation ("Azure" or the "Company") for the year ended December 31, 2009. This MD&A is also prepared in accordance with Canadian generally accepted accounting principles and is stated in Canadian dollars.

FORWARD LOOKING STATEMENTS

This MD&A contains forward-looking statements related to Azure's financial and other projections, expected future plans, events, financial and operating results, objectives and performance, as well as underlying assumptions, all of which involve risks and uncertainties. When used in this MD&A, the words "believe", "anticipate", "intend", "estimate", "expect", "project" and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain such words. These statements reflect management's current beliefs and are based on information currently available to Azure's management and are subject to certain risks, uncertainties and assumptions. Actual results may differ materially from management expectations as projected in such forward-looking statements for a variety of reasons and no assurances can be given as to actual future results, performance or prospects. Factors that may cause such differences include, but are not limited to: the early stage of development of the Company; a lack of product revenues and a history of losses; the need for additional financing; uncertainty as to commercial viability; uncertainty as to product development and commercialization milestones being met; uncertainty as to the market for the Company's products and unproved acceptance of the Company's technologies; competition; uncertainty as to target markets; dependence upon third parties; changes in environmental policies; uncertainty as to patent and proprietary rights; availability of management and key personnel; available regulatory approvals; and conflicts of interest by directors and officers of the Company. More detailed information about these and other factors that could affect Azure's operations or financial results are included in Azure's filings with Canadian securities regulatory authorities. Azure does not assume any obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law. Because of these risks, uncertainties and assumptions, readers should not place undue emphasis on Azure's forward-looking statements.

BUSINESS STRATEGY OF THE COMPANY AND OVERALL PERFORMANCE

The Company has developed proprietary electric and hybrid electric technologies principally for the light to heavy duty commercial vehicle category (the "Technology"). Azure has expertise in the areas of vehicle controls software, power electronics, electric machine design, vehicle systems engineering and vehicle integration. The principal business of Azure is the supply of hybrid electric vehicle ("HEV") and electric vehicle ("EV") control and powertrain systems. The Company also has an established portfolio of proprietary component products that complement its core technical skills and makes use of an extensive industry supplier base to offer complete powertrain solutions to its target market.

Azure has developed three primary product groups, which include: full hybrid electric; mild hybrid electric; and pure electric solutions. Since its inception, the Company has primarily been engaged in the development and testing of its Technologies. Several of the Company's products are now generating commercial revenues while other products are still in the development stage. Generally, Azure does not intend to be the ultimate manufacturer of components or assembler of powertrain systems; rather, the Company uses the supply capacity that exists within the commercial vehicle industry to assemble products to its specifications which are then distributed via existing industry channels to the customer.

Azure seeks to closely align its product development and sales efforts with recognized industry partners (vehicle manufacturers, battery suppliers, component suppliers, distributors, dealerships and customers) thereby gaining access to product development support and established distribution networks which can help accelerate the penetration of its three primary product groups into the commercial vehicle markets.

The Company has ongoing arrangements with Ford Motor Company ("Ford"), which has facilitated the Company's efforts for its full hybrid product group. Balance™ Hybrid Electric (parallel hybrid) serves three primary target market applications; delivery, utility, and shuttle buses.

The Company has concluded an arrangement with Kidron, a division of VT Specialized Vehicles Corporation ("Kidron"), which has facilitated the Company's efforts for its mild hybrid product group. The Company's arrangement with Kidron for the branding, marketing and sale of Azure's LEEP™ Freeze systems targets the refrigerated truck body segment in North America. The Company is currently working in the development stages with Altec Industries, Inc. ("Altec"), a leading manufacturer of aerial boom trucks targeting the electric utility and telecommunications markets and has delivered two demonstration LEEP™ Lift systems to AT&T.

The Company has concluded an additional arrangement with Ford which has facilitated the Company's efforts for its pure electric product group. Azure Dynamics and Ford Motor Company have joined in a collaborative effort to deliver a pure electric Ford Transit Connect van for the United States and Canadian markets. With this collaboration, Ford will release a Transit Connect glider, which is a complete van without the gas powertrain or its associated systems (fuel and exhaust). Azure will then integrate its Force Drive™ electric powertrain auxiliaries and battery pack and sell the battery electric Transit Connects.

During the fourth quarter, 102 full hybrid electric systems, 60 mild hybrid electric systems, and 18 pure electric systems were shipped. Of the full hybrid electric systems, 100 were Balance™ Hybrid Electrics including 90 delivery vans and chassis 10 shuttle buses. There were also two CitiBus™ units sold. All 60 mild hybrid electric systems were LEEP™ Freeze systems that incorporated into Kidron refrigerated trucks. 18 pure electric Force Drive™ systems were delivered to various customers.

BALANCE™ HYBRID ELECTRIC (PARALLEL HYBRID)

The agreement to develop a parallel hybrid powertrain on the Ford E-series chassis provides Azure with an avenue to achieve rapid penetration of a higher volume market for commercial vehicles in North America. The Company has launched into production both a stripped hybrid chassis for general delivery vans as well as a cutaway hybrid chassis for use in shuttle buses and other vocational trucks.

The Balance™ Hybrid Electric shuttle bus has completed durability testing at Altoona which qualifies Ford E-450 shuttle buses built with Azure's Balance™ Hybrid electric drive train system for Federal Transit Authority (FTA) programs of up to 80% funding when purchased by public transit agencies across the United States. Altoona testing subjects vehicle to a lifetime of usage in just a few months at the Altoona PA accelerated durability test center where harsh road conditions mimic real-world conditions endured by a commercial shuttle bus over a seven year, 200,000 mile cycle.

In addition to the notification from the Internal Revenue Service that the 2009 model Balance™ Hybrid was certified as a new qualified heavy-duty hybrid motor vehicle which qualifies for a $3,000 US Federal tax credit to eligible buyers, Azure received notification of certification from the California Air Resources Board (CARB) for the 2009 Azure Balance™ Hybrid E-450. The EPA and CARB certifications are requirements for the Balance™ Hybrid to qualify for the California Hybrid Truck and Bus Voucher Incentive Project (HVIP). The HVIP will provide vouchers of $10,000 to $45,000 on a first-come, first-served basis for purchase of each eligible new hybrid truck or bus.

With the proven reliability of the Balance™ hybrid fleet and higher quantity of vehicles in service, the Company is no longer tracking specific customer mileage.

Within the fourth quarter, the Company continued development and testing of advancements to the current production Balance™ Hybrid system which will reduce the cost and weight versus the current system. The Company plans to launch the product improvements in two phases in 2010. A preliminary release which will include the product upgrades to the inverter controllers and the Johnson Controls-Saft lithium-ion battery pack will be released first. A later release of major advancements to the Company's industry leading belt-starter-generator system will be released on the 2011 model year vehicle. Within the fourth quarter the Company was able to demonstrate in test cells and prototype vehicles the advancements to its industry first belt starter generator system on a V8 engine and design refinements were made related to the durability test phase of the program. Also in the fourth quarter the Company continued its development and testing of the lithium-ion battery pack from Johnson Controls-Saft (JCS). Second generation prototype battery packs were received and are running in the Azure development fleet.

The Company incurred $2.1 (2008 - $6.3 million) in research and development expenses for the year ended December 31, 2009 related to internally funded Balance™ Hybrid Electric projects. The Company anticipates further costs for product development will be incurred in future quarters in order to validate this product. No costs have been deferred or capitalized. During 2009, the Company recognized approximately $6.0 million (2008 - $3.8 million) in revenue on sale of 157 (2008 – 149) Balance™ Hybrid Electric systems.

TRANSIT CONNECT ELECTRIC

Azure and Ford Motor Company have joined in a collaborative effort to deliver a pure battery electric Ford Transit Connect van for the United States and Canadian markets. Within this unique collaboration, Ford will release a unique Transit Connect glider, which is a

complete van without the gas powertrain or its associated systems (fuel and exhaust). Azure will then integrate its Force Drive electric powertrain auxiliaries and battery pack and sell the battery electric Transit Connects.

On October 30, 2009 the Company completed the development agreement with Ford for the Transit Connect Electric. By December 1 2009 the Company completed a development and supply agreement with JCS to collaborate on the lithium ion battery pack for the Ford Transit Connect. Also within the fourth quarter the Company moved rapidly to complete its concept design release as well as produce the initial show vehicle for Ford. Testing on the completed vehicle was in process through the end of 2009, and the delivery to Ford occurred in January 2010. The build of a second engineering vehicle was also started within the fourth quarter.

The Company plans to have initial production vehicles for sale and delivery in the fourth quarter of 2010.

The Company incurred $1.9 million in research and development expenses for the year ended December 31, 2009 related to the Transit Connect Electric. The Company anticipates further costs for product development will be incurred in the future quarters in order to validate this product. No costs have been deferred or capitalized.

LOW EMISSION ELECTRIC POWER (LEEP™)

Electric Drive Solutions consists of Azure's Low Emission Electric Power (LEEP™) and electric drive components. The product name LEEP™ refers to all systems whereby clean electric power is generated via the vehicles' powertrain (and, in some cases, via the grid) to supply a range of auxiliary systems (e.g. pumps, refrigeration, etc.) and export power applications. The Company is currently developing two variants: a refrigeration variant (LEEP™ Freeze); and a utility and telecommunications truck variant (LEEP™ Lift).

The Company has a supply agreement with Kidron for the LEEP™ Freeze refrigeration units that encompass branding, marketing and sale of Azure's LEEP Freeze systems throughout the North American refrigerated truck body market. The LEEP™ Freeze system developed by Azure for Kidron stores cooling potential in the cold plate refrigeration system when the engine is running. When the engine is off, the cold plate is used to maintain refrigeration temperatures in the box. The LEEP™ Freeze system has the potential to replace the ancillary motors/generators used in the other method of cooling refrigerated trucks, thereby reducing fuel consumption, noise and emissions.

In the fourth quarter, the Company received its largest purchase order to date from Kidron for 248 LEEP™ Freeze units. The Company also completed final validation testing and manufacturing ramp up activities to support production. Forty systems were produced and delivered by year end.

The Company has a working relationship with Altec, a leading manufacturer of aerial boom trucks for the utility, telecommunications and contractor markets. The LEEP™ Lift system is specifically designed to be installed on these trucks, in which a boom is driven by a hydraulic pump that is normally powered by a transmission power take-off unit. The LEEP™ Lift system charges onboard high-voltage batteries while the truck is in a normal drive cycle, and when the truck is stationary and the boom is active, the motor/generator drives the hydraulic pump and 12VDC loads using the stored energy to minimize use of the truck's engine during time spent at work sites. The initial unit demonstrated approximately 30% fuel savings versus a conventional truck on a representative test cycle.

During the fourth quarter, the demonstration unit with AT&T in Kansas and Texas continued its trial. The Company continues to monitor the trial and consider the business case for taking the LEEP Lift product into full series production.

The Company incurred $0.5 million (2008 - $0.8 million) in research and development expenses for the year ended December 31, 2009 related to internally funded LEEP projects. The Company anticipates further costs for product development will be incurred in 2010, in order to complete this product. No costs have been deferred or capitalized. During 2009, the Company recognized approximately $0.5 million (2008 - $0.1 million) in revenue on sale of 74 LEEP Freeze systems.

