Westport
INNOVATIONS INC.

Advancing the shift of global commercial transportation to natural gas and hydrogen.

Report to Shareholders

Management's Discussion and Analysis

Consolidated Financial Statements

for the years ended:

March 31, 2006 and 2005

BASIS OF PRESENTATION

This management's discussion and analysis of the financial results of Westport Innovations Inc. ("Westport", "the Company", "we") should be read in conjunction with, and is qualified by, Westport's Consolidated Financial Statements and related notes for the year ended March 31, 2006 (the "Financial Statements"), which have been prepared in accordance with Canadian generally accepted accounting principles ("GAAP"). Reference should be made to Note 20 of the Financial Statements for a reconciliation of Canadian and U.S. generally accepted accounting principles. All of the information presented herein is expressed in Canadian dollars, unless otherwise stated. Certain prior year amounts have been reclassified to conform to the current year presentation.

This report contains forward-looking statements, including statements regarding the future success of our business and technology strategies and future market opportunities. These statements are neither promises nor guarantees, but involve known and unknown risks and uncertainties that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activities, performance or achievements expressed in or implied by these forward-looking statements. These risks include risks related to our revenue growth, operating results, industry and products as well as other factors discussed below and elsewhere in this report. Readers should not place undue reliance on any such forward-looking statements, which speak only as of the date they were made. We disclaim any obligation to publicly update or revise such statements to reflect any change in our expectations or in events, conditions or circumstances on which any such statements may be based, or that may affect the likelihood that actual results will differ from those set forth in the forward-looking statements.

Additional information relating to Westport, including our Annual Information Form, is on SEDAR at www.sedar.com.

This management's discussion and analysis is dated June 13, 2006.

BUSINESS OVERVIEW

Westport is engaged in the research, development and marketing of high performance, low-emissions engine and fuel systems which use gaseous fuels such as natural gas, propane or hydrogen. We expect strong demand for these products for transportation, power generation and industrial applications because of the performance, emissions characteristics and life-cycle costs when compared to alternatives now available or known to be under development for these applications. Our strategy is to develop our technologies and products in cooperation with the world's leading engine and vehicle manufacturers and fuel infrastructure providers. To date, we have established cooperative fuel system development programs with a number of automotive companies including Isuzu, Ford and BMW, and are in various stages of negotiations to develop and commercialize our technologies with Energy Developments Limited of Australia ("EDL" or "ENE"), Weichai Power Co. Ltd., and others. We have also announced our intention to form a joint venture to develop and market liquid natural gas tanks for the transportation market with Beijing Tianhai Industry Co. Ltd, a Chinese-Korean company with its headquarters and manufacturing facilities in China. We already have one commercial joint venture, Cummins Westport Inc. ("CWI"), with Cummins Inc. ("Cummins"), a global power leader in engines, power generation and other related technologies based in Columbus, Indiana. As at March 31, 2006, we also held an approximate 8% investment interest in Clean Energy Fuels Corp., North America's largest provider of vehicular natural gas.

We currently have one operating segment, which involves the research, development, and related commercialization of engines and fuel systems operating on gaseous fuels such as natural gas and hydrogen. Our share of the assets, liabilities, revenue and expenses of CWI are disclosed separately in note 15 of our financial statements. We are focused primarily on the development and commercialization of advanced proprietary technologies related to the use of cleaner burning natural gas and other gaseous fuels in traditional internal combustion engines. Our joint venture, CWI, is focused on the development, marketing and sale of mid-range natural gas or LPG engines for transit bus, shuttle and urban specialty vehicles. Geographically, CWI's revenues are derived mainly from North America with strong interest and markets developing in China, India, Europe and South America.

In 2005, we observed three trends that we believed would drive significant changes in the global transportation industry:

1. Slowing growth of oil production in a time of fast-growing demand, particularly from China and India. As a result, countries are increasingly looking towards alternative fuels for transportation, such as natural gas.
2. Rapid urbanisation, particularly in Asia, creating demand for private cars, public transit vehicles and trucks for transportation of goods.
3. Increasing recognition of transportation as a primary and growing contributor to complex environmental challenges, including urban air pollution and climate change.

