non-resource sector issue
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continuous disclosure | update

MD&A GUIDANCE for junior companies in non-resource sectors

Includes MD&A example with explanatory notes

British Columbia Securities Commission

Better Management Discussion and Analysis (MD&A)

How to improve this critical window on your company's performance

We have prepared this special edition of the Continuous Disclosure Update to assist management and directors of junior non-resource sector companies listed on the TSX Venture Exchange to comply with MD&A disclosure requirements for their annual and quarterly reports (BC form 51-901F). Currently, in Canada, all TSX Venture and many TSX listed companies are required to provide MD&A. However, in the next year, a new National Disclosure Rule is expected to be introduced that will require thorough MD&A disclosure by all Canadian public companies.

We're working to meet the needs of the public AND reporting companies

As a regulator our role is to protect investors and maintain confidence in the capital markets. At the same time, we are working hard to ensure companies are not excessively burdened in ways that hamper their business. This is why we supply as much step-by-step information as possible to help junior public companies understand and meet their obligations. This guide to MD&A preparation is part of our effort to make the compliance process easier and help your company meet its obligations to the investing public.

BCSC

Investors are demanding better disclosure from public companies

The global trend to improved public disclosure

Corporate accounting scandals, economic conditions and their combined negative impact on capital markets have resulted in a new emphasis on public company accountability. The demand for more and better information from public companies is being driven by investors, and the impact is being felt by companies and regulators alike. From the investor's perspective, a company's "continuous disclosure record" — regulatory filings and other communications with shareholders and potential investors — is the *only* basis available for assessing its performance and integrity. This is the underlying reason efforts to improve public disclosure are being stepped up, locally and globally.

Good disclosure is good for business

Full public disclosure is a strong indicator to investors of a quality management team and a well-run operation. Conversely, a lack or inconsistency of information makes a strong negative statement. Even if a company's results are less positive than expected, or operational problems arise, management that explains on a timely basis *why* these events have occurred and their strategies for moving forward, cannot but help their public credibility. It is when information is withheld or misrepresented that today's investors show zero tolerance. So, beyond compliance, good disclosure is good for business. It promotes investor confidence in individual companies and in the markets as a whole, and can lead to positive market attention and greater share liquidity.

MD&A and Financial Statements:

The Management Discussion and Analysis (MD&A) was originally intended to be supplementary to a company's financial statements. However, with the trend to improved corporate disclosure, the MD&A itself has become an integral part of public company reporting. In November 2002, the Canadian Institute of Chartered Accountants (CICA) published extensive guidance on the disclosure now required in an MD&A, stating "the MD&A and the financial statements together now form the foundation for business reporting and comprise a stand-alone disclosure package."

"The MD&A, like financial statements, provides the opportunity for a company to demonstrate accountability to investors... for meeting important strategic objectives. Also, the discipline required to prepare an effective MD&A can strengthen internal management focus."

— CICA
'MD&A Guidance on Preparation and Disclosure'

The financial statements reflect *what* happened during a reporting period — the MD&A explains *why* these changes occurred

The MD&A accompanies your financial statements. Neither is a substitute for the other and each must contain the appropriate level of detail. In an MD&A, management must analyze the financial statements and discuss the dynamics of the business. The discussion is directed at current shareholders and potential investors, but is also often reviewed by others assessing the company. MD&A disclosure provides management with an opportunity to explain how the company has performed, and discuss its financial position and future prospects.

The BC Securities Commission's MD&A rules require that companies provide investors with a *meaningful* analysis and discussion of their operations. In other words, you must provide a clear explanation of the nature of, and reasons for, changes in your company's performance during the reporting period.

Example: The income statement tells shareholders how much has been spent. The MD&A should explain why the expenditures were made. If an expenditure level is being compared from one period to another, the MD&A must explain the reasons for the difference.

"Financial statements and MD&A complement one another. The financial statements show investors and others how funds were raised and spent; the MD&A explains why these transactions occurred and what impact they will have on future operations."

— *Doug Hyndman*
Chair, BCSC

The discussion should help readers to understand trends, events, transactions and expenditures, and their impact on future operations. Both positive and negative developments must be discussed. For example, if the company did not achieve a planned milestone within the budget or time frame previously disclosed, the reason for not achieving the milestone, and its impact on the company's future operations, has to be clearly explained. This is particularly important when a company has previously raised funds to finance a project or acquisition — investors have a right to know how funds they have invested are being spent.

Example: If you previously announced a plan to expand your plant facilities at an estimated cost of $400,000, and you spent $400,000 during the current reporting period but only accomplished 50% of the planned expansion, you must disclose this information to your investors and explain the impact the shortfall will have on your future plans.