FORCE DRIVE™ ELECTRIC VEHICLE SYSTEMS AND COMPONENTS

The Company has developed a full range of electric drive components, including AC motors, inverters and converters, controllers and battery chargers. Full powertrain kits or electric drive sub-components can be ordered. The Company sold 18 Force Drive™ electric vehicle systems during the fourth quarter to various customers engaged in the manufacture or conversion of pure electric vehicles.

During the fourth quarter the Company progressed on performance and specification upgrades to its inverter power electronics which will be used in both internal hybrid programs including the Balance™ system as well as external Force Drive™ sales. The activities in the quarter

included the completion of the first prototype builds for each of the three new inverters and the preliminary design verification testing.

During the first quarter of 2010, the Company received a second generation prototype advanced soft-switched inverter which is being developed with support of the Freedom Car program. The inverter will be tested in the coming quarter.

During 2009, the Company recognized approximately $0.8 million (2009 – $1.2 million) in revenue on the sale of Force Drive™ electric vehicle systems and components.

AZURE G1 HYBRID AND CITIBUS™ (SERIES HYBRID)

The Azure G1 series hybrid delivery vans and CitiBus™ product are specifically designed for inner-city use and are highly suitable for urban general delivery vans and shuttle buses which both have demanding start and stop drive-cycles.

Purolator's fleet of 49 series hybrid vehicles have approximately 1.3 million miles as of December 31, 2009. The vehicles are deployed in Montreal, Ottawa, Toronto and Vancouver. All 19 diesel hybrids have now surpassed three years in service and are now outside of their warranty period. The 30 gas series hybrids have surpassed two years in service. The earlier units will hit the three year in-service milestone in the first quarter of 2010. In addition to the Purolator fleet, the Bronx Overall Economic Development Corporation has operated their five CitiBus™ hybrids for 16 months. Customer mileage on the bus fleet is not being tracked and reported on by Azure. With the G1 vehicles now coming out of warranty periods, we will no longer be reporting on vehicle statistics in 2010.

During the fourth quarter of 2009 the Company shipped two Azure CitiBus™ hybrid chassis (series hybrid) to StarTrans bringing the total number of delivered units to 39. The product has completed durability testing at Altoona and is eligible for funding programs administered by the Federal Transit Administration (FTA) in the United States. Azure has signed agreements with various StarTrans bus distributors across North America and therefore has access to a distributor network for the targeted shuttle bus market in the US and Canada. With the increasing sales of the Balance™ Hybrid shuttle bus product, the Company will be discontinuing the G1 CitiBus™ hybrid product line in 2010 and is taking steps to redeploy the remaining usable inventory of parts associated with the product.

With the final production of G1 Hybrid vans and CitiBus™ being complete in 2009, the program will now move into a maintenance mode, which considering the hi-mileage and years in service of the G1 fleets, will serve to provide Azure with valuable durability data for future developments. We expect incremental work to continue throughout the life of the products and engineering changes required based on the in service feedback from G1 van and shuttle bus customers. Based on customer feedback and further in-service time, the Company released a cold weather powertrain software upgrade in the fourth quarter.

The Company incurred $0.03 million (2008 – $2.5 million) in gross research and development expenses for the year ended December 31, 2009 related to the Azure CitiBus™ (series hybrid) product line. Expenses continue to decrease compared to the prior year due to the phase out of this program. The Company does not anticipate incurring additional cost in the future quarters. During 2009, the Company recognized $1.6 million (2008 - $2.3 million) in revenue on the sale of 14 shuttle buses.

The total number of employees decreased from 148 at the end of fiscal 2008 to 119 at December 31, 2009. The Company leases facilities in Vancouver (20,000 square feet), Boston (77,000 square feet) and Detroit, MI (36,000 square feet), as well as the service and support center in Mississauga, Canada. The Company considers that its various facilities are suitable to meet the foreseeable requirements for engineering, workshop, test, and administrative accommodations.

OPERATING RESULTS, CASH FLOWS AND FINANCIAL CONDITION

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

		For the years ended December 31	
Years ended	2009	2008	2007
	$	$	$
Revenue	9,403	7,651	2,801
Net loss	(27,808)	(38,867)	(30,235)
Net loss per share - basic and diluted	(0.07)	(0.12	(0.14)
Total assets	58,414	43,691	55,887
Long-term liabilities	2,816	3,561	3,005

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

	Q4, 2009 (Oct–Dec)	Q3, 2009 (Jul–Sep)	Q2, 2009 (Apr–Jun)	Q1, 2009 (Jan–Mar)
	$	$	$	$
Revenue	4,434	3,168	1,228	573
Gross margin	(2,961)	(426)	(1,191)	(539)
Expenses, net	(5,072)	(5,266)	(5,471)	(6,882)
Net loss for the period	(8,033)	(5,692)	(6,662)	(7,421)
Net loss per share - basic and diluted	(0.02)	(0.01)	(0.02)	(0.02)
Weighted average number of shares	454,698	410,242	379,405	379,376

	Q4, 2008 (Oct–Dec)	Q3, 2008 (Jul–Sep)	Q2, 2008 (Apr–Jun)	Q1, 2008 (Jan–Mar)
	$	$	$	$
Revenue	2,573	1,325	3,383	370
Gross margin	(4,079)	(807)	(182)	(147)
Expenses, net	(10,453)	(7,502)	(7,937)	(7,760)
Net loss for the period	(14,532)	(8,309)	(8,119)	(7,907)
Net loss per share- basic and diluted	(0.04)	(0.03)	(0.03)	(0.03)
Weighted average number of shares	379,376	316,333	279,376	279,376

RESULTS OF OPERATIONS

For the year ended December 31, 2009, the Company incurred a net loss of $27.8 million ($0.07 per share) compared to a net loss of $38.9 million ($0.12 per share) in the prior year. The lower loss in the current year is primarily the result of the Company's restructuring plan announced in early 2009 to reduce expenses. During the first quarter of 2009, the Company reduced 25% of its workforce and reduced discretionary expenses wherever possible. Negative gross margin during the year is primarily the result of production variances, increases in certain component costs, inventory write downs and warranty reserves.

The Company incurred a net loss of $8.0 million ($0.02 per share) in the fourth quarter of 2009 compared to a net loss of $14.5 million ($0.04 per share) in the fourth quarter of the prior year. The lower loss in the current year quarter is related to the restructuring plan as noted above. Gross margin improved by $1.1 million in the current year quarter, which was primarily attributable to improved product mix, increases in selling prices, offset by a one time inventory write down.

As a result of the early stage in the Company's development, there are currently no specific seasonality patterns for the financial results of the Company over the past eight quarters. Historically, variations in revenues, gross margin, expenses and net loss are driven primarily by the timing of development projects which vary on a project by project basis. Financial results for 2009 reflect early production revenues from the above mentioned programs and it is expected that variations in the future financial results will be driven by expected increase in orders as the Company gains additional customers and completes the product launches of the above mentioned programs.

Revenue and Gross Margin

Revenue for the year ended December 31, 2009 was $9.4 million (2008–$7.7 million). The higher revenue in the current year is attributable to sales of 14 Azure CitiBus™ (series hybrid) shuttle buses, 157 Balance™ Hybrid Electric (parallel hybrid) systems and 60 LEEP™ Freeze systems recorded in 2009 compared to 16 shuttle buses, 149 Balance™ Hybrid Electric (parallel hybrid) systems and nine LEEP™ Freeze systems recorded in 2008.

Revenue for the fourth quarter ended December 31, 2009 was $4.4 million (2008–$2.6 million). The higher revenue in the fourth quarter is attributable to sales of 100 Balance™ Hybrid Electric (parallel hybrid) systems and 60 LEEP™ Freeze systems recorded in 2009 compared to one Azure CitiBus™ (series hybrid) shuttle bus, 80 Balance™ Hybrid Electric (parallel hybrid) systems and seven LEEP™ Freeze systems recorded in 2008.

After considering direct and applicable indirect costs of sales, the gross margin from revenue in the current year was negative $5.1 million compared to negative $5.2 million in the prior year (gross margin as percentage of sales was negative 54% in 2009 versus negative 68% in 2008). The gross margin in the fourth quarter was negative $3.0 million compared to negative $4.1 million in the prior year (gross margin as percentage of sales was negative 67% in 2009 versus negative 159% in 2008). The improved gross margin in the current year and fourth quarter is a result of improved product mix, increases in selling prices, offset by a one time inventory write down.

Engineering, Research, Development and Related Costs, Net

Before contributions, the Company expended $15.6 million on engineering, research and development operations in 2009 (2008–$21.5 million), including $6.1 million in respect of product development costs (2008–$11.6 million). In 2009, the Company received contributions receivable related to Technology Partnerships Canada (TPC) of $2.8 million; the entire $2.8 million related to 2007 and 2008 which decreased current year engineering, research and development costs. In 2009, the Company also received customer contributions of approximately $1.1 million in a collaborative effort to deliver a pure battery electric van. For the fourth quarter, the Company expended $5.2 million (2008–$6.0 million) on engineering, research and development operations and $2.9 million (2008–$3.1 million) in product development. At December 31, 2009, Azure employed 93 research, engineering, operations and technical personnel (2008–118). Engineers and technical personnel are either working on revenue contracts and sales orders, on servicing vehicles or products in the field, or on core product development programs. For product development and other unabsorbed overheads the direct costs and related overheads, net of customer or government contributions, are expensed.

Product development expenses of $6.1 million (2008–$11.6 million) in the year included the continuation of Balance™ Hybrid Electric system, LEEP™ system development, and costs related to the development of pure electric Ford Transit Connect Electric van.

The Company is required to make royalty payments to TPC, EnCana Corporation and the Natural Resources Canada (NRCan) based on revenues in respect of specified products. To the end of 2009, the Company has made payments of $16,500 each to both EnCana and NRCan and payment of $45,000 to TPC.

Selling and Marketing

Selling and marketing costs were $2.4 million in the year compared to $2.8 million in 2008. Selling and marketing costs in the fourth quarter were $0.9 million, compared to $0.9 million in the fourth quarter of 2008. The head count at December 31, 2009 was seven employees (2008–nine).

General and Administrative

General and administrative costs were $9.1 million in the year compared to $7.9 million in 2008. General and administrative costs in the fourth quarter were $3.1 million, compared to $2.1 million in the fourth quarter of 2008. The increase in the current year and fourth quarter is primarily attributable to a special retention and performance bonus that was accrued and will be paid out under certain circumstances over the next three fiscal years. The head count at December 31, 2009 was 19 (2008–21).

Amortization

Amortization of property, equipment and other assets was $1.0 million in the year and $0.3 million in the fourth quarter compared to $1.0 million for the year and $0.3 million in the fourth quarter in 2008. Property and equipment primarily consists of workshop equipment, tooling, computer hardware and software. The Company purchased assets with a value of $0.2 million in the year (2008–$1.5 million) and $0.04 million in the fourth quarter (2008–$0.1 million) which also includes assets under capital lease. Other assets are primarily the cost of patents and trademarks. In addition, the intangible assets acquired as a result of the US acquisition have been amortized by $1.3 million in the year (2008–$1.4 million) and $0.3 million in the fourth quarter (2008–$0.3 million). Amortization of property, equipment and other assets are allocated to the relevant cost categories on the Statement of Operations.