In the past twelve months, we have seen the world oil prices increase from approximately $50 per barrel to over $70 per barrel. While oil prices have occasionally spiked in reaction to world events such as instability in the Middle East and Hurricane Katrina, we believe the overall trend will continue to be increasing oil prices as diminishing supply and increasing demand keep oil prices at or above current levels requiring governments to look for alternative energy sources such as natural gas, nuclear, solar, wind, clean coal and others. However, solutions for transportation will be limited. While many alternatives other than natural gas such as nuclear and coal, can be used for power generation, there is no obvious solution for transportation, which currently accounts for 57% of the world's energy use and 21% of the pollutants.

We believe we can capitalise on these trends through our patented technologies and by expanding our market-focused partnership strategies. By partnering with original equipment manufacturers, governments, infrastructure providers, and end-users, we have been able to deliver complete solutions to vehicle fleets for over a decade. We also recognise that while natural gas has significant environmental benefits over diesel, we must also have a cost effective solution for fleet owners to change fuels. Accordingly, by working in every segment of the supply chain, we are helping to ensure the whole system operates effectively to deliver cost effective solutions to the customer.

In fiscal 2006, we made a substantial shift to move our business from being technology focused to market driven:

- We increased non-CWI related sales and marketing expenditures by approximately $1.3 million (excluding stock-based compensation).
- In August, 2005, we announced our intention to form a joint venture to develop and market liquid natural gas tanks for the transportation market with Beijing Tianhai Industry Co. Ltd., a Chinese-Korean company with its headquarters and manufacturing facilities in China.
- In September, 2005, we signed a letter of intent with Weichai Power Co. Ltd., a Hong Kong listed Chinese engine manufacturer, to cooperate on the development, marketing and sales of gaseous-fuelled engines and vehicles for the Chinese market.
- In November, 2005, we entered into an exclusive arrangement with Energy Developments Limited to conduct business planning for liquefied natural gas mine trucks. With the initial feasibility study completed, EDL agreed to pay us approximately $130,000 to complete a detailed program plan, budget, and a joint business plan for the commercialization of the LNG mine truck retrofit product. The proposed program forms part of EDL's plans for expanding LNG production and distribution in Australia.
- In December, 2005, we signed a $1.5 million, one year development agreement with Isuzu Motors Limited of Japan to demonstrate up to 25% fuel economy improvement using our Compressed Natural Gas Direct Injection (CNG-DI) technologies compared to Isuzu's current spark-ignited CNG engines. We expect to deepen our working relationship with Isuzu in this phase of the agreement and have commenced discussions on an Intellectual Property Rights framework.

- We announced in March, 2006 that our HPDI system adapted to a Cummins ISX engine had been certified by the California Air Resources Board and was ready for commercial deployment for 2006 deliveries.

We also saw these global macro-economic trends benefit CWI's business. CWI successfully completed its limited production launch of its B-Gas International ("BGI") natural gas engine in India. Local assembly of the engine takes place at Cummins India Limited's ("CIL") modern Daman facility in Western India. CIL is also responsible for sales and distribution for the local Indian market with CWI providing kits for local assembly and related parts. This launch marks CWI's entry into the Indian market which has not been addressable in the past because of high import tariffs and duties. CWI also announced in October that it had finalised an agreement with Dongfeng Cummins Engine Company ("DCEC") for manufacturing of CWI's BGI engine in China. In March 2006, CWI also announced a 278 unit order of C-Gas Plus engines in Russia. While international markets continue to provide significant growth opportunities for CWI, 82% of its revenues in 2006 continued to be generated in North America where government incentives play a significant role.

On June 12, 2006, we announced that Perseus, L.L.C. ("Perseus"), a US based private equity fund management company, would be strategically investing up to $22.1 million in Westport. This transaction is more fully described in the Capital Requirements, Resources and Liquidity section of this MDA.