The "Most common MD&A problems" and "Fundamental steps to improve your MD&A" sections that follow give other examples and describe key factors to consider in preparing an MD&A.

the new "core business-reporting package" (CICA, 11/02)

Benefits of MD&A disclosure for junior companies

MD&A disclosure is particularly important for junior companies that do not have a history of profitable operations which might otherwise give investors assurance about the company's long-term prospects. The MD&A offers an opportunity for you to provide investors, and others who review company information, with your perspective of how the company has performed and how that performance will likely affect future plans. In the MD&A, you can share your management strategy and put the information contained in the financial statements into context. In this way, a properly prepared MD&A can significantly improve an investor's understanding of your business and its operations.

No need for added cost in preparing your MD&A

Some smaller companies have expressed concern about the time and cost required to prepare their MD&A. Providing accurate, complete and timely disclosure of information to shareholders is a responsibility all public companies assume, regardless of size. While developing an initial MD&A may take added time, it becomes easier once the process and format are familiar. In terms of cost, preparing an MD&A should not necessitate the use of outside consultants, as the purpose is to provide management's interpretation of what happened during the reporting period. Therefore, management should be providing the discussion and analysis, as they know the company best.

"...improved disclosure can lead to a lower cost of capital, increased financial analyst coverage, improved corporate governance, a more appropriate risk premium and better capital allocation decisions."

— excerpt from CICA news release

We are significantly increasing the number of MD&As we review

As part of BCSC's Continuous Disclosure Review Program, we regularly review the information filed by the 1,800 BC-based public companies we regulate to ensure they comply with disclosure standards. Through this program, we have found that the MD&A disclosure of many companies does not meet the requirements. Of the companies we reviewed from April 1, 2000 to December 31, 2002 approximately 41% had to amend and refile their MD&As. In approximately 10% of cases, the quality was so poor, companies were put on the "Issuers in Default List" (see next page) without warning.

In keeping with the increased emphasis on MD&A disclosure, in the coming year we plan to review the financial statements and MD&A filings of many more companies than in previous years. All companies are potential candidates for continuous disclosure review. We select companies in two ways: using a risk-based system that takes several factors into account, and randomly, so that the chances of companies being selected are equal.

"Whenever I talk to CEOs or investor relations professionals and ask them if they prefer to have a majority of institutional investors or retail investors, without exception they say retail investors. That's because retail investors tend to side with management's point of view. Good MD&A gives you a better chance of acquiring that larger base of retail investors. To attract those retail investors you have to make your business understandable to them."

*— John Bart
Founder, Canadian
ShareOwners Association*

The costs of non-compliance

There are a number of costs associated with failing to provide adequate MD&A disclosure. Some are obvious, and some are less apparent but still potentially damaging to a business.

The BCSC generally takes a "benefit of the doubt" approach when encountering disclosure deficiencies, particularly on a first-time basis. That is, in addition to providing as much guidance as we can to help companies, we normally work on the assumption that when information has not been fully provided, the company simply may not be completely aware of the requirements. Our system of regulatory consequences reflects this approach, increasing in severity according to the seriousness of the compliance problem:

1 Correct the Information in Future Filings

If problems are relatively minor, we ask the company to improve its disclosure in future filings.

2 Amend and Refile

When there are more serious disclosure problems, we ask the company to amend and refile its materials and publish a comprehensive news release.

3 Issuers in Default List

A company can be placed on BCSC's Issuers in Default List without notice if its disclosure problems are serious or extensive enough. An example would be disclosing "nothing to report" in the MD&A section when the financial statements show significant activity. This list is posted on our website and is widely circulated every week through various news media, such as Market News and Bloomberg.

4 Cease Trading Order

In extreme cases, a Cease Trading Order may be issued against a company's securities, which remains in effect until the problems are corrected. For example, this would apply where we determine a company has made a material misrepresentation.

The negative impacts on a business from the above measures range from pure inconvenience at the lower end of the scale all the way to potential derailment of a financing in more serious cases. Here are some of the direct and indirect costs to keep in mind that can result from not providing full disclosure:

- the need to go back and explain previously filed information
- the need to file missing information
- administrative time of senior people to respond and comply
- the need to involve accountants, auditors, lawyers or other outside consultants
- the impact of a negative news release, coverage in key publications such as Stockwatch, and undermining of expensive investor relations campaigns
- inability to obtain a Certificate of Good Standing from the Commission that can lead to a failed financing
- undervalued shares because investors do not understand the business
- exposure to litigation

The most common MD&A PROBLEMS *we find in our reviews*

no meaningful analysis and discussion of operations; the company simply reproduces numeric information from its financial statements with no explanation of why significant changes in operating results occurred

no explanation of why the company failed to achieve significant milestones within previously disclosed time frames or the implications of not achieving those milestones

no discussion of future operating and financial plans, particularly important when a company has liquidity or solvency problems

focussing only on positive items and ignoring negative items, sometimes to the extent that the MD&A is little more than a company marketing vehicle

confusing technical jargon where simple explanations of business and technical concepts will be more appreciated by the reader

a discussion that is missing key pieces of basic, useful information for investors, such as what the company does and its objectives; assumes the reader knows this information

information that is inconsistent with the company's other public information, such as on its website

no reconciliation of how funds were spent to how they were budgeted in offering documents

MD&A not updated each quarter; just a repeat of previously disclosed information from press releases or earlier MD&As; no new information or analysis provided

required "subsequent events" information not included: no discussion of material changes in operations between the end of the fiscal reporting period and the date the MD&A is filed

"...to be useful to investors, MD&A disclosure must convincingly answer three basic questions: How does this company make money and create value? What makes this company valuable today and tomorrow? Why does this company deserve investors' money? The better a company communicates with those who assess its value in capital markets, the better the markets will understand and reward underlying potential and prospects."