Other Expenses

Other expenses excluding interest income or expense totalled $0.6 million year to date (2008–$0.6 million). Other expenses excluding interest income or expenses totalled negative $8,000 for the fourth quarter (2008–$7,000). The 2009 expenses primarily related to the Company's restructuring plan as announced in early 2009.

Foreign Currency Losses

Foreign currency gains totalled $0.7 million (2008–loss of $0.4 million) for the year and $0.09 million in the fourth quarter (2008–loss of $0.3 million). These were mainly unrealized gains in respect of foreign currency monetary balance sheet accounts which reversed out subsequent to the quarter and year end. The United States currency against the Canadian currency was at a rate of 1.051 at December 31, 2009, a 13.7% decrease comparing to the rate of 1.218 at December 31, 2008.

BALANCE SHEET DISCUSSION

Cash and Cash Equivalents

Cash and cash equivalents at December 31, 2009 were $33.6 million compared to $13.8 million at December 31, 2008 and $5.3 million at September 30, 2009. Net cash inflows were approximately $19.8 million in the year compared to net cash outflows of $10.3 million for the prior year. The increase in cash inflows of $30.1 million in the current year is primarily attributable to a higher level of net equity financings ($12.9 million higher in the current year), decreased net loss ($9.9 million lower after adjusting for non cash items) and increase in non-cash working capital of $6.4 million. In the fourth quarter, the Company's cash and cash equivalents increased by $28.3 million compared to a decrease of $7.4 million in the fourth quarter of 2008. The increase in cash inflows in the current year quarter of $35.7 million is primarily a result of a higher level of net equity financings ($27.9 million higher in the fourth quarter of the current year), lower net loss ($6.1 million lower in the current year after adjusting for non cash items), and an increase in non cash working capital of $1.6 million.

Accounts Receivable

Accounts receivable at December 31, 2009 were $2.6 million compared to $2.3 million at December 31, 2008 and $2.6 million at September 30, 2009.

Inventory

Inventory was $5.2 million at December 31, 2009 compared to $8.3 million at December 31, 2008 and $8.3 million at September 30, 2009. The lower inventory amount at December 31, 2009 compared to the prior year end and the third quarter is primarily due to write downs of inventory to the net realizable value. As at December 31, 2009, Azure no longer supported the sales of any additional G1 units and management decided to write-off related inventory to its net realizable value.

Prepaid Expenses

Prepaid expenses at December 31, 2009 were $1.0 million compared to $0.7 million at December 31, 2008 and $1.4 million at September 30, 2009. The higher balance at December 31, 2009 compared to the prior year end is primarily due to a prepayment of $0.3 million paid to a supplier for inventory purchases. The lower balance at December 31, 2009 compared to the prior quarter end is attributable to the amortization of prepaid inventory purchases.

Property and Equipment

Net property and equipment was $5.3 million at December 31, 2009 compared to $6.2 million at December 31, 2008 and $5.5 million at September 30, 2009. The lower amount at the end of 2009 is attributable to amortization.

Goodwill and Other Intangibles

Intangible assets were $6.8 million at December 31, 2009 ($8.0 million at December 31, 2008 and $7.1 million at September 30, 2009). The lower amount at the end of 2009 is attributable to amortization.

Accounts Payable and Accrued Liabilities

Accounts payable and accrued liabilities were $9.8 million at December 31, 2009 compared to $4.8 million at December 31, 2008 and $4.2 million at September 30, 2009. The higher amount at the current year end compared to the prior year end and prior quarter is attributable to a special retention and performance bonus that was accrued and will be paid out under certain circumstances over the next three fiscal years and several high dollar value invoices for product development.

Customer Deposits and Deferred Revenues

Current and long-term deferred revenue and customer deposits total $1.4 million at December 31, 2009 compared to $1.2 million at December 31, 2008 and $0.9 million at September 30, 2009. The amount is primarily attributable to the US operation and consists of deferred revenue that is primarily in respect of a payment received from Singapore Technologies Kinetics Ltd. ("STK") for a license agreement for certain technology that expires in 2020. The license agreement fee is being recognized in revenue over the 17-year duration of the agreement. The higher balance at December 31, 2009 compared to the prior year end is primarily related to deposits received from customers for systems that are to be delivered in the first quarter of 2010.

Notes Payable

The note payable is attributable to the US subsidiary and is the Company's proportionate share of a mortgage on the Boston property owned by ND Solectria LLC, in which the Company has a 50% interest. The note was refinanced in November 2006, is repayable on November 20, 2011, bears interest at a floating rate of the applicable Treasury rate plus 200 basis points and is secured by the mortgaged premises. As at December 31, 2009, total obligations under the notes payable were $2.1 million compared to $2.5 million at December 31, 2008 and $2.2 million at September 30, 2009.

Share Capital

Share capital at December 31, 2009 was $202.3 million compared to $165.0 million at December 31, 2008. The increase in share capital in the fourth quarter compared to the prior year quarter is primarily related to the equity financings in August and December 2009 (increase to share capital of $37.2 million).

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

	March 24, 2010	December 31, 2009	December 31, 2008
Common shares	605,150,265	605,084,932	379,376,177
Deferred Share Units	4,439,238	4,439,238	3,128,605
Stock options issued under the Stock Option Plan, with expiry dates ranging up until January 21, 2016 and average exercise price of $0.40	31,815,396	26,105,729	15,080,126

During the period from December 31, 2009 to March 24, 2010, 65,333 options were exercised into common shares.

LIQUIDITY, CAPITAL RESOURCES AND RISK FACTORS

At December 31, 2009 the Company had $34.6 million (December 31, 2008–$15.2 million) in net cash reserves. The Company invests its cash, in accordance with its investments policy, in highly-liquid, highly-rated financial instruments such as bankers acceptances and term deposits. At December 31, 2009 approximately $1.0 million of cash was restricted (December 31, 2008–$1.4 million). The restricted cash is related to a security deposit in respect of the facility in Boston, MA ($0.8 million) and a standby letter of credit related to the security deposit for the new facility in Oak Park, MI ($0.2 million). Working capital was $31.7 million at December 31, 2009 compared to $19.8 million at December 31, 2008. The increase in working capital of $11.9 million is primarily due to the increased cash balances of $19.8 million at the current year end, offset by the increased accounts payable and accrued liabilities balances of $5.0 million and decreased inventory balances of $3.1 million at the current year end.

The Company has incurred losses since its inception as it has invested in the development of its technology. Although the Company is active in a number of revenue-generating programs it also continues to incur product development costs. As a result, the Company has relied on its financing activities to fund its operations. In addition, Azure has in the past, subject to TPC conditions, been eligible to access the grant of up to $9.0 million available under the terms of the TPC contribution agreement. As at December 31, 2009 the Company had received the entire $9.0 million in accordance with the terms of the TPC agreement.

While the Company has derived limited revenue from the sale of vehicles and components to third parties, its ability to continue operations is uncertain and dependent upon the successful completion of technical and commercial development of its Technology, obtaining additional financing and achieving profitable operations. The outcome of these matters cannot be predicted at this time. These circumstances lend significant doubt as to the ability of the Company to meet its obligations as they come due, and accordingly, the appropriateness of accounting principles applicable to a going concern. In recognition of these circumstances, the Company raised net proceeds of $37.2 million during fiscal 2009 through the issuance of common shares. Management plans to secure the required future financing through a combination of strategic alliances and new equity issuances, however, there can be no assurance that such initiatives will be successful.

The Company holds substantially all of its cash at a recognized Canadian national financial institution, and as such is exposed to all of the risks associated with that institution. The Company operates in foreign markets and has foreign subsidiaries and is therefore exposed to foreign currency exchange risk. Azure's operations are subject to all of the risks inherent in the establishment of a new business enterprise—please see Risk Factors—Annual Information Form, dated March 24, 2010 (this document and additional information relating to the Company is available for inspection at www.sedar.com). These risks include the practical risks of implementation and execution of its commercialization strategy (for example, the risk that Azure is delayed in the development of customer product requirements specified in development agreements, or is delayed in the process of establishing the infrastructure required to support its commercialization plans). To better manage all risk factors, the Company has a system of reporting and measuring progress towards milestones on a regular basis. The Company has an organization structure commensurate with its growth plans and has implemented an internal control and process system supported by an appropriate ERP system that encompasses all existing engineering/support operations. The Company recently completed its International Organization for Standardization ("ISO") certification at its Canadian location in Vancouver, B.C. The Boston, Massachusetts location already conforms to ISO. Management accepts the responsibility of ensuring that control systems and procedures are established and are effective and monitored and is required to report to the Board and its sub-committees on a regular basis on such matters.

FINANCIAL INSTRUMENTS

The Company has no foreign contracts or any other financial hedging instruments.

RELATED PARTY TRANSACTIONS

There have been no related party transactions for the year ended December 31, 2009.

CONTRACTUAL OBLIGATIONS AND OFF-BALANCE SHEET ARRANGEMENTS

Contractual Obligations

As at December 31, 2009 the Company had the following contractual obligations and operating lease commitments:

(Stated in thousands)					Payments due by period
Contractual Obligations	Total $	Less than 1 year $	1-3 years $	4-5 years $	After 5 years $
Operating leases[1]	8,394	1,348	2,850	2,337	1,859
Purchase obligations[2]	5,193	–	909	2,207	2,077
Long term debt[3]	2,251	138	2,113	–	–
Capital leases[4]	204	116	79	9	–
Total contractual obligations	16,042	1,602	5,951	4,553	3,936

Off-Balance Sheet Arrangements

Pursuant to a contractual agreement with Natural Resources 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 $296,000. To the end of 2009, the Company has made payments in the amount of approximately $16,500.

Pursuant to a contractual agreement with TPC, the Company is required to make royalty payments equal to the greater of 0.28% of yearly gross business revenues or in accordance with a fixed repayment schedule, with repayment amounts ranging from $0.7 million to $1.0 million per year starting in 2008 and totalling $1.3 million, provided that certain minimum sales levels are achieved. The obligation to make royalty payments commences when the minimum sales levels are achieved and continues until the earliest of 2015 or when a cumulative payment ceiling of $20.5 million is reached. On March 23, 2005, the Company entered into a contract amendment with TPC whereby the royalty payment period was extended to December 31, 2020. To the end of 2009, the Company has made payments in the amount of approximately $45,000.

Pursuant to a contractual agreement with EnCana Corporation, whereby EnCana sponsored the development of power train product, the Company is required to make royalty payments equal to 1% of gross revenue from sales of the power train product up to a maximum payment of $1.0 million. To the end of 2009, the Company has made payments in the amount of approximately $16,500.

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

CRITICAL ACCOUNTING ESTIMATES

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

Revenue Recognition

Certain product lines within Solectria (acquired in January 2005), in addition to the G1 Shuttle Bus and P1 delivery van, are no longer considered development stage. Therefore the Company recognizes revenues on the sales of those products at the time of shipment, provided that the Company has evidence of an arrangement, the fee is fixed and determinable, delivery has occurred, title and risk of loss have passed to the customer, and collection is reasonably assured.