SELECTED ANNUAL FINANCIAL INFORMATION

Selected Statements of Operations Data for years ended March 31, 2004 to 2006

	Fiscal Year ended March 31		
	2006	**2005**	**2004**
Expressed in thousands of Canadian dollars, except for per share amounts, shares outstanding and units shipped			
Units shipped	1,327	1,277	1,255
Total revenue	43,552	34,436	32,430
Cost of revenue	28,642	23,762	22,516
Gross margin	14,910	10,674	9,914
GM %	34%	31%	31%
Research and development	16,939	18,423	26,090
General and administrative	4,866	5,627	6,227
Sales and marketing	5,849	3,884	6,213
Foreign exchange gain	-93	-603	-1,023
Depreciation and amortization	2,752	6,323	6,861
Bank charges and interest	314	277	308
Loss before undernoted	15,717	23,256	34,763
Interest, investment and other income	381	453	718
Write downs, restructuring and other	69	-3,337	-3,677
Joint Venture Partner's share of income from joint venture	-1,593	-69	0
Net loss	16,860	26,209	37,722
Net loss per share – basic and diluted (1)	0.23	0.38	0.64
Weighted average shares outstanding	74,228,495	69,381,968	59,046,993
Cash and short-term investments	7,832	20,291	20,784
Total assets	29,500	44,442	50,149
Long-term financial liabilities (2)	3,497	4,609	5,102
Cash used in operations before changes in non-cash working capital	8,661	13,571	24,994

Certain comparative figures may have been reclassified to conform with the basis of presentation adopted in the current year.

(1) Fully diluted loss per share is not materially different as the effect of stock options, warrants and performance share units would be anti-dilutive.

(2) Excluding current portion of warranty liability, long-term debt obligations and Joint Venture Partner's share of income from joint venture

Over the past three years we have continued our strategy of increasing shareholder value by growing our sales and gross margins, transitioning our business from technology to market development, reducing our net investments in research and development, and increasing development funding from government and industry partners. We have reduced our net loss from $37.7 million in fiscal year 2004 to $26.2 million in 2005 to $16.9 million in 2006, an overall reduction of 55%. We have also reduced cash used in operations before changes in working capital from $25.0 million in 2004 to $13.6 million in 2005 to $8.7 million in 2006, an overall reduction of 65%. Revenues in this three year period have increased by 34% on modest unit growth and higher parts revenue as the result of changes made in parts revenue accounting from net revenue reporting to gross revenue reporting when we amended the CWI joint venture agreement in December, 2003 and from increased parts sale volumes. Our plan is to continue to aggressively grow revenues, pursue funding and to manage our costs while maintaining our technology leadership position in the alternative fuels market as we drive towards profitability.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Financial statement preparation requires that we use estimates and assumptions that affect the reported amount of assets and liabilities as well as revenues and expenses. Our accounting policies are described in note 2 to our Financial Statements. The following policies have a significant impact on the consolidated financial statements or are impacted significantly by judgments, assumptions and estimates used in the preparation of our consolidated financial statements.

Variable Interest Entity Accounting

In June 2003, the Canadian Institute of Chartered Accountants issued Accounting Guideline 15 AcG-15 "Consolidation of Variable Interest Entities" which applies to annual or interim periods beginning on or after November 1, 2004. A Variable Interest Entity ("VIE") is any type of legal structure not controlled by voting equity, but rather by contractual and/or other financial arrangements. Interests in VIE's are consolidated by the company that is the primary beneficiary. Westport has identified CWI as a VIE, determined that we are the primary beneficiary, and accordingly consolidate CWI, reflecting 100% of CWI's assets, liabilities, revenues and expenses in our financial statements and showing the 50% interest held by Cummins Inc. as "Joint Venture Partner's share of income from joint venture".

Warranty Liability

Estimated warranty costs are recognised at the time CWI sells its products and included in cost of revenues. CWI uses historical failure rates, and costs to repair product defects during the warranty period, together with information on known products to estimate the warranty liability. The ultimate amount payable and the timing will depend on actual failure rates and the actual cost to repair. Since many of CWI's products are new to the market and the majority of its engines are still under warranty, historical data may not necessarily reflect actual costs to be incurred and exposes us to the potential for significant positive or negative fluctuations in the warranty liability. CWI reviews its warranty provision quarterly and makes adjustments to its assumptions based on the latest information available at that time. Adjustments to the warranty provision are recorded in cost of revenues.

Revenue Recognition

Product revenue is recognised, net of estimated costs of returns, allowances, and sales incentives, when the products are shipped and title passes to the customers. Shipments of most products and parts sold by CWI originate from Cummins' facilities. Revenue also includes fees earned from performing research and development activities for third parties. Revenue from research and development activities is recognised as the services are performed. Amounts received in advance of revenue recognition are recorded as deferred revenue.

Parts revenue is recognised as the parts are sold.