— Jim Goodfellow, Chair,
Canadian Performance
Reporting Initiative Board

fundamental steps to impro

- **use plain language and limit the use of technical jargon** so the average investor can understand
- **the discussion and analysis must be meaningful and comprehensive:** the question to ask is "will a non-insider understand where the company is coming from (as reflected in the financial statements), where it is now, and where it plans to go?"
- **provide a brief description of the company's business:** what does the company do and what are its objectives?
- **the MD&A should stand on its own;** investors should not have to hunt for disclosure in other sources such as press releases to understand the information
- **ensure the MD&A covers the company's operations for the fiscal period under review** – including significant events occurring subsequent to the period – up to and including the date the report is signed
- **be factual, balanced and non-promotional;** this means discussing negative information as well as positive
- **if relevant, disclose material terms of important agreements,** such as expiry dates and payment due dates
- **discuss the nature and purpose of significant expenditures** recorded during the period
- **explain the reasons for significant changes in operating results and assets** (including deferred costs) and liabilities; it is not sufficient to simply recite, without explanation, the changes from period to period that are easily determined from the financial statements
- **discuss the company's liquidity and solvency,** including any related future plans for addressing problems in these areas

ve your MD&A disclosure

- **if the company is in the development stage** (devoting substantially all its efforts to establishing a new business and planned principal operations have not commenced), and the current period's financial results are not fully comparable to those of the corresponding period in the prior year due to the rapidly changing nature of the company's business, consider comparing the current quarter's operating results to those of the immediately preceding quarter in addition to those of the prior year

- **include a comparison of how funds were actually spent to how they were budgeted** in recent offering documents; material variances between the two must be explained, as well as the impact of those variances on the company's ability to achieve milestones and objectives disclosed in the offering documents

- **discuss any acquisitions, disposals or write downs** of material capital assets

- **discuss any outstanding commitments and obligations** not reflected in the financial statements

- **discuss any current or pending legal proceedings and contingent liabilities**

- **discuss the nature and purpose of related party transactions,** including details of the specific services provided

- **disclose any management changes**

- **if regulatory (exchange) approval is required** for a particular transaction, discuss if this approval has been sought and obtained, for example, the sale of shares to insiders

- **discuss the company's future plans in general terms,** but avoid providing extensive, numerical future-oriented financial information, such as projections or forecasts, unless there is proper back-up (for more information see National Policy 48 Future-oriented Financial Information)

A COMPANY'S CONTINUOUS DISCLOSURE RECORD INCLUDES:

- regulatory filings and other communications with shareholders and potential investors such as quarterly and annual reports
- interim and annual financial statements
- Annual Information Forms (AIF) if applicable
- Information Circulars
- Material Change Reports
- information in press releases, on company websites, and in web-casts and speeches given by directors, officers and employees of the company

MD&A Example: the following example illustrates the type of Management Discussion and Analysis disclosure that should be provided by a development stage company. *Abbreviated financial statements are included simply as a reference for the purposes of highlighting portions of the example. This sample does not include all of the financial statement and Schedule B disclosure required by BC Form 51-901F.*

ABC FUEL SYSTEMS INC.
September 30, 20X2

Description of Business

ABC Fuel Systems Inc. develops and supplies custom software that significantly improves vehicle fuel economy. Customers remove the flux capacitor (FC) from their vehicles and courier it to us. Our installers implement our software in the FC, test it to ensure proper functioning and then return the unit to the customer via overnight courier.

Our fuel economy software has been fully tested in accordance with Office of Energy Efficiency standards for conditions and variables. The detailed test results are available on our website (www.abcfuel.com).

All test conditions documented and explained. Care has been taken to ensure the company has followed industry accepted standard test procedures, ensuring comparability of its results to manufacturer claims.

Until recently, our company had limited resources to devote to engineering and development. As a result, our product line has been limited to software applications for certain large luxury cars, trucks and SUVs. We have concentrated on these vehicles as they use the greatest amount of fuel and benefit most from the improved fuel economy provided by our product.

We began selling our software products in the second quarter of 20X1. Sales were relatively modest until an independent third party published a favourable review of our software in 20X2, which generated significantly increased demand.