In addition, the Company recognizes revenues on long term engineering contracts using the percentage of completion method. The revenue recognized is determined based on the total contract value and the percentage of the contract estimated completed at the end of the reporting period. Because of inherent uncertainties in estimating the costs to complete contracts in progress, it is possible that the estimates used will change within the near term. Changes in estimated job profitability are accounted for as changes in estimates in the current period. Where applicable, the entire amount of future estimated losses on contracts in progress are recognized when they become known.

Warranty Provision

The Company generally warranties its products against defects and workmanship for a period of one to five years from the date of shipment, subject to certain guidelines and exclusions. A provision has been established for this warranty obligation. In establishing the accrued warranty liability, management has estimated the likelihood that products sold will experience warranty claims and the estimated costs to resolve the claims received, taking into account the nature of the product and the past and projected claims experience with the products. Should these estimates prove to be incorrect, the Company may incur costs different from those provided for in the warranty provisions.

Inventory Provision

In establishing the appropriate provision for inventory obsolescence, management estimates the likelihood that inventory carrying values will be affected by changes in market demand for the Company's products and by changes in technology, which could make inventory on hand obsolete. The Company performs regular reviews to assess the impact of changes in technology, sales trends and other changes on the carrying value of inventory. Where it is determined that such changes have occurred and will have a negative impact on the value of inventory on hand, appropriate provisions are made. Unforeseen changes in these factors could result in additional inventory provisions being required.

Intangible Assets and Goodwill

As a result of the Solectria acquisition, the Company recorded intangible assets and goodwill on the balance sheet. In accordance with Canadian GAAP, the Company does not amortize goodwill. Intangible assets are amortized over periods ranging from two to ten years. At least annually, management reviews the carrying value of intangible assets and goodwill by segment for potential impairment. If circumstances indicate that impairment in the value of these assets has occurred, the impairment is recorded in the earnings of the current period.

Stock Based Compensation

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

NEW ACCOUNTING PRONOUNCEMENTS AND DEVELOPMENT

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

Goodwill and Intangibles Assets

Effective January 1, 2009, the Company adopted Section 3064 "Goodwill and intangible assets", replacing Section 3062, "Goodwill and other intangible assets". The new section establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill are unchanged from the standards included in the previous Section 3062. The adoption of this standard had no significant impact on the Company's financial statements.

Financial Statement Concepts

Effective January 1, 2009, the Company adopted Section 1000, "Financial Statement Concepts" which has been amended to focus on the capitalization of costs that truly meet the definition of an

asset and de-emphasizes the matching principle. The adoption of this standard had no significant impact on the Company's financial statements.

International Financial Reporting Standards (IFRS)

Background, project structure and project progress:

In February 2008, the Canadian Accounting Standards Board ("AcSB") confirmed that Canadian public entities will have to adopt IFRS effective for fiscal years beginning on or after January 1, 2011. The Company will issue consolidated financial statements in accordance with IFRS as issued by the International Accounting Standards Board ("IASB") for the first quarter ended March 31, 2011, with comparative information.

Preliminary Impact Assessment

An initial evaluation or impact assessment was completed to analyze potential significant differences between current IFRS and Canadian GAAP as they apply to the Company. The results of this assessment identified:

- Preliminary analysis of all Canadian GAAP to IFRS differences and IFRS 1 elections and resulting prioritization of high, medium and low impact areas of focus for the Company based on potential impact
- Preliminary resource requirements
- Preliminary training requirements
- A preliminary IFRS Transition Plan (details outlined below)

IFRS Transition Plan

During the year the Company established a formal IFRS Transition

Plan. This plan includes:

- An established project structure and governance practices
- Detailed timetable with milestones and deliverables
- Identification and allocation of resources (combination of internal and external)
- Development and execution of a training program
- Detailed analysis of all Canadian GAAP to IFRS differences
- Detailed analysis and selection of all IFRS 1 elections
- Assessment of impact on data systems, internal controls over financial reporting, and business activities, such as financing and compensation arrangements

To date, the project is progressing according to plan. The Company has completed the diagnostic phase of the project and is nearing completion on the detailed assessment phase for all standards that affect the transition. The Company has begun the solutions development and the implementation phase on many of the IFRS issues that could potentially have a significant impact on the Company's financial statements.

Potential accounting changes as a result of transition to IFRS

Outlined below is a very brief summary of select IFRS that may impact the Company, their differences from Canadian Generally Accepted Accounting Principles ("GAAP") and their potential impact. The list is not comprehensive and does not include all of the differences from GAAP for the standards noted. Also, the list does not include all the standards that may require changes for the transition to IFRS. Some of the standards not presented in the table may have a significant impact on the Company's consolidated financial statements.

Presentation & Disclosure - IFRS requires significantly more disclosure than GAAP for certain standards. In some cases, IFRS also requires different presentation on the balance sheet and income statement. This will be the most significant impact to the Company. Specifically, the increased disclosure requirements will cause the Company to change current processes and implement new financial reporting processes to ensure the appropriate data is collected for disclosure purposes.

Revenue Recognition - There are certain differences in revenue recognition criteria between Canadian GAAP and IFRS because IFRS contains measurement standards requiring fair value for consideration received or receivable.

Property Plant & Equipment - IAS 36 uses a one step approach for both testing for and measuring impairment, with the asset carrying values compared to the higher of fair value less costs to sell and value in use (which uses discounted future cash flows). This may result in more frequent write downs where carrying values of assets were previously accepted under GAAP on an undiscounted basis, but could not be supported on a discounted cash flow basis.

Business Combinations - We expect to apply the business combinations exemption in IFRS 1 to not apply IFRS 3 Business Combinations retrospectively to past business combinations. Accordingly, we will not restate business combinations that took place prior to the transition date or modify the carrying amounts arising on business combinations occurring before the transition date.

Share Based Payments - IFRS 2 Share-based Payment only requires recognition of equity instruments in respect of share-based payment

transactions granted prior to the transition date. We expect to apply IFRS 2 to equity instruments granted after November 7th, 2002 which have not vested by the transition date.

At this time, the Company can not quantify the impact of IFRS to its financial statements. The Company is close to finalizing preliminary conclusions and accounting policy choices on the standards noted above. Those conclusions and accounting policy choices will be reported on when finalized.

The IASB has several projects slated for completion in 2010 and 2011 that may significantly impact the transition to IFRS and the financial statements of the Company. The Company continues to monitor the IASB's progress on these projects and their impact on the Company's transition to IFRS.

Impact on Information Systems and Technology

It is anticipated that the adoption of IFRS will have some impact on information systems requirements. The Company has assessed the need for systems upgrades or modifications to ensure an efficient conversion to IFRS. The main drivers for systems changes include:

- Additional information required as a result of enhanced note disclosures,
- Tracking of IFRS to GAAP differences during the transition, and
- Tracking sufficient level of details within the accounting records to allow management to maintain adherence with IFRS going forward.

The impact and changes to systems are on-going and will be prioritized as part of the project.

Impact on Reporting and Internal Controls

In accordance with the Company's approach to certification of internal controls required under Canadian Securities Administrators' National Instrument 52-109, all entity-level, information technology, disclosure and business process controls will require updating and testing to reflect changes arising from the Company's conversion to IFRS. Where material changes are identified, these changes will be mapped and tested to ensure that no material control deficiencies exist as a result of the Corporation's conversion to IFRS.

Business Combinations, Consolidated Financial Statements and Non-Controlling Interests

In January 2009, the CICA issued sections 1582, "Business Combinations", 1601, "Consolidated Financial Statements", and 1602 "Non-Controlling Interests" which superseded current sections 1581, "Business Combinations" and 1600 "Consolidated Financial Statements". These sections will be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011. Earlier adoption is permitted. If an entity applies these sections before January 1, 2011, it is required to disclose that fact and apply each of the new sections concurrently. These new sections were created to converge Canadian GAAP to IFRS.

Credit Risk and Fair Value of Financial Assets and Liabilities

In January 2009, the CICA issued EIC-173, "Credit Risk and the Fair Value of Financial Assets and Financial Liabilities." The EIC will be applicable to financial statements relating to fiscal years beginning on or after January 20, 2009. Accordingly, the Company will adopt the new standards for its fiscal year beginning January 1, 2010. The EIC provides guidance on how to take into account credit risk of an entity and counter-party when determining the fair value of financial assets and financial liabilities, including derivative instruments, for presentation and disclosure purposes. The Company is currently evaluating the impact of the adoption of this EIC on its consolidated financial statements.

OTHER MD&A REQUIREMENTS

Management has designed disclosure controls and procedures to provide reasonable assurance that material information relating to the Company, including its consolidated subsidiaries, is made known to the Chief Executive Officer and the Chief Financial Officer by others within those entities, particularly during the period in which the annual filings of the Company are being prepared, in an accurate and timely manner in order for the Company to comply with its continuous disclosure and financial reporting obligations and in order to safeguard assets. Consistent with the concept of reasonable assurance, the Company recognizes that the relative cost of maintaining these controls and procedures should not exceed their expected benefits. As such, the Company's disclosure controls and procedures can only provide reasonable assurance, and not absolute assurance, that the objectives of such controls and procedures are met.

The Corporation's financial reporting procedures and practices have enabled the certification of Azure Dynamics' annual filings in compliance with Multilateral Instrument 52-109 "Certification of Disclosure in Issuers' Annual and Interim Filings". Management has designed such internal controls over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements and other annual filings in accordance with Canadian Generally Accepted Accounting Principles, except as noted below.

Given the size of the Company, the evaluation of the design of internal controls over financial reporting for the Company resulted in the identification of the following weaknesses:

Management is aware that due to its relatively small scale of operations there is a lack of segregation of duties due to a limited number of employees dealing with accounting and financial matters. However, management has concluded that considering the employees involved and the control procedures in place, including management and Audit Committee oversight, risks associated with such lack of segregation are not significant enough to justify the expense associated with adding employees to clearly segregate duties.

Management is aware that in-house expertise to deal with complex taxation, accounting and reporting issues may not be sufficient. The Company requires outside assistance and advice on new accounting pronouncements and complex accounting and reporting issues, which is common with companies of a similar size.

There have been no significant changes to the Company's internal controls over financial reporting that occurred during the most recent interim period that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

ADDITIONAL INFORMATION

Additional information regarding Azure, including its Annual Information Form, can be found on SEDAR at www.sedar.com.

AUDITOR'S REPORT

To the Shareholders of Azure Dynamics Corporation:

We have audited the consolidated balance sheet of Azure Dynamics Corporation as at December 31, 2009 and the consolidated statements of operations, comprehensive loss and deficit and cash flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluation 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, 2009 and the results of its operations and its cash flows for the year then ended in accordance with Canadian generally accepted accounting principles.

The consolidated financial statements of the Company as of December 31, 2008 and for the year then ended were audited by other auditors whose report dated March 31, 2009 expressed an unqualified opinion on those statements.

PricewaterhouseCoopers LLP

Chartered Accountants
Vancouver, BC
March 17, 2010

"PricewaterhouseCoopers" refers tp PricewaterhouseCoopers LLP, an Ontario limited liability partnership, or, as the contect requires, the PricewaterhouseCoopers global network or other member firms of the network, each of which is a separate legan entity.