Inventory

In establishing whether or not a provision is required for inventory obsolescence, we estimate the likelihood that inventory carrying values will be affected by changes in market demand for our products and by changes in technology, which could make inventory on hand obsolete. We perform regular reviews to assess the impact of changes in technology, sales trends and other changes on the carrying value of inventory. If and when we were to determine that such changes have occurred and that they would have a negative impact on the carrying value of inventory on hand, adequate provisions would be made. Unforeseen changes in these factors could result in additional inventory provisions being made.

Long-term Investments

We account for long-term investments in non-consolidated entities using the equity method to the extent that we have significant influence over the investee's strategic operating, financing and investing policies. All other long-term investments are accounted for using the cost method. Long-term investments are reduced to market value only to the extent that the loss in value is other than temporary. In determining market value for our long-term investments, which are privately held companies, we use assumptions around future cashflows from the investments, recent equity transactions involving its investees and the current financial performance of the investees to determine fair value. In the year ended March 31, 2005, we determined that our investment in Edge Technologies Inc., had suffered a permanent impairment in value and accordingly, wrote down our investment by $3.1 million. We account for our interest in Clean Energy at cost.

Equipment, Furniture, and Leasehold Improvements and Intellectual Property

Generally accepted accounting principles in Canada require that we consider whether or not there has been an impairment in our long-lived assets, such as equipment, furniture and leasehold improvements and intellectual property, whenever events or changes in circumstances indicate that the carrying value of the assets may not be recoverable. If such costs are not recoverable, we are required to write down the assets to fair value. When quoted market values are not available, we use the expected future cashflows discounted at a rate commensurate with the risks associated with the recovery of the asset, as an estimate of fair value to determine whether or not a write down is required. For the year ended March 31, 2005, we adjusted the carrying value of our equipment, furniture and leasehold improvements by $0.4 million. For the year ended March 31, 2006, we determined that no adjustments were required.

CHANGES IN ACCOUNTING POLICY

Financial Instruments

Effective for our fiscal year beginning April 1, 2005, we adopted the amended provisions of Handbook Section 3860 – "Financial Instruments – Disclosure and Presentation" related to financial instruments that are contractual obligations of a fixed amount but are settleable with our common shares. Amendments to Handbook Section 3860 require that these instruments be classified as liabilities rather than shareholders' equity because they do not represent a residual interest in Westport until the common shares are issued. Accordingly, the value assigned to the Technology Partnerships Canada ("TPC") warrants and the GVH Entwicklungsgesellschaft für Verbrennungsmotoren and Energietechnik mbH ("GVH") obligation to issue shares, both of which were previously included in "Other Equity Instruments", are in substance a liability to us, because the number of common shares to be issued is determined based on a fixed contractual amount of fair value due to TPC and the vendors of GVH. These fixed contractual amounts will be settleable with equity instruments with the number of such instruments to be determined based on the market value of our common shares on the date these instruments are settled. We changed our accounting policy to treat these amounts as liabilities effective April 1, 2005 and have restated the comparative figures on a consistent basis.

DISCLOSURE CONTROLS

We have disclosure controls and procedures in place that are designed to provide reasonable assurance that material information relating to Westport is disclosed on a timely basis. We have reviewed our disclosure controls and have concluded that they were effective during the reporting period.

FINANCIAL OVERVIEW

For the years ended March 31, 2006 and 2005, total revenues were $43.6 million, up 26% from $34.4 million, primarily because of changes in product mix and higher parts revenue. Net loss decreased by 36% from $26.2 million, or $0.38 per share, to $16.9 million, or $0.23 per share primarily as the result of higher gross margins ($4.2 million) and decreased depreciation and amortization expenses ($3.6 million) offset by a $1.5 million increase in our joint venture partner's 50% share of CWI income. In 2005, we also wrote down our investments by $3.1 million and our equipment, furniture and leasehold improvements by $0.4 million. For the year ended March 31, 2006, cash used in operations before changes in working capital was $8.7 million, down from $13.6 million in 2005 primarily resulting from the higher gross margins.

For the year ended March 31, 2006, CWI's income for the year was $3.2 million, up from $0.2 million in the prior year. The $3.0 million increase was primarily the result of a 27% increase in revenues and a 40% increase in associated gross margin contribution. CWI's business model – leveraging existing Cummins facilities and distribution channels – has been highly scalable, allowing CWI to increase gross margins without incurring significant additional operating costs. After taking into account Cummins' 50% share of profits, CWI contributed $1.6 million in net income to our consolidated results.