Our long-term goals for the business include:

- being selected as an Original Equipment Manufacturer (OEM) supplier by a car manufacturer
- expanding our product line to include software for a greater number of vehicle makes and models

The Company is a reporting issuer in British Columbia and Alberta, and trades on the TSX Venture Exchange under the symbol ABC.

Operations

ABC Fuel Systems experienced very rapid growth in 20X2, far greater than we had anticipated. Although this growth was welcome, it brought new challenges to our Company. We had to quickly increase staffing levels and, due to the inexperience of some new staff, quality control suffered for a brief period. A number of installations had to be recalled, which resulted in a considerable charge to our income statement for warranty claims. The warranty problems were attributed to poor soldering that was traced to an employee who is no longer with the Company. We have changed our testing procedures to ensure a similar problem does not occur in the future.

MD&A is factual, balanced and non-promotional, with both positive and negative developments discussed. Later in the MD&A, the warranty problem is discussed in greater detail.

One of our key corporate goals is to expand our product offerings. During 20X2 we developed 33 new products for previously unsupported vehicles.

During the second quarter, we completed development and testing of our Towing Package software. For an additional $100, customers may add this option to our basic software ($500). The Towing Package has proved to be a popular option among our customers who tow a boat or trailer behind their vehicle.

Selection as an OEM is critical to our future growth, as the potential exists for automobile manufacturers to begin developing software similar to ours, which would significantly reduce the demand for our products. We continue to meet with industry representatives to pursue this objective. Although several have expressed an interest in our product, a major issue is that our company produces only a portion of the software within a typical FC. Therefore, any manufacturer selecting us would require multiple software suppliers to address other vehicle functions. In this situation, manufacturers would prefer to deal with one supplier that can provide all functions.

We will continue to pursue this potentially valuable source of business. If we feel it is warranted, we may decide to add engineers and develop software applications for other vehicle functions.

Future plans, challenges and their implications are discussed. This gives the reader an idea of the company's future prospects, as well as a basis for evaluating management's ability to achieve their stated goals.

We believe our small size and the experience of our team allow us to innovate more quickly than large manufacturers and consistently offer added value to customers. We have taken steps to protect our intellectual property by encrypting all of our software, as well as having our engineers sign non-competition agreements. We also provide our software engineers with a base salary substantially higher than industry average, and generous bonus and stock option plans, details of which can be found in the executive compensation portion of our Annual Information Form.

DISCUSSION OF OPERATIONS & FINANCIAL CONDITION

Three months ended September 30, 20X2

Revenues and cost of sales

Revenues for the third quarter ended September 30, 20X2 were $3,402,100, compared to $1,812,700 for the quarter ended June 30, 20X2. The significant increase in sales over the second quarter is largely attributed to the following factors:

- many new customers have been received through referrals from existing customers
- a favourable review of our software in Wheels Today, which provided independent verification of our results and valuable exposure, continues to result in significant new orders
- our Towing Package software was completed near the end of the second quarter, therefore, third quarter results reflect sales of the Towing Package for the full three months, versus only two weeks in the second quarter; the Towing Package represents approximately 20% of our sales increase in the third quarter

Comparatively, sales for the third quarter of last year were $250,000 as, at that time, our product was new to the market and our advertising program had just commenced.

Warranty costs for the current quarter were $215,325 compared to $190,200 in the previous quarter. The past two quarters had substantially higher warranty costs than previous quarters as a result of problems caused by poor soldering on the part of a single installer who is no longer with the Company. Improper soldering of the computer chip containing our software by this employee caused some FCs to malfunction. Consequently, management decided to recall all of the units the employee had worked on. To demonstrate its commitment to customer service, the Company paid for rental cars for customers affected by this problem who were without their vehicles for several days. We have taken a number of measures, including changing our testing procedures, to ensure this problem will not reoccur.

In dollar terms, warranty costs for three months ended September 30, 20X2 have increased compared to the three months ended June 30, 20X2. However, as a percentage of sales they have decreased to 6.3% for the current quarter compared to 10.5% for the previous quarter. The higher percentage in the second quarter resulted from a one-time $100,000 charge related to the soldering problem described above. As we have resolved that problem, we expect our long-term warranty provision to be approximately 5% or less. By comparison, warranty costs for the third quarter of 20X1 were $10,500, which represented approximately 4.2% of sales. No actual warranty claims were made prior to September 30, 20X1.

Gross margin for the quarter ended September 30, 20X2 was 89.4%, up from 83.4% for the quarter ended June 30, 20X2. The increase in gross margin reflects the fact that our optional Towing Package was available for the entire third quarter. Adding the Towing Package to a customer's order does not significantly increase our cost of sales, however it improves our revenues, which positively impacts on our gross margin. Comparing these results to last year, gross margin for the third quarter of 20X1 was 94.8%. The higher margin was primarily due to lower labour costs in our first year of operation, as well as lower warranty costs as described above. Labour costs were lower as we did not employ any full-time installers in 20X1 and this work was performed by available staff. It became necessary to hire full-time installers as sales increased in 20X2.