CONSOLIDATED BALANCE SHEETS

AS AT DECEMBER 31

(Stated in thousands of Canadian dollars, except per share amounts and number of shares)

ASSETS	2009 $	2008 $
Current		
Cash and cash equivalents	33,588	13,803
Accounts receivable	2,632	2,317
Inventory (Note 5)	5,215	8,318
Prepaid expenses	974	675
	42,409	25,113
Restricted cash (Note 4)	1,041	1,440
Property and equipment (Note 6)	5,277	6,194
Intangible assets (Note 7)	6,755	8,012
Goodwill	2,932	2,932
	58,414	43,691

LIABILITIES AND SHAREHOLDERS' EQUITY		
Current		
Accounts payable and accrued liabilities	9,837	4,806
Customer deposits & deferred revenue (Note 8)	746	360
Current portion of notes payable (Note 3)	66	74
Current portion of obligations under capital leases (Note 9)	99	114
	10,748	5,354
Long-term		
Obligations under capital leases (Note 9)	117	263
Customer deposits & deferred revenue (Note 8)	644	839
Notes payable (Note 3)	2,055	2,459
	2,816	3,561
Shareholders' equity		
Share capital (Note 11)	202,250	165,007
Contributed surplus (Note 11)	7,139	6,500
Deficit	(164,539)	(136,731)
	44,850	34,776
	58,414	43,691

Nature of operations and going concern (Note 1)
Commitments (Note 9 and 16)
Subsequent events (Note 19)

Approved on behalf of the Board:

(signed) "D. Campbell Deacon"
D. Campbell Deacon, Director

(signed) "James C. Gouin"
James C. Gouin, Director

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

CONSOLIDATED STATEMENTS OF OPERATIONS COMPREHENSIVE LOSS & DEFICIT

AS AT DECEMBER 31

(Stated in thousands of Canadian dollars, except per share amounts and number of shares)

	2009 $	2008 $
Revenues	9,403	7,651
Cost of sales	14,520	12,866
Gross margin	(5,117)	(5,125)
Expenses		
Engineering, research, development and related costs, net (Note 13)	11,681	22,286
Selling and marketing	2,388	2,833
General and administrative	9,134	7,899
Total expenses	23,203	33,018
Loss from operations	(28,320)	(38,233)
Interest and other income, net	546	347
Interest expense	(110)	(10)
Other expense	(586)	(568))
Foreign currency gains/(losses)	662	(403)
Net loss and comprehensive loss	(27,808)	(38,867)
Deficit, beginning of year	(136,731)	(97,864)
Deficit, end of year	(164,539)	(136,731)
Loss per share–basic and diluted	(0.07)	(0.12)
Weighted average number of shares – basic and diluted	406,148,487	313,802,407

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

AS AT DECEMBER 31

(Stated in thousands of Canadian dollars, except per share amounts and number of shares)

CASH FLOWS FROM OPERATING ACTIVITIES	2009 $	2008 $
Net loss for the period	(27,808)	(38,867)
Adjustments for:		
Amortization of property and equipment	1,048	1,005
Amortization of intangible assets	1,460	1,414
Unrealized foreign currency (gains)/losses	(448)	525
Stock option compensation expense	400	711
Deferred share units compensation expense	244	184
	(25,104)	(35,028)
CHANGES IN NON-CASH WORKING CAPITAL ITEMS (Note 17)	8,032	1,625
Total cash flows from operating activities	(17,072)	(33,403)
CASH FLOWS FROM FINANCING ACTIVITIES		
Issuance of common shares (net of costs)	37,238	24,342
Principle payments on notes payable	(69)	(40)
Repayment of obligations under capital lease	(160)	(26)
Total cash flows from financing activities	37,009	24,276
CASH FLOWS FROM INVESTING ACTIVITIES		
Acquisition of property and equipment	(141)	(1,089)
Acquisition of intangible assets	(203)	(143)
Sale of property and equipment	35	–
Changes in restricted cash	211	–
Total cash flows from investing activities	(98)	(1,232)
INCREASE/(DECREASE) IN CASH AND CASH EQUIVALENTS	19,839	(10,359)
Exchange impact on cash held in foreign currency	(54)	29
Cash and cash equivalents, beginning of year	13,803	24,133
Cash and cash equivalents, end of year	33,588	13,803
SUPPLEMENTAL CASH FLOW INFORMATION		
Cash paid for interest	110	159
Cash paid for taxes	–	–
Non cash investing and financing activities:		
Vehicles and equipment acquired under capital lease	24	364

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

YEARS ENDED DECEMBER 31, 2009 & 2008

1. NATURE OF OPERATIONS AND GOING CONCERN

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

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (GAAP) on a going concern basis which presumes the realization of assets and discharge of liabilities in the normal course of business. While the Company has derived limited revenue from the sale of vehicles and components to third parties, its ability to continue operations is uncertain and dependent upon the successful completion of technical development of its technology, obtaining additional financing and achieving profitable operations. The outcome of these matters cannot be predicted at this time. These circumstances lend significant doubt as to the ability of the Company to meet its obligations as they come due, and accordingly, the appropriateness of accounting principles applicable to a going concern. In recognition of these circumstances, the Company raised net proceeds of $37.2 million during fiscal 2009 through the issuance of common shares. Management plans to secure the required future financing through a combination of strategic alliances and new equity issuances, however, there can be no assurance that such initiatives will be successful. These consolidated financial statements do not include any adjustments to the assets and liabilities that might be necessary should the Company be unable to continue in business and such adjustments could be material.

2. SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements of the Company have been prepared by management in accordance with Canadian generally accepted accounting principles and are stated in Canadian dollars unless otherwise noted. The preparation of consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. The consolidated financial statements have, in management's opinion, been properly prepared using careful judgment with reasonable limits of materiality and within the framework of the significant accounting policies summarized below.

(a) Consolidation

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

(b) Revenue Recognition

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

In addition, the Company recognizes revenues on long term engineering contracts within these product lines using the percentage of completion method. The revenue recognized is determined based on the total contract value and the percentage of the contract estimated to be completed at the end of the reporting period. Because of inherent uncertainties in estimating the costs to complete contracts in progress, it is possible that the estimates used will change within the near term. Changes in estimated job profitability are accounted for as changes in estimates in the current period. Where applicable, the entire amount of future estimated losses on contracts in progress are recognized when they become known.

The Company also recognizes revenues related to a technology and software licensing agreement (see note 8). The

agreement provided for non-refundable payments which are being recognized in revenue on a straight-line basis over the period of the license agreement.

Customer deposits and deferred revenue primarily represent amounts paid by customers in advance of products being shipped, contract revenue recognized, and the license agreement referred to in note 8.

(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 and there is reasonable assurance regarding collection of the claim. Claims not settled by the balance sheet date are recorded as a receivable on the consolidated balance sheets. The determination of the amount of the claim, and hence the receivable amount, requires management to make calculations based on its interpretation of eligible expenditures in accordance with the terms of the programs. The reimbursement claims submitted by the Company are subject to review by the relevant government agencies. Although the Company has used its best judgment and understanding of the related program agreements in determining the receivable amount, it is possible that the amounts could increase or decrease by a material amount in the near term dependent on the review and audit by the government agency.

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

(d) Investment Tax Credits

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

(e) Cash and Cash Equivalents

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

(f) Restricted Cash

Restricted cash consists of cash on deposit and highly liquid short-term bearing securities. These instruments are held as partial security for standby letters of credit and cannot be used for any other purpose.

(g) Financial Instruments

All financial instruments are initially recognized at fair value on the balance sheet and management has classified each financial instrument into one of the following categories: held for trading, loans and receivables and other liabilities. Subsequent measurement of financial instruments is based on their classification.

Financial assets “held for trading” are subsequently measured at fair value with changes in those fair values recognized in operations. “Loans and receivables” and “other financial liabilities” are subsequently measured at amortized cost using the effective interest method.

Cash and cash equivalents and restricted cash are classified as “held for trading”. Accounts receivable and contributions receivable are classified as “loans and receivables” and accounts payable and accrued liabilities and notes payable are classified as “other financial liabilities”.

(h) Inventory

Inventory is comprised of product, spare parts, product components and materials held for resale or use in the Company’s product development activities or customer projects and include prepayments made for components on

order. Work in progress inventory is comprised of material, labour and a portion of overhead costs relating to in-progress customer and internal orders. Inventory is valued at the lower of cost or net realizable value. Cost is generally determined on a first in, first out basis.

(i) Accrued Warranty Liabilities

The Company generally warranties its products against defects and workmanship for a period of one to five years from the date of shipment, subject to certain guidelines and exclusions. A provision has been established for this warranty obligation. In establishing the accrued warranty liability, management has estimated the likelihood that products sold will experience warranty claims and the estimated costs to resolve the claims received, taking into account the nature of the product and the past and projected claims experience with the products.

(j) Guarantees—Letter of Credit ("LOC")

The Company has entered into several Letters of Credit (LOC) with varying financial institutions whereby if certain obligations are not fulfilled by the Company, the beneficiaries of the Letter of Credit, may draw down on the LOC at these financial institutions. The Company recognizes the various letters of credit at their face value in the form of restricted cash. All foreign denominated LOCs are measured at the prevailing foreign exchange rate as at year end.

(k) Property and Equipment

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

Workshop equipment	5 years
Computer software	2 to 3 years
Computer hardware	3 years
Tooling	3 to 5 years
Office furniture and equipment	5 years
Automotive	3 to 5 years
Leasehold improvements	term of lease
Equipment under capital lease	2 to 5 years

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

(l) Intangible Assets

Intangible assets include the fair value of identifiable intangible assets acquired in a purchase business combination. Amortization of the product technology asset is provided on a straight-line basis over the estimated useful life of ten years. The costs of acquiring and applying for patents, and trademarks are capitalized and amortized on a straight-line basis over their estimated useful lives of fifteen years. The costs of acquiring and applying for patents and trademarks 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.

(m) Impairment of Long-Lived Assets

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

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

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

(n) Goodwill

Goodwill represents the excess of the purchase price over

the fair value of identifiable assets acquired in a purchase business combination and is subject to an annual fair value impairment test.

Impairment is identified by comparing the fair value of the reporting unit to which the goodwill relates to its carrying value. To the extent that a reporting unit's carrying amount exceeds its fair value, the Company measures the amount of impairment as the excess of the carrying value over the implied fair value of goodwill. Impairments are recorded in the statement of operations in the period determined.

(o) Foreign Currency Translation

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

For the year ended December 31, 2009 a foreign exchange gain of $662,000 was recognized in consolidated operations (2008 – foreign exchange loss of $403,000).

(p) 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 operations 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.

(q) Stock Based Compensation

The Company grants stock options to officers, directors, employees and consultants pursuant to a stock option plan described in Note 11(c). The Company accounts for the stock-based compensation using the fair-value method as at the grant date. Under this method, compensation expense related to option grants is recorded in consolidated operations over the vesting period of the options or, for consultants, as the work is performed. The compensation expense amount is based on the fair value of the option as estimated using the Black-Scholes option pricing model. The assumptions used in calculating the value of the stock options issued include management's best estimate, as of the date of grant, of the expected share price volatility over the term of the stock option and expected option life. As such, the amounts reported as compensation expense are subject to measurement uncertainty as the expense amount may vary significantly based on the assumptions used. The forfeiture of stock options are accounted for as they occur.