RESULTS FROM OPERATIONS

Revenues for the year ended March 31, 2006 were $43.6 million compared to $34.4 million in 2005. Revenues, cost of sales and gross margin are sensitive to product mix, customer sales cycles and foreign exchange fluctuations (both revenue and cost of sales, including warranty, are US dollar denominated). During the year, the US dollar weakened by approximately 7% against the Canadian dollar.

Product revenue was $29.9 million for the year ended March 31, 2006, up 17% from 2005 revenues of $25.7 million on 1327 units shipped compared to 1277 in the prior year. The higher per unit revenue reflects a change in geographical mix. In 2005, a higher proportion of sales consisted of lower priced B engines shipped to China. In 2006, sales consisted largely of higher horse power C-plus and L-plus engines with 4% of total revenues from China compared to 24% in the prior year. Non-CWI revenues were relatively flat at $1.3 million in 2006 compared to $1.2 million in 2005.

Revenue
Expressed in thousands of Canadian dollars

	Year ended March 31 2006	2005
Engine shipments (units)	1,327	1,277
Product revenue	29,932	25,661
Parts revenue	13,620	8,775
	43,552	34,436

Product Revenue by Geographic Region
As a percentage of revenue dollars

	Year ended March 31 2006	2005
North America	82%	61%
China	4%	24%
Rest of the world	14%	15%

Parts revenue for the year ended March 31, 2006 was $13.6 million compared to $8.8 million in 2005, reflecting an updated and expanded parts list negotiated with Cummins during the year. Parts revenue is a function of engine population, failure rates and price.

Cost of revenue increased to $28.6 million in the year ended March 31, 2006 from $23.8 million in the prior year, or 66% and 69% of total revenues respectively. Cost of revenue includes production costs and the associated warranty.

Estimated warranty costs are recognised at the time CWI sells its products and included in cost of revenues. CWI uses historical failure rates, and costs to repair product defects during the warranty period, together with information on known products to estimate the warranty liability. The ultimate amount payable and the timing will depend on actual failure rates and the actual cost to repair. Since many of CWI's products are new to the market and the majority of its engines are still under warranty, historical data may not necessarily reflect actual costs to be incurred and exposes us to the potential for significant positive or negative fluctuations in the warranty liability. CWI reviews its warranty provision quarterly and makes adjustments to its assumptions based on the latest information available at that time. Adjustments to the warranty provision are recorded in cost of revenues. During the year, as the actual claims experience continued to be lower than the expected experience at the time of the initial warranty accrual, CWI changed its estimated warranty liability balance, reducing its warranty liability and cost of sales by $1.8 million (2005 - $1.1 million).

Gross margin was $14.9 million for the year ended March 31, 2006, or 34% of total revenues compared to $10.7 million in 2005, or 31% of total revenues. Product gross margin percentages improved from an average margin of approximately 30% to 37% during the year as the result of lower estimated warranty costs associated with improved product reliability and customer, application and product mix. Excluding the change in estimated warranty liability, gross margin percentage for the year would have been approximately 30%. Parts margins dropped from approximately 36% to 28% with the re-negotiated and expanded parts list in the year including lower margin items and higher standard costs.

Research and development expenses were $16.9 million and $18.4 million for the years ended March 31, 2006 and 2005 respectively. Excluding stock based compensation of $1.6 million and $0.4 million, research and development expenses were $15.3 million and $18.0 million for the years ended March 31, 2006 and 2005. The $2.7 million decrease excluding stock based compensation was due primarily to increased government funding which increased from $6.0 million to $8.7 million year over year. The $1.2 million increase in stock based compensation related to a special grant of stock options in the year to all employees. For the year ended March 31, 2006, CWI research and engineering costs remained flat at $6.6 million, or approximately 39% of consolidated net research and development costs. The remaining amounts were invested primarily in our heavy-duty and light-duty development and demonstration programs.

Research and Development Expenses
Expressed in thousands of Canadian dollars

	Year ended March 31		Year over year % change	
	2006	2005	2006	2005
Research and development expenses	25,628	24,402	5%	-29%
Program funding	(8,689)	(5,979)	45%	-26%
Net research and development expenses	16,939	18,423	-8%	-29%

General and administrative expenses for the year ended March 31, 2006 decreased from $5.6 million in 2005 to $4.9 million primarily because of a $0.4 million decrease in associated stock based compensation and resources reallocated to sales and marketing.