Due to rapid sales growth, we now employ 10 full-time installers, compared to seven during the second quarter and one in the first quarter of 20X2.

Throughout this section the current quarter has been compared to the corresponding period in the prior year and the immediately preceding quarter due to rapid growth.

Rather than discuss cost of sales, which vary with sales volume, gross margin has been discussed. Changes in gross margin and the underlying reasons for them provide the reader with a better understanding of changes in the company's total gross profit.

Underlying reasons for the changes in financial statement items have been provided. The reader gains a greater understanding of the business and is better able to predict what the future financial impacts of other factors or events might be.

Future plans, challenges and their implications are discussed.

Underlying reasons for the changes in financial statement items have been provided.

Future plans, challenges and their implications are discussed.

Administrative

Salaries and benefits were $332,578 for the three months ended September 30, 20X2, compared to $297,845 for the three months ended June 30, 20X2. The increase was the result of higher bonuses accruing to employees as sales exceeded quotas during the third quarter. Bonuses also accrued to employees in the second quarter, however, third quarter sales were substantially higher. Salaries and benefits for the corresponding three months ended September 30, 20X1 were $47,541.

Due to the sharp increase in orders that began during the second quarter of 20X2, unacceptable workload demands were placed upon both our staff and quality control processes. To remedy this problem we have added two additional staff starting in the fourth quarter.

Total general and administrative costs for the three months ended September 30, 20X2 were 18.4% of sales, compared to 29.2% of sales for the three months ended June 30, 20X2, and 44.3% for the three months ended September 20X1. The decrease over time reflects the efficiencies being achieved as our Company grows.

Sales and marketing

Advertising costs for the current quarter were $450,813, up from $273,500 in the previous quarter. The significant increase reflects the development of a new advertising campaign to announce additions to our product line, and substantially expanded advertising coverage to include publications throughout North America and Europe. The total cost to produce the new advertising campaign was approximately $70,000.

By comparison, advertising costs for the three months ended September 30, 20X1 were $25,000, which represented the commencement of our advertising efforts with a small-scale local print campaign.

Over 90% of travel costs in the current quarter relate to our cross-country tour in which our President, technical support person and two installers traveled to various North American cities to install our software in customers' vehicles. We advertised the tour on our website. We felt it was important to provide our product to customers who were not comfortable removing their own FC or could not be without their car for two to three days.

Although the tour allowed us to reach customers who might otherwise not purchase our product, and provided us with increased exposure, ultimately it was not a cost-effective means of offering local installation. However, the local installation concept is a logical next step for our business and we have decided it is most cost-efficient to pursue arrangements with existing establishments that already have local installation capabilities in place. We recently announced the first of these agreements, which is described in the discussion of events subsequent to the third quarter.

Research and development

During the third quarter we completed 23 new software applications in response to the demand for more products. As part of our product development process, we rent both the vehicles for which we are developing software and dynamometers to test the vehicles. Increased development in the third quarter resulted in equipment rental costs of $296,825, compared to $213,925 in the previous quarter.

Despite the increase in output, research and development salaries remained relatively constant at $114,542 for the third quarter, compared to $112,854 in the second quarter.

Our research and development activity was considerably lower in the third quarter of 20X1, with only two software applications developed, reflecting the Company's limited resources at that time.

As manufacturers constantly add new vehicle models or update existing models, we anticipate the level of research and development experienced in the last two quarters of 20X2 should remain relatively constant in the future, as software will have to be continually upgraded and new versions released.

Net Income

ABC Fuel Systems recorded its second consecutive quarterly profit in the three-month period ended September 30, 20X2. We had a net income of $1,279,774 or $0.98 per share, compared to a net income of $153,666 for the three months ended June 30, 20X2 or $0.13 per share, and $7,340 or $0.01 per share for the three months ended September 30, 20X1. Our improved operating results reflect a large increase in sales driven by growing demand for our software.

DISCUSSION OF OPERATIONS & FINANCIAL CONDITION

Nine months ended September 30, 20X2 compared to the nine months ended September 30, 20X1

Revenues and cost of sales

Revenues for the nine months ended September 30, 20X2 were $5,488,300, a significant increase from $475,000 for the comparable period a year earlier when we were in the start-up stage of operation. Our revenues have grown as a result of:

- increased demand for our software due to a favourable review in a national car magazine (*Wheels Today*), customer referrals and increased advertising
- the addition of 33 new products that have performed well
- the addition of our Towing Package option that became available in late June 20X2 and which now represents approximately 7% of sales

Underlying reasons for the changes in financial statement items have been provided.

Gross margin for the nine months ended September 30, 20X2 was 87.5% compared to 94.8% for the nine months ended September 30, 20X1. The decrease resulted primarily from unusually high warranty costs, as previously described, which adversely affected gross margins during the period.