(r) Deferred Share Unit ("DSU") Compensation

The Company has a Deferred Share Unit Plan ("DSU Plan") under which it may grant deferred share units ("DSU") to non-executive directors and selected employees pursuant to the DSU Plan described in Note 11(e). Under the DSU Plan, non-executive directors and selected employees may elect to receive their retainer or bonus compensation in DSU's. The number of DSU's issued is calculated based on the amount owing and the trading price of the Company's common shares at the time of the election. As the number of DSU's issued is fixed and the Company has the right to settle the DSU's in cash or in the delivery of shares, this amount is reflected in contributed surplus in the period in which the DSU's are granted. DSU's issued on a performance-based measure are recorded in consolidated operations over the vesting period.

(s) Loss Per Share

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

(t) Use of Estimates

The preparation of consolidated financial statements requires the Company's management to make estimates and assumptions that affect the amounts reported in these consolidated financial statements and notes thereto. Significant areas requiring management to make estimates include the useful lives of long-lived assets, inventory valuation, product war-

ranty obligations, revenue recognition, the collectability of receivables, stock based compensation and the recoverability of fixed assets, intangibles and goodwill. Actual results could differ from those estimates.

(u) Comparative Figures

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

(v) Adoption of New Accounting Standards

Goodwill and Intangible assets

Effective January 1, 2009, the Company adopted Section 3064 "Goodwill and intangible assets", replacing Section 3062, "Goodwill and other intangible assets". The new section establishes standards for the recognition, measurement, presentation and disclosure of goodwill subsequent to its initial recognition and of intangible assets by profit-oriented enterprises. Standards concerning goodwill are unchanged from the standards included in the previous Section 3062. The adoption of this standard had no significant impact on the Company's financial statements.

Financial Statement Concepts

Effective January 1, 2009, the Company adopted Section 1000, "Financial Statement Concepts" which has been amended to focus on the capitalization of costs that truly meet the definition of an asset and de-emphasizes the matching principle. The adoption of this standard had no significant impact on the Company's financial statements.

(w) Recent Accounting Pronouncements

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

International financial reporting standards (IFRS)

In February 2008, Canada's Accounting Standards Board confirmed that IFRS will replace Canadian GAAP for publicly accountable enterprises for financial periods beginning on and after January 1, 2011. The Company's first mandatory filing under IFRS will be the first quarter of 2011 which will contain IFRS compliant information on a comparative basis. Due to the anticipated changes to IFRS prior to transition, it is currently not possible to fully determine the impact on the Company's consolidated results.

Business combinations, consolidated financial statements and non-controlling interests

In January 2009, the CICA issued sections 1582, "Business Combinations", 1601, "Consolidated Financial Statements", and 1602 "Non-Controlling Interests" which superseded current sections 1581, "Business Combinations" and 1600 "Consolidated Financial Statements". These sections will be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after January 1, 2011. Earlier adoption is permitted. If an entity applies these sections before January 1, 2011, it is required to disclose that fact and apply each of the new sections concurrently. These new sections were created to converge Canadian GAAP to IFRS.

Credit Risk and Fair Value of Financial Assets and Liabilities

In January 2009, the CICA issued EIC-173, "Credit Risk and the Fair Value of Financial Assets and Financial Liabilities." The EIC will be applicable to financial statements relating to fiscal years beginning on or after January 20, 2009. Accordingly, the Company will adopt the new standards for its fiscal year beginning January 1, 2010. The EIC provides guidance on how to take into account credit risk of an entity and counterparty when determining the fair value of financial assets and financial liabilities, including derivative instruments, for presentation and disclosure purposes. The Company is currently evaluating the impact of the adoption of this EIC on its consolidated financial statements.

3. INVESTMENT IN REAL ESTATE JOINT VENTURE

The Company's US subsidiary, Azure Dynamics Incorporated (formerly Solectria) owns a 50% interest in ND Solectria LLC, a joint venture partnership with NDNE Real Estate, Inc., a real estate development corporation. The investment in the real estate joint venture, which is accounted for using the proportional consolidation method, was formed for the purpose of holding property located in Woburn, Massachusetts. On October 1, 2001, the Company entered into a lease agreement for the Woburn property. The Company provided a security deposit of US$400,000 (Cdn$420,000) and made guarantees of an additional US$600,000 (Cdn$631,000) that is in the form of a letter of credit, which expires October 1, 2010 and is collateralized by certain cash equivalents. This letter of credit is renewed yearly based on the contract. NDNE Real Estate, Inc. maintains the unilateral right to sell the property during the lease term and manages the property. The Company is entitled to 50% of earnings of ND Solectria LLC. For the year ended December 31, 2009 the Company's interest in earnings from the real estate joint venture amounted to $266,000 (2008–$213,000).

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

(Stated in thousands of dollars)

ASSETS	2009 $	2008 $
Current		
Cash and equivalents	316	347
Accounts receivable	5	7
Prepaid expenses	4	9
	325	363
Land	429	429
Property and equipment	2,058	2,514
	2,812	3,306

(Stated in thousands of dollars)

LIABILITIES AND SHAREHOLDERS' EQUITY	2009 $	2008 $
Current		
Accounts payable and accrued liabilities	292	322
Notes payable–current	66	74
	358	396
Note payable–long term	2,055	2,459
Shareholders' equity	399	451
	2,812	3,306

The note payable is the Company's proportionate share of a mortgage on the Boston property owned by ND Solectria LLC. The note is repayable on November 20, 2011, bears interest at a floating rate of the applicable Treasury rate plus 200 basis points and is secured by the mortgaged premises. For the year ended December 31, 2009, the Company incurred $74,000 of interest expense relating to this long-term debt (2008 - $69,000). As both parties are jointly and severally liable for repayment of the note payable, the maximum exposure to loss as a result of its involvement with this entity is US$4.0 million (Cdn$4.2 million). The principal repayments over the next two years payable by the joint venture are approximately as follows: 2010 - US$126,000 (Cdn$132,000), 2011 - US$3,911,000 (Cdn$4,110,000).

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

(Stated in thousands of dollars)

	2009 $	2008 $
Net rental income	391	355
Interest on note payable	(79)	(142)
Foreign currency gains/(losses)	(46)	0
Net income	266	213

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

CASH FLOWS FROM OPERATING ACTIVITIES	2009 $	2008 $
Net Income	266	213
Amortization	73	69
Unrealized foreign currency gains	20	–
Changes in non cash working capital balances	22	64
	381	346

CASH FLOW FROM FINANCING ACTIVITIES	2009 $	2008 $
Principal payments on note payable	(69)	(41)
Capital distribution to owners	(318)	(244)
	(387)	(285)
Exchange impact on cash held in foreign currency	(25)	0
Cash and cash equivalents beginning of year	347	286
Cash and cash equivalents end of year	316	347

4. RESTRICTED CASH

Restricted cash consists of short term U.S. treasury bills pledged as security with a bank as the collateral for a letter of credit which forms part of the security deposit for the facility in Woburn, Massachusetts (note 3). The treasury bill varies in length of time depending on yield. Current treasury bill has a yield of approximately of 0.1%.

5. INVENTORY

As at December 31, 2009, the Company had the following inventory levels:

(Stated in thousands of dollars)

	2009 $	2008 $
Raw materials	4,660	4,787
Work in progress	1,119	322
Finished goods	4,178	6,593
Total Inventory	9,957	11,702
Less: reserve for obsolescence	4,742	3,384
Net inventory	5,215	8,318

For the year ended December 31, 2009, the total amount of inventory recognized as an expense was $12.3 million (2008 - $9.3 million). The Company also recognized an additional $1.4 million (2008 - $2.5 million) in its provision for inventory obsolescence. Inventory items provided for reflect management's belief that there is no future recovery for inventory that was purchased in previous periods. As at December 31, 2009, management no longer supported the sales of any additional G1 units and decided to write-off related inventory to its net realizable value. As at December 31, 2009, no inventories were pledged as security for liabilities.

6. PROPERTY AND EQUIPMENT

(Stated in thousands)			2009 $
	Cost	Accumulated Amortization	Net Book Value
Building	3,780	995	2,785
Workshop equipment	1,460	901	559
Tooling	1,032	475	557
Leasehold improvements	1,174	650	524
Land	429	–	429
Equipment under capital leases	353	139	214
Computer hardware and software	1,907	1,741	166
Office furniture and equipment	299	263	36
Automotive	200	193	7
	10,634	5,357	5,277

(Stated in thousands)			2008 $
	Cost	Accumulated Amortization	Net Book Value
Building	3,780	853	2,927
Workshop equipment	1,518	764	754
Tooling	1,024	287	737
Leasehold improvements	1,159	529	630
Land	429	0	429
Equipment under capital leases	364	51	313
Computer hardware and software	2,525	2,194	331
Office furniture and equipment	325	260	65
Automotive	214	206	8
	11,338	5,144	6,194

Amortization expense of property and equipment was $960,000 for the year ended December 31, 2009 (2008 - $954,000). In addition, amortization expense for equipment under capital leases was $88,000 (2008 – $51,000).

7. INTANGIBLE ASSETS

(Stated in thousands)	2009 $ Cost	Accumulated Amortization	Net Book Value
Patents and trademarks	1,072	670	402
Product technology	12,500	6,147	6,353
	13,572	6,817	6,755

(Stated in thousands)	2008 $ Cost	Accumulated Amortization	Net Book Value
Patents and trademarks	869	461	408
Product technology	12,500	4,896	7,604
	13,369	5,357	8,012

Amortization expense of intangible assets was $1.5 million and for the year ended December 31, 2009 (2008 - $1.4 million).

The costs of acquiring and applying for patents and trademarks are capitalized and amortized on a straight-line basis over their estimated useful lives of fifteen years. The product technology asset is amortized on a straight-line basis over a 10 year period.

8. CUSTOMER DEPOSITS AND DEFERRED REVENUE

In November 2003, Azure Dynamics Incorporated (formerly Solectria) entered into a Transfer of Technology and Software Licensing Agreement ("TTA Agreement") with Singapore Technologies Kinetics ("STK"), a former shareholder. Under the terms of the agreement, STK has a non exclusive license to use and manufacture specified technology in specified Asian countries. The Company also provided STK with the training necessary for the transfer of the technology. The license expires in November 2020, and is subject to automatic one-year renewals thereafter. The Company received cash consideration for the license and transfer of technology, and for the training in the aggregate amount of US$1.0 million. Revenues from the TTA Agreement are being recognized on a straight-line basis over the period of the license agreement. As of December 31, 2009, the Company has deferred revenue associated with the TTA Agreement in the amount of $0.7 million (2008–$0.8 million). During the year ended December 31, 2009, revenues recognized by the Company from the sale of products to STK and its related companies and from certain other contractual arrangements totalled approximately $68,000 (2008–$62,000).