Sales and marketing expenses for the year ended March 31, 2006 increased by $2.0 million to $5.8 million from $3.9 million in 2005. CWI sales and marketing expenses increased by $0.4 million primarily because of increased costs in Europe, some of which had been shared with Cummins in the prior year. Non-CWI sales and marketing expenses increased by $1.3 million (excluding stock-based compensation) with our increased focus on new business development, particularly in China. Stock based compensation also increased by $0.3 million with a special grant of stock options to all employees in the year.

Foreign exchange gain of $0.1 million for year ended March 31, 2006 primarily reflects the realised net gains and losses on foreign currency transactions and the net unrealised gains and losses on our net US dollar denominated assets and liabilities, which consist primarily of US dollar short-term investments and warranty. The Canadian dollar has strengthened by 7% during the year. In the prior year, we recognised a foreign exchange gain of $0.6 million, primarily of the translation of US dollar denominated warranty balances.

Depreciation and amortization for the years ended March 31, 2006 and 2005 were $2.8 million and $6.3 million respectively. The $3.6 million decrease in the year resulted from certain intellectual property, equipment and furniture being fully amortized as of March 31, 2005. In addition, effective July 1, 2006, we changed our estimates of the useful life of our research and development machinery and equipment from five to eight years. The net impact of this change in estimate was approximately $1.1 million for the year. Remaining intellectual property is being amortized over seven years.

Write down of equipment, furniture, and leasehold improvements of $0.4 million in the year ended March 31, 2005 related to impairments in value associated with equipment and leasehold improvements located in Vancouver and Germany. No write downs were considered necessary in 2006.

Write off of long-term investments of $3.1 million for the year ended March 31, 2005 related to our determination that our investment in Edge Technologies Inc., of Ames, Iowa, had been permanently impaired. We continue to hold the exclusive, royalty-free worldwide rights to use and make Edge's Terfenol-D technology in gaseous fuel engine applications and to work with Edge on its development. We use Terfenol-D, which quickly expands or contracts in the presence of a magnetic field, to govern the flow of fuel through natural gas injectors for high speed diesel engines.

Joint Venture Partner's share of income from joint venture for the year ended March 31, 2006 of $1.6 million (2005 - $0.1 million) reflects Cummins' 50% share of CWI net operating contribution in the period. Since January 1, 2005, Cummins has shared equally in any CWI profit or loss.

CAPITAL REQUIREMENTS, RESOURCES AND LIQUIDITY

As at March 31, 2006, our cash, cash equivalents and short-term investment position was $7.8 million. We also have a $13 million credit facility with our bank, which has been drawn down by our demand instalment loan of $2.5 million, capital leases of $0.3 million, and a $0.6 million letter of credit. We have also relied on public and private sources of equity financing to fund our operations. Since our incorporation in 1995, we have raised $230 million in common share equity primarily from a number of private and public offerings.

On June 12, 2006, we agreed to issue up to $22.1 million in 5 year secured, subordinated convertible notes with a coupon rate of 8% to Perseus of Washington, DC, a private equity fund management group. The notes are to be issued in two tranches of $13.8 million and $8.3 million, respectively. Interest will be payable semi-annually in arrears in additional notes or shares for the first two years, at our option. After the first two years, interest will be calculated at a rate of 8% on the outstanding principal amount only for the number of trading days in the period on which the share price is below $3.00 and is payable semi-annually in cash, additional convertible notes or shares at our option. The first tranche is convertible to common shares at a conversion price of $1.30 at any time during the term of the notes and the second tranche is convertible to common shares at a conversion price equal to $1.40. At the time of issuance, the noteholder will also receive warrants to acquire, at an exercise price equal to the conversion price of the accompanying notes, common shares of Westport equal to 25% of the number of common shares into which the notes are convertible. The term to expiry of the warrants is four years from the date of issuance and the warrants include a cashless exercise provision which would allow the noteholder to receive the number of common shares having a value equal to the net gain that would be realized by the noteholder had the warrant been exercised for cash and the related shares sold at the market price on the date the option is exercised. Any warrants under the cashless exercise provision converted will be cancelled. For so long as Perseus continues to hold notes and warrants convertible into a specified percentage of Westport's issued and outstanding shares, Perseus will also be entitled to nominate two of seven board seats. The notes will be secured with a second charge on all of our assets.