Changes in gross margin and the underlying reasons for them provide the reader with a better understanding of changes in the company's total gross profit.

Margins were also negatively affected by the significant overtime that had to be paid to installers. This was a temporary situation necessitated by the rapid increase in volume of orders we experienced and the lag time in hiring additional installers to meet the new level of demand.

We now employ 10 full-time installers which is adequate to meet our current requirements. Another rapid increase in volume would again create the need to pay overtime to installers, thus reducing margins. Although overtime is expensive, we believe it is prudent to use overtime to deal with short-term spikes in demand, allowing us time to determine whether additional full-time staff are warranted.

Administrative

Salaries for the nine months ended September 30, 20X2 were $705,423, compared to $145,446 for the comparable period a year earlier. This increase reflects the addition of several new employees as follows:

- an order desk employee was added because our existing staff could not handle the large volume of orders we began receiving following the publication of a favourable review of our software
- the addition of two computer systems people was necessary to manage increased customer use of our website and to address our need for enhanced computer capabilities
- an office manager was hired to oversee day-to-day operations and allow our founder, Tim Clapp, to spend more time on software development and meeting with potential business partners
- three shipping/receiving employees were added to handle the greatly increased volume of orders

Underlying reasons for the changes in financial statement items have been provided.

Significant bonuses were accrued to staff during the second and third quarters this year as a result of sales levels increasing dramatically. Details of bonus arrangements can be found in the executive compensation portion of our Annual Information Form. In addition to bonuses, a health and dental plan, necessary to attract skilled labour, was implemented near the end of the first quarter adding to salaries and benefits.

For an explanation of office lease costs, please refer to related party transactions.

Sales and marketing

Advertising costs increased from $25,000 for the nine months ended September 30, 20X1, to $788,677 for the comparable period this year. The dramatic increase reflects the costs of developing a major product advertising campaign for the first time, and greatly increased circulation of our advertising, which is now carried through various media in North America and Europe. In the same period last year, our marketing efforts consisting only of local print advertising. We feel our present advertising coverage is sufficient and do not expect to create a new advertising campaign in the next year. As a result, we anticipate that our ongoing quarterly advertising costs, consisting mainly of print advertising in trade publications, will level off. In addition to the advertising campaign development ($70,000), current quarter advertising costs of $450,813 also reflect our annual attendance at the Detroit Auto Show ($25,000). Absence of these non-recurring costs in forthcoming quarters will reduce expenditures.

Future plans, challenges and their implications are discussed.

As discussed in the results for the third quarter, the majority of the year-to-date costs in travel relate to a cross-country tour designed to make our product available to a greater number of customers. Ongoing travel costs will consist of meetings with automobile manufacturers as we pursue plans to become an OEM supplier and seek installation agreements with companies such as Cullen Automotive, described in our discussion of events subsequent to the reporting period.

During the first quarter we spent $125,000 developing our website. Ongoing maintenance costs of the website are reflected in the salaries of our computer systems staff within general and administrative costs.

Research and development

We developed 33 new products in the nine months ended 20X2, compared to three in the comparable period last year. At the beginning of the year, we did not anticipate this significant increase in development. However, the favourable review of our software, discussed earlier, resulted in numerous requests to provide software for vehicles we did not support. Due to the high demand for additional product, we were confident that increased sales revenues from new products would more than offset the additional development costs.

Underlying reasons for the changes in financial statement items have been provided.

Increased research and development activity resulted in significant cost increases as we added a second full-time software engineer. Combined with improved bonuses, this resulted in salaries increasing from $86,057 for the nine months ended September 30, 20X1 to $233,654 for the comparable period this year.

In order to develop and test new products it is necessary for us to rent certain equipment. The two most significant components of our equipment rental costs are dynamometer rental time, required to test vehicles, and the rental of vehicles for which we are developing software. Equipment rental costs for the nine months ended September 30, 20X2 were $603,879, a significant increase from $86,028 for the comparable period a year earlier, reflecting the large number of new products developed during the period.

Future plans, challenges and their implications are discussed.

Many automobile manufacturers introduce revised models of cars within a four to six year cycle. Therefore, we anticipate that research and development costs will stay relatively constant in future years, as our product line will require constant updating in keeping with these cycles.

Related party transactions

A discussion of the related third party transaction explains what the company is receiving from the related party and why the transaction was necessary. As shareholders are informed of how much the space costs, what type of space it is and size of the space leased, they can compare this to similar transactions to ascertain whether or not they believe the terms are fair.

On January 1, 20X2 ABC Fuel Systems moved into substantially larger premises owned by our principal Tim Clapp. This move was necessary as we had outgrown our old office space and it became obvious that our business required warehouse space. Although the 30,000 square foot space was far larger than our requirements when we moved in, we were unable to find a suitable combination of office, warehouse and garage space for a reasonable cost.