The Company recorded the following customer deposits and deferred revenue as at December 31:

(Stated in thousands of dollars)	2009 $	2008 $
Deferred revenue - TTA	709	776
Deferred revenue - Others	136	357
Customer deposits	545	66
Total customer deposits and deferred revenue	1,390	1,199
Current portion	(746)	(360)
Long term portion	644	839

9. OBLIGATION UNDER CAPITAL LEASE

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

Year	Amount $
2010	116
2011	60
2012	46
2013	22
	244
Less: imputed interest	(28)
Total capital lease obligation	216
Less: current portion of capital lease obligation	(99)
Long term portion of capital lease obligation	117

Lease terms vary from 2 to 5 years. Furthermore, the imputed interest rates on these leases range from 7%–23%. The leases are secured by the vehicles, equipment, and computer equipment under capital lease.

10. PENSION CONTRIBUTIONS

After an executive officer or employee has completed one year of service, the Company may 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 of $397,000 for the year ended December 31, 2009 (2008–$435,000).

11. SHARE CAPITAL AND STOCK OPTIONS

a) Authorized

Unlimited common shares without par value

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

b) Issued and Outstanding Common Shares

(Stated in thousands of dollars)

	Number of Shares	Amount
Balance, December 31, 2007	279,376,177	140,665
August 2008 private placement (i)	100,000,000	24,342
Balance, December 31, 2008	379,376,177	165,007
Issued on exercise of options	218.559	14
August 2009 private placement (ii)	58,823,529	9,390
December 2009 private placement (iii)	166,666,667	27,839
Balance, December 31, 2009	605,084,932	202,250

(i) On August 27, 2008, the Company completed a private placement of 100,000,000 common shares of the Company at a price of $0.25 per share, for net proceeds of $24.3 million after deducting share issue costs of $0.7 million.

(ii) On August 13, 2009, the Company completed a private placement of 58,823,529 common shares of the Company at a price of $0.17 per share, for net proceeds of $9.4 million after deducting share issue costs of $0.6 million.

(iii) On December 22, 2009, the Company completed a private placement of 166,666,667 common shares of the Company at a price of $0.18 per share, for net proceeds of $27.8 million after deducting share issue costs of $2.2 million.

c) Stock Options

The Company has a stock option plan (the “Plan”) which authorizes the Board to issue options to insiders, employees and service providers of the Corporation and its subsidiaries. The maximum number of common shares issuable under stock options, together with common shares as may be subject to options pursuant to other share compensation arrangements, shall not exceed 10% of the outstanding common shares. The exercise price shall not be lower than the closing trading price of the common shares on the TSX, on the last trading day prior to the date on which the option is granted. The options have terms ranging from one to seven years and generally vest over periods of up to twenty-four months. As at December 31, 2009 the Company had 26,105,729 stock options outstanding under the Plan.

The stock options are exercisable at a weighted average exercise price of $0.37 per common share. The stock options expire on various dates between September 9, 2011 and March 27, 2016.

Stock option transactions for the year ended December 31, 2009, and the number of stock options outstanding are summarized as follows:

	2009		2008	
	Number of Optioned Common Shares	Weighted Average Exercise Price	Number of Optioned Common Shares	Weighted Average Exercise Price
		$		$
Outstanding, beginning of year	15,080,126	0.73	14,451,626	0.91
Options granted	14,222,509	0.04	7,300,000	0.31
Options exercised	(218,559)	0.04	–	–
Options forfeited	(1,732,500)	0.63	(2,288,333)	0.36
Options expired	(1,245,847)	0.68	(4,383,167)	0.81
Outstanding, end of year	26,105,729	0.37	15,080,126	0.73
Exercisable	15,397,409	0.51	11,295,795	0.79

As at December 31, 2009 the numbers of optioned common shares outstanding and exercisable are as follows:

		Options outstanding		Options exercisable	
Range of exercise prices	Number outstanding at December 21, 2009	Weighted average remaining contracted life	Weighted Average Exercise Price	Number exercisable at December 31, 2009	Weighted Average Exercise Price
$		YEARS	$		$
0.04–0.28	15,378,950	6.01	0.06	5,777,275	0.09
0.35–0.53	3,845,000	4.82	0.36	2,738,355	0.37
0.63–0.87	4,310,989	3.46	0.83	4,310,989	O.83
0.95–1.04	645,790	2.21	0.99	645,790	0.99
1.05–1.10	1,205,000	2.97	1.07	1,205,000	1.07
1.11–1.30	720,000	3.06	1.11	720,000	1.11
0.04–1.30		5.10	0.33	15,397,409	0.51

d) **Stock Compensation Expense**

The fair value of each performance share and stock option is determined at each issue or grant date using the Black-Scholes model with the following assumptions: risk free interest rate - 5% (2008 - 5%), expected life – 4 years (2008 - 4 years), expected dividend yield – nil (2008 - nil), and expected volatility – 78% (2008 - 44%). The Company recorded a compensation expense charge of $0.4 million to consolidated loss for the year ended December 31, 2009 (2008 - $0.7 million) with a corresponding credit to contributed surplus. The amount released from contributed surplus and added to share capital due to option exercise was $5,000 for the year (2008 - $Nil). The weighted average fair value per option granted in 2009 was $0.02 (2008 – $0.13).

e) **Deferred Share Unit Plan**

The Company has a Deferred Share Unit Plan (“DSU Plan”) under which it may grant deferred share units (“DSUs”) to non-executive directors and selected employees. The maximum number of common shares issuable from the Company’s treasury to participants under this DSU plan shall not exceed 6,900,000 common shares at any one time. Under the DSU Plan, non-executive directors can elect to receive a portion of their retainer fees in DSUs and selected employees can elect to receive up to 100% of their annual performance bonus in DSUs. Such elections must be made in advance of the determination of bonuses in the case of selected employees, and prior to the year in which the non-executive directors’ retainers will be earned in accordance with plan provisions. The DSU Plan also provides the Corporate Governance and Compensation Committee the authority to make discretionary grants of DSUs to non-executive directors as an additional component of their compensation and to selected employees as part of their annual remuneration.

Once a non-executive director or selected employee ceases employment, by way of termination, resignation, retirement, disability or death, the Company can, in its sole discretion, either settle the obligation in cash equal to the number of DSUs held by the person multiplied by the previous five day weighted average trading price of the Company's common shares, or in common shares on a one for one basis for each DSU held by the person. The DSUs issued pursuant to the DSU Plan, together with all of the Company's other previously established security based compensation arrangements, may not result at any time in the aggregate number of common shares reserved for issuance from the Company's treasury to insiders exceeding 10% of the outstanding issue or the issuance to insiders from the Company's treasury, within a one year period, of an aggregate number of common shares exceeding 10% of the outstanding issue. The DSU Plan is an unfunded plan and any obligations of the Company under the DSU Plan are unsecured. The DSU plan was effective on May 8, 2007.

A total of 1,310,633 (2008 – 1,003,878) DSUs were issued to executives and directors of the Company during the year ended. As of December 31, 2009 there were 4,439,238 DSUs outstanding (2008 – 3,128,605). Compensation expense of $0.2 million (2008 - $0.2 million) was recognized during the year ended December 31, 2009 related to DSUs.

(f) Contributed Surplus

(Stated in thousands)	$
Balance, December 31, 2007	5,605
Stock option compensation expense	711
Deferred share units compensation expense	184
Balance, December 31, 2008	6,500
Stock option compensation expense (Note 11(d))	400
Deferred share units compensation expense (Note 11(e))	244
Release to share capital on exercise of stock options	(5)
Balance, December 31, 2008	**7,139**

12. INCOME TAXES

A reconciliation of the income tax provision computed at statutory rates to the reported income tax provision is as follows:

	2009	2008
Statutory tax rate	30%	31%
Loss before income taxes	(28,130)	(38,867)
Expected income tax recovery on net loss, before income tax	(8,439)	(12,049)
Increase (decrease) in income tax recovery resulting from:		
Permanent differences	216	299
Foreign tax rate differential	(1,503)	660
Effect of change in statutory rate and other	3,018	(1,394)
Change in valuation allowance	6,708	12,484
Income tax recovery	–	–

The significant components of the Company's future income tax assets and liabilities are as follows:

	2009	2008
Future income tax assets:		
Non-capital losses carry forward	36,597	33,353
Scientific research expenditures	12,815	11,893
Investment tax credits	8,570	10,432
Reserves and other	753	929
Deferred revenue and other liabilities	330	532
	59,065	57,139
Less: valuation allowance	(58,712)	(56,052)
Net long-term future income tax assets	353	1,087
Future income tax liability		
Property and equipment and intangible assets	(353)	(1,087)

As at December 31, 2009, the Company has unclaimed consolidated research and experimental development expenditures of $22.6 million that are available to offset future taxable income. The Company also has $120.5 million of consolidated non-capital tax losses that are available for carry forward to offset future taxable income, and $10.4 million of consolidated investment tax credits that are available to offset future income taxes payable, that expire as follows:

Expiry	Non-Capital Losses	Investment Tax Credits	R&D Tax Credits
December 31, 2010	1,785	39	2
December 31, 2011	–	210	10
December 31, 2012	–	130	2
December 31, 2013	–	71	12
December 31, 2014	6,539	247	39
December 31, 2015	12,049	412	45
December 31, 2016	–	522	55
December 31, 2017	318	590	109
December 31, 2018	1,950	680	43
December 31, 2019	47	316	2
December 31, 2020	1,736	70	63
December 31, 2021	4,931	510	31
December 31, 2022	2,861	235	141
December 31, 2023	1,746	127	155
December 31, 2024	2,831	954	72
December 31, 2025	3,646	743	34
December 31, 2026	15,552	1,772	18
December 31, 2027	21,944	1,288	185
December 31, 2028	17,325	1,177	254
December 31, 2029	25,261	322	94
Infinite	2	–	21,210
TOTALS	120,523	10,415	22,576

Of the $120.5 million consolidated non-capital tax losses, $77.2 million related to the operation in Canada and $43.3 million to the related operation in US.

Section 382 of the US Tax Reform Act of 1986 contains provisions that may limit the amount of net operating loss and tax credit carry forwards that the Company may use in any one year in the event of certain cumulative changes in ownership over a three-year period in excess of 50%, as defined. The Company believes it has experienced a change in ownership in excess of 50%; however, the amount of the limitation has not yet been determined.

13. GOVERNMENT ASSISTANCE

On March 31, 2002 the Company entered a $9.0 million Research and Development agreement with the Government of Canada, through its Technology Partnerships Canada ("TPC") program. The agreement provides a 26.6% contribution by TPC towards specific expenditures in respect of the research and development of the G1 and G2 hybrid electric and electric powertrains, up to a maximum reimbursement of $9.0 million. During 2009, the agreement has been revised and included eligible expenditures from the P1 program. The entire $9.0 million has been collected as at December 31, 2009.

The Company expended the following research and development costs in 2009 and 2008:

	2009 $	2008 $
Engineering, research development and relarted costs	15,568	21,455
Government Assistance	(2,828)	831
Customer contributions	(1,059)	–
Engineering, research, development and related costs, net	11,681	22,286

Before contributions, the Company expended $6.1 million on product development costs in 2009 (2008 - $11.6 million). In 2009, the Company received contributions receivable related to TPC of $2.8 million (2008 - $nil); the entire $2.8 million related to 2007 and 2008 TPC claims which decreased current year engineering, research and development costs.