$5.5 million of the first tranche of $13.8 million has been received with the balance due by July 15, 2006. The second tranche of $8.3 million, the proceeds of which are to be used for a new business venture, is subject to receiving Westport shareholder approval and the Company meeting certain milestones within 180 days of the receipt of such shareholder approval.

On June 13, 2006, we also entered into an agreement with Matco Capital Ltd. ("Matco") to reorganize Westport Research Inc ("WRI"), a wholly owned subsidiary of Westport. We will transfer all of the current assets, liabilities and operations of WRI to other wholly owned Westport companies. Matco will then acquire a 45% equity interest in WRI, following which we and Matco will source and pursue other opportunities to maximize the value of our respective interests in WRI. The reorganization and share sale is expected to close on or before July 31, 2006. We expect to access at least $10 million in cash on closing with the ultimate amount to be determined by the value of the reorganized WRI, including any new ventures.

In the prior fiscal year ending March 31, 2005, we had entered into a bought deal financing agreement with a syndicate of investment dealers to issue 9.0 million units, each consisting of one of our common shares and one-half of one warrant. One full warrant entitles the holder to purchase one of our common shares upon payment of

$2.10 on or before March 29, 2006. The financing raised $15.1 million in net proceeds. As at March 31, 2006, no warrants were outstanding.

As at March 31, 2005, we had $20.3 million in cash and short-term investments. During the year ended March 31, 2006, we used $8.7 million for operations and $3.0 million for working capital purposes. Inventory held by CWI in China and sold during the year contributed $0.6 million of working capital but was offset by the release of $1.2 million in deferred revenue. Deferred revenue relates primarily to amounts advanced to CWI by Cummins based on the terms of the amended joint venture agreement, but where the engines have not yet been shipped to the final customer. Accounts payable consumed $1.2 million primarily because of higher trade payables associated with the increase in government funded work in the fourth quarter of 2005 which were paid to suppliers in 2006. Warranty liabilities also used $1.0 million in working capital. We also used $0.4 million to acquire equipment, furniture and leasehold improvements, drew down a further $1.2 million against our bank credit line and repaid $1.7 million of loans and other debt obligations.

We believe that our current cash, cash equivalents and short-term investments, our investment in Clean Energy and the commitment received from Perseus and Matco provide us with sufficient capital to meet our committed milestones and obligations for our current programs. Our capital requirements will vary depending on a number of factors, including the contributions from the sales of products and parts, progress of our current programs, any decisions by us and our current engine partners to enter into new program phases and any decision by us to establish additional programs or strategic alliances. In addition, we review investment and acquisition opportunities on a regular basis for technologies, businesses and markets that would complement our own products or assist us in our commercialization plans.

Significant new or expanded engine programs, acquisitions or investments could require additional funding. If such additional funding is not available to us, or if we have significant overspending in our programs, we may be required to delay, reduce or eliminate certain research and development activities and possibly forego new program, acquisition or investment opportunities. Any of those circumstances could potentially result in a delay of the commercialization of our products in development.

SHARES OUTSTANDING

During the year ended March 31, 2006, we granted 3,178,218 stock options with various vesting terms. 1,692,933 employee share options vest 1/3 if and when the stock price increases 20% over the price on the grant date, 1/3 if and when the share price increases 35% and 1/3 if and when the stock price increases 50%, all such prices are calculated on a rolling average over twenty consecutive trading days. The stock price on the grant date was $1.51 per share. 1,167,144 share options granted pursuant to Westport's Executive

Compensation Plan vest based on the earlier of the attainment of a $5.00 share price as a rolling average over twenty consecutive trading days, and the 5th anniversary of the grant date. During the year, 612,070 share options expired or were cancelled.

For the year ended March 31, 2006, we also granted pursuant to the 2003 Performance Share Unit ("PSU") Plan and Annual Bonus plan 816,919 PSU's of which 316,919 vested on the date of grant and with 300,000 vesting only on the achievement of performance milestones approved by the Board of Directors. The remainder vest over time. 4,499,450 warrants with an exercise price of $2.10 expired on March 29, 2006.