As a result, we leased space larger than our present needs and planned to sub-lease a portion of our warehouse space to reduce our net occupancy costs. We have been unsuccessful in sub-leasing warehouse space, and even with our rapid growth, our leased space is roughly double our current requirements. Due to uncertainty about our future requirements, we have decided to take our excess space off the market until our business operations level off. At that time we will re-evaluate our space requirements. Our current lease term is five years at $40,000 per month, expiring on December 31, 20X6. This transaction has been approved by the TSX Venture Exchange.

The improvement in our operating results meant that Tim Clapp did not need to provide additional shareholder loans to the company during the period for the first time in our history. As the company had a large cash balance at the end of the third quarter, combined with positive cash flow from operations, we were able to repay one-half ($1,000,000) of the existing shareholder loan from Mr. Clapp early in the fourth quarter (see subsequent events), and have committed to repay the balance by September 30, 20X3.

Total salaries and bonuses paid to Tim Clapp for the nine months ended September 30, 20X2 were $158,000. Details regarding his compensation package are discussed in the executive compensation portion of our Annual Information Form.

Net income

Net income for the nine months ended September 30, 20X2 was $1,076,943 or $0.92 per share, compared to a loss of $135,826 the previous year. The Company's improved profitability has resulted primarily from customer referrals and the favourable magazine review of our product that generated significantly increased demand for our software.

Liquidity & Capital Resources

At the end of the third quarter our cash balance was $3,309,918, compared to $1,675,269 at June 30, 20X2. Our working capital deficit was $411,107 compared to a deficit of $1,815,881 the previous year. A shareholder loan of $2,000,000 is included in these figures, of which $1,000,000 was repaid after September 30, 20X2 (see subsequent events).

If the Company generates more than $1,800,000 of cash flow from operations in the next fiscal year, we have an understanding with our principal shareholder that the balance of his loan will be repaid in full.

Use of Proceeds

During the first quarter we issued 200,000 shares for proceeds of $500,000 in a private placement. Our intended use of funds compared to our actual use of funds is illustrated in the table below.

	Budgeted	Actual	Variance
Dynamometer purchase (Capital)	$ 400,000	$ —	$ 400,000
Equipment rentals (R&D)	100,000	603,879	(503,879)
Total	$ 500,000	$ 603,879	$ (103,879)

A reconciliation of the use of proceeds has been provided. In this situation, there has been a significant variance between the budget and how the funds were spent. The resulting variances and reasons for them are explained.

We had intended to allocate $400,000 of the proceeds from our private placement toward the purchase of two dynamometers during the second quarter. However, our rapid growth during the second and third quarters resulted in our decision to redirect these funds to the development of software. Due to significant increased product demand, we are confident that the payback period on the redirected funds will be relatively short and we expect to be in a position to purchase the dynamometers by the first quarter of next year with cash flow from operations. Having our own dynamometers will result in several benefits for our Company. We will have access to this equipment whenever we require it rather than having to schedule rental time, our equipment rental costs will decrease substantially, and we will save the staff time required to travel to the location of the rental equipment.

Future plans, challenges and their implications are discussed.

Other than the dynamometers, we do not have any significant capital expenditures planned for 20X3.

Employees exercised stock options during the year, providing $100,000 in cash.

Events Subsequent to September 30, 2002

The following material events occurred after September 30, 20X2 and are not reflected in our financial statements.

On October 19, 20X2 we repaid to our founder Tim Clapp, as planned, $1,000,000 or one-half of his total shareholder loan to the Company.

Material events that took place subsequent to the quarter and up to the date the report is filed have been discussed.

On November 4, 20X2 we reached an agreement to have Cullen Automotive become an authorized installer of our software. Cullen Automotive is a well-established company that has been in operation for over 20 years, with 71 locations in BC, Alberta, Saskatchewan, Washington and Oregon. As a result of extensive meetings and a thorough examination of their operations, we are confident that Cullen Automotive has the necessary understanding and skill to properly support our product. The signing of this agreement will make our product available to numerous customers who were not comfortable removing units from their vehicles themselves. After pre-ordering our software, customers will be able to drive into a local Cullen Automotive location and have our product installed and tested within two hours. This expanded installation capability should positively impact on our sales and geographic reach without overburdening our central operation. Cullen Automotive will receive a commission of 25% of the sale price of all customer orders they install.

Material terms of new arrangements are disclosed.

MD&A Example:

Abbreviated financial statements are included simply as a reference for the purposes of highlighting portions of the MD&A example. This sample does not include all of the information required by BC Form 51-901F.

Specifically:

• the financial statements do not contain the statement of cash flows and note disclosure required by CICA Handbook sections 1540 and 1751.

• Schedule B information has not been provided

BC FORM 51-901F

ABC FUEL SYSTEMS INC.