The Company is required to make royalty payments to TPC as described under Note 16(c).

14. CAPITAL RISK MANAGEMENT

The Company's objectives when managing capital is to maintain its ability to continue as a going concern in order to provide returns for shareholders and benefits for other stakeholders. The Company includes equity comprising of issued common shares, contributed surplus, and deficit in the definition of capital. The following table represents Azure's current capital structure as at December 31, 2009:

(Stated in thousands)	2009 $	2008 $
Share Capital	202,250	165,007
Contributed Surplus	7,139	6,500
Deficit	(164,539)	(136,731)
Total Capital Structure	44,850	34,776

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

Due to the stage of development the Company is currently in, as well as the various stages the Company's products are in, the Company may face difficulty in managing its capital resources and obtaining financing except through raising capital through the issuance of equity. It is the Company's ability to raise financing through equity that has created the cash balances as at December 31, 2009.

The Company is subject to externally imposed capital requirements through letters of credit ("LOC") that the Company maintains through various financial institutions. These LOCs are performance guarantees as referenced in note 2(i) and may be drawn upon by the beneficiaries of the LOC in the event the Company fails to perform its obligations as agreed upon with the beneficiaries. Certain LOCs have been collateralized through treasury bills. Furthermore, all LOCs have been classified as restricted cash on the consolidated financial statements. There has been no change with respect to overall capital risk management strategy during the year ended December 31, 2009.

15. FINANCIAL INSTRUMENTS

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

The Board of Directors has the overall responsibility for the establishment and oversight of the Company's risk management framework and establishes and monitors risk management policies to identify

and analyze the risks faced by the Company; set appropriate risk limits and controls; and to monitor risks and adherence to market conditions and the Company's activities.

During 2009, CICA Handbook Section 3862, Financial Instruments – Disclosures, was amended to include enhanced disclosures about inputs to fair value measurement, including their classification within a hierarchy that prioritizes the inputs to fair value measurement. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (level 1) and the lowest priority to unobservable inputs (level 3). The three levels of the fair value hierarchy are:

Level 1–Unadjusted quoted prices in active markets for identical assets or liabilities;

Level 2–Inputs other than quoted prices that are observable for the asset or liability either directly or indirectly; and

Level 3–Inputs that are not based on observable market data.

Fair Values

The Company's financial instruments consist primarily of cash and cash equivalents, restricted cash, accounts receivable, accounts payable and accrued liabilities and notes payable.

The carrying values of cash, restricted cash, accounts receivable, and accounts payable and accrued liabilities approximate fair values due to the immediate short-term maturity of these financial instruments.

The Company's note payable incurs interest at a floating rate of interest and therefore, its carrying value approximates fair value.

Credit Risk

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

As previously mentioned under note 14 the Company has entered into various LOCs of which certain LOCs have been collateralized by treasury bills.

Financial assets that are either past due or impaired:

The Company's accounts receivable consist mainly of various customers in the hybrid or electric automotive industry. Credit risk from accounts receivable encompasses the default risk of these customers due to the size of their organizations and the conditions in which they operate in.

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

Management does not believe that there is significant credit risk arising from any of the Company's other customers. The maximum exposure to loss arising from accounts receivable is equal to their total carrying amounts. As at December 31, 2009, the Company provisioned for uncollectible accounts receivable for approximately $0.3 million (2008–$0.3 million). No other provisions have been made.

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

	Current	31–60 days	61–90 days	91+ days	Carrying value on the balance sheet $
Accounts receivable	40%	27%	21%	12%	2,906
Provision for non-collection	–	–	–	100%	(274)
Net accounts receivable	44%	30%	24%	2%	2,632

The definition of items that are past due is determined by reference to terms agreed with individual customers. Of the 91 days+ balance at December 31, 2009, this relates primarily to two customers in which one customer has a misappropriated funding issue and another customer has moved away from the Company's program. Both receivables have been provided for at December 31, 2009.

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

Collateral and other credit enhancements obtained:

As at December 31, 2009, the Company did not hold any collateral or other credit enhancements such as letters of credit that would enhance the Company's ability to collect any outstanding debts (i.e. accounts receivable) owed to the Company.

Interest Rate Risk

The Company has exposure to interest rate risk as it relates to its notes payable. Interest rate risk relates to the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market interest rates. The Company incurs interest rate risk on its cash and cash equivalents, restricted cash, accounts receivable and accounts payable balances. The Company does not hedge its exposure to interest rate risk. The impact on net loss of a 300 basis point change in interest rates during 2009 would have been approximately $2,500.

Foreign Currency Exchange Risk

Foreign currency exchange risk is the risk that the fair value of financial instruments or future cash flows will fluctuate as a result of changes in foreign exchange rates. The Company substantially holds its cash in Canadian dollars; however, is starting to have a greater operating presence in the United States which requires settlement of future operating expenses in US currency. The Company had no forward exchange rate contracts in place as at or during the year ended December 31, 2009.

As at December 31, 2009, the Company held $2.2 million (2008 - $6.0 million) of cash, restricted cash and accounts receivable in United States dollars. In addition, the Company held $4.9 million (2008 - $5.4 million) of accounts payable, obligations under capital leases and notes payable in United States dollars. With a +/- 5% change in United States dollars foreign exchange rate, the Company estimated the impact on net loss for the year would be +/- $702,000.

Liquidity Risk

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

Aside from the note payable, the Company does not have any borrowings or debt facilities and settles its financial obligations out of cash and cash equivalents. The Company's ability to settle its obligations as they come due is based on the Company being able to successfully rely on external financing as well as collection of its outstanding accounts receivable.

The Company manages liquidity risk through an ongoing review of accounts receivable balances and by following up of amounts past due and the management of its cash and cash equivalents through budgeting efforts.

As at December 31, 2009, the Company's accounts payable and accrued liabilities were approximately $9.8 million (2008 - $4.8 million) which fall due for payment within twelve months of the balance sheet date and the current portion of the outstanding note payable is $0.07 million (2008 - $0.07 million).

Market Risk

Market risk is the risk that changes in market prices such as foreign exchange rates, commodity prices and interest rates will affect the Company's net loss or the value of financial instruments. The objective of market risk management is to mitigate exposures within acceptable limits, while maximizing returns. As at December 31, 2009, the Company did not utilize any forward exchange contracts to mitigate any of the risks as mentioned above. Furthermore, the Company is not materially affected by commodity prices or interest rates.

16. COMMITMENTS

As of December 31, 2009, the Company has committed to lease payments for premises, equipment and entered into purchase orders for inventory and goods/services requiring payments in future periods as follows:

2010	$	1,602
2011		3,816
2012		2,135
2013		2,164
2014		2,389
2015		3,091
2016		845
	$	16,042

Approximately $9.8 million (USD$9.4 million) of this total is attributable to the US operation and is US dollar denominated, and thus, is subject to currency risk.

(a) Azure Dynamics Incorporated leases its operating facility in Woburn, Massachusetts under a non-cancellable lease agreement. Through a joint venture agreement, the Company has a 50% interest in the lessor, ND Solectria LLC (Note 3). The lease agreement provides for a minimum monthly rental payment plus certain operating costs. The Company's lease agreement contains escalation clauses and expires in September 2016.

In May, 2004 Azure Dynamics Inc. entered into a lease for a facility in Burnaby, British Columbia, which supports engineering and operations activities. The lease is for a 5 year term, concluding on April 20, 2009. In February 2009, Azure Dynamics Inc. renewed the above lease. The lease is for a 5 year term, concluding on April 30, 2014.

(b) Pursuant to a contractual agreement with Natural Resources Canada (NRCan), the Company is required to make royalty payments in the event that the Company successfully commercializes its intellectual properties specified in this agreement. The royalty payments, if any, are calculated at a rate of 1% of yearly gross sales earned from its intellectual properties. The obligation to make royalty payments expires at the earlier of January 2011 or when aggregate royalty payments reach $296,000. As at December 31, 2009, payments of approximately $16,500 (2008 - $16,500) have been paid to NRCan.

(c) Pursuant to a contractual agreement with Technology Partnerships Canada ("TPC"), the Company is required to make royalty payments equal to the greater of 0.28% of yearly gross business revenues or in accordance with a fixed repayment schedule, with repayment amounts ranging from $0.7 million to $1.0 million per year starting in 2008 and totalling $1.3 million, provided that certain minimum sales levels are achieved. The obligation to make royalty payments commences when the minimum sales levels are achieved and continues until the earlier of 2015 or when a cumulative payment ceiling of $20.5 million is reached. On March 23, 2005, the Company entered into a contract amendment with TPC whereby the royalty payment period was extended to December 31, 2020. As at December 31, 2009, payments of approximately $45,000 (2008 - $nil) have been paid to TPC.

(d) Pursuant to an agreement with EnCana Corporation, whereby EnCana sponsored the development of a power train product, the Company is required to make royalty payments equal to 1% of gross revenue from sales of the power train product up to a maximum payment of $1.0 million. As at December 31, 2009, payments of approximately $16,500 (2008 - $16,500) have been paid to EnCana Corporation.

(e) The Company has entered into employment agreements with certain executive directors and officers. In addition to defining the terms of employment, the agreements entitle the executives to termination payments of up to one year compensation, and the immediate vesting of all options previ-

ously granted in the event of termination without cause and in some cases in the event of termination due to a change in the control of the Company.

(f) The Company has entered into purchase orders for the supply of materials to support anticipated future sales of its products. Gross commitments entered into as at December 31, 2009 were $5.2 million payable in the coming years.

17. CHANGES IN NON-CASH WORKING CAPITAL ITEMS

(Stated in thousands of dollars)	2009 $	2008 $
Accounts receivable	(333)	(1,655)
Contributions Receivable	–	1,128
Inventory and related prepayments	3,103	1,882
Prepaid expenses	(299)	25
Accounts payable and accrued liabilities	5,372	152
Customer deposits and deferred revenue	189	93
	8,032	1,625

18. SEGMENTED FINANCIAL INFORMATION

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

(Stated in thousands)

	Revenues	Total Assets	Property, Plant, Equipment and Goodwill
	2009	December 31, 2009	December 31, 2009
	$	$	$
Canada	1,737	39,916	1,056
United Kingdom	–	6	–
United States	7,272	18,492	7,153
Other foreign countries	394	–	–
Total	9,403	58,414	8,209

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

	Twelve months ended December 31, 2009	Twelve months ended December 31, 2008
	Percentage	Percentage
First	23%	32%
Second	14%	27%
Third	10%	8%
Others	53%	33%
Total	100%	100%

19. SUBSEQUENT EVENT

In January 2010, the Company issued 5,775,000 of stock options to outside directors, executive employees and non-executive employees with an exercise price equal to market price on January 20, 2010. The options have a term of seven years and vest over a period ranging from immediately to two years.

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Chief Executive Officer, Azure Dynamics Corporation

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Dennis A. Sharp
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Ford Motor Company

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Curt A. Huston
Chief Operating Officer

Ronald V. Iacobelli
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