BALANCE SHEET

SEPTEMBER 30, 20X2

(Unaudited – prepared by management)

	Sept. 30, 20X2	Dec. 31, 20X1 (audited)
Assets		
Current		
Cash	$ 3,309,918	$ —
Prepaid expenses	45,000	38,075
Inventory	125,800	15,600
	3,480,718	53,675
Capital assets	675,000	50,000
	$ 4,155,718	$ 803,675
Liabilities and Shareholders' Equity		
Current		
Bank overdraft	$ —	$ 285,250
Accounts payable	1,520,250	643,975
Warranty provision	371,575	37,500
Shareholder loans	2,000,000	1,250,000
	3,891,825	2,216,725
Share capital	2,475,000	1,875,000
Deficit	(2,211,107)	(3,288,050)
	263,893	(1,413,050)
	$ 4,155,718	$ 803,675

ABC FUEL SYSTEMS INC.

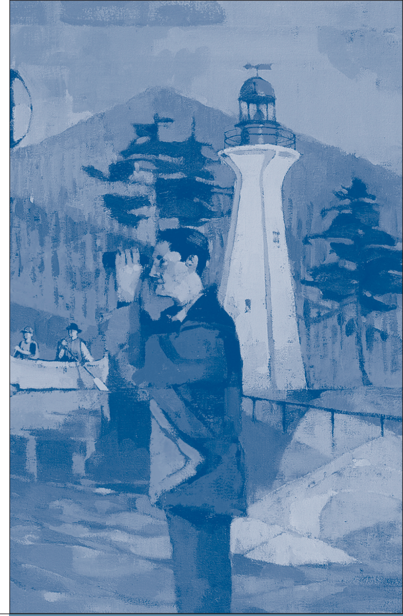
STATEMENT OF INCOME AND DEFICIT

FOR THE PERIODS ENDED SEPTEMBER 30, 20X2

(Unaudited – prepared by management)

	For the three months ended Sept. 30,		For the nine months ended Sept. 30,	
	20X2	20X1	20X2	20X1
Sales	$ 3,402,100	$ 250,000	$ 5,488,300	$475,000
Cost of goods sold				
Warranty provision	215,325	10,500	419,200	20,100
Labour	113,400	2.000	216,000	2,750
Materials	30,500	400	51,235	1,300
Supplies	800	100	1,675	700
	360,025	13,000	88,110	4,850
Gross Margin	3,042,075	237,000	4,800,190	450,150
General and administrative				
Salaries and benefits	332,578	47,541	705,423	145,446
Office lease	120,000	25,000	360,000	75,000
Freight and courier	86,925	17,251	143,775	33,209
Depreciation	8,125	8,125	24,375	24,375
Supplies	68,938	7,813	109,151	11,803
Legal	4,500	2,500	13,500	7,500
Accounting	4,500	2,500	13,500	7,500
	625,566	110,730	1,369,724	304,833
Selling and marketing				
Advertising	450,813	25,000	788,677	25,000
Travel	168,675	—	351,150	—
Entertainment	47,555	4,532	92,538	18,433
Website development costs	—	—	125,000	—
Communications	7,500	5,000	22,500	15,000
	674,543	34,532	1,379,865	58,433
Research and development				
Salaries and benefits	114,542	32,145	233,654	86,057
Equipment rentals	296,825	35,378	603,879	86,028
Supplies	33,950	—	85,500	—
Depreciation	16,875	16,875	50,625	50,625
	462,192	84,398	973,658	222,710
Total Expenses	1,762,301	229,660	3,723,247	585,976
Income (loss) before income taxes	1,279,774	7,340	1,076,943	(135,826)
Income tax provision•	—	—	—	—
Net Income (loss)	1,279,774	7,340	1,076,943	(135,826)
Deficit, beginning of period	(3,490,881)	(3,248,085)	(3,288,050)	(3,104,919)
Deficit, end of period	$ (2,211,107)	$ (3,240,745)	$ (2,211,107)	$(3,240,745)
Income (Loss) per share	$ 0.98	$ 0.01	$ 0.92	$ (0.14)

• *Note: For this example, we assumed the Company has tax loss carryforwards available to offset any current taxable income.*



BRITISH COLUMBIA SECURITIES COMMISSION

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If you have any questions about this CD Update, suggestions for future CD Update topics, or questions and comments about the BCSC's Continuous Disclosure Review Program, please call Larry Wilkins, CA, Manager, Continuous Disclosure Review at 604-899-6712 or email lwilkins@bcsc.bc.ca

MD&A information resources:

National Policy (NP) 51-201 Disclosure Standards (should be read in conjunction with this Update)

Instructions to Schedule C of BC Form 51-901F

Ontario Securities Commission Rule 51-501 (www.osc.gov.on.ca)

National Instrument (NI) 44-101F2 MD&A (for AIFs)

BCSC Continuous Disclosure Review Program, April 2000 Staff Report

BCSC Continuous Disclosure Updates

Canadian Performance Reporting Initiative Board: MD&A Guidance on Preparation and Disclosure (www.cica.ca)

Unless otherwise noted, all documents can be obtained from the BCSC website: www.bcsc.bc.ca