For the year ended March 31, 2006, the weighted average number of shares used in calculating loss per share was 74,228,495. Actual shares outstanding as of March 31, 2006 were 74,391,779. As March 31, 2006, we had nil warrants outstanding, 4,968,563 share options outstanding at a weighted average exercise price of $2.05 and 1,431,125 performance share units outstanding. Of the share options outstanding, 1,544,266 options were exercisable at a weighted average exercise price of $3.22. Of the performance share units outstanding, 587,142 were exercisable.

Subsequent to March 31, 2006, on April 28, 2006, under our obligations to GVH, we also issued 214,000 Euros worth of shares, which translated into 293,924 shares.

As of June 13, 2006, we had 74,685,703 shares outstanding, 1,062,115 warrants outstanding and 4,956,558 options outstanding at a weighted average price of $2.04, of which 1,527,625 were exercisable at a weighted average exercise price of $3.19 and 1,746,841 performance share units outstanding, of which 1,346,842 were exercisable. We also had a convertible note for $5.5 million outstanding at a conversion price of $1.30.

REVIEW OF THE FOURTH QUARTER ENDING MARCH 31, 2006

Selected Quarterly Operations Data (Unaudited)

Three months ended	30-Jun-04	30-Sep-04	31-Dec-04	31-Mar-05	30-Jun-05	30-Sep-05	31-Dec-05	31-Mar-06
Units shipped	352	152	328	445	310	384	245	388
Average foreign exchange rate (C$:US$)	$ 1.36	$ 1.30	$ 1.20	$ 1.23	$ 1.24	$ 1.19	$ 1.17	$ 1.15
(Expressed in thousands of Canadian dollars except per share)								
Product revenue	$ 6,481	$ 3,617	$ 7,031	$ 8,532	$ 7,006	$ 9,095	$ 5,147	$ 8,684
Parts revenue	$ 2,343	$ 2,364	$ 2,211	$ 1,857	$ 3,508	$ 3,134	$ 3,466	$ 3,512
Total revenue	$ 8,824	$ 5,981	$ 9,242	$ 10,389	$ 10,514	$ 12,229	$ 8,613	$ 12,196
Cost of sales	$ 6,525	$ 4,205	$ 5,693	$ 7,339	$ 7,804	$ 7,934	$ 4,933	$ 7,971
Gross margin	$ 2,299	$ 1,776	$ 3,549	$ 3,050	$ 2,710	$ 4,295	$ 3,680	$ 4,225
	26%	*30%*	*38%*	*29%*	*26%*	*35%*	*43%*	*35%*
Loss for the period	$ 6,908	$ 5,837	$ 4,156	$ 9,308	$ 6,213	$ 3,329	$ 3,607	$ 3,711
Basic and diluted loss per share (1)	$ 0.11	$ 0.09	$ 0.06	$ 0.12	$ 0.08	$ 0.05	$ 0.05	$ 0.05
Cash used in operations before change in non-cash working capital	$ 4,653	$ 3,713	$ 2,105	$ 3,100	$ 3,019	$ 1,463	$ 2,225	$ 1,954
Company's 100% share of CWI loss (income), excluding foreign exchange	$ 1,155	$ 1,126	$ (1,314)	$ (233)	$ (211)	$ (1,251)	$ (517)	$ (1,099)
Joint Venture Partner's share of CWI	$ -	$ -	$ -	$ (69)	$ (66)	$ (758)	$ (251)	$ (518)

(1) Fully diluted loss per share is not materially different as the effect of stock options, warrants and performance share units would be anti-dilutive.

Our net loss in the three months ended March 31, 2006 was $3.7 million compared to $9.3 million for the same period last year with product revenues of $8.7 million on 388 units shipped compared to $8.5 million and 445 units shipped in the prior year. Unit sales can vary significantly from quarter to quarter depending on customer delivery dates. In the three months ended March 31, 2005, shipments to China accounted for more than half of the shipments while shipments in the fourth quarter of fiscal 2006 consisted of primarily sales of larger, more expensive engines to North American customers. Accordingly, revenues were comparable despite a 13% decrease in unit shipments. Parts revenue was $3.5 million compared to $1.9 million in the fourth quarter of 2005. In 2005, our write off of our investment in Edge also accounted for $3.1 million of the $9.3 million loss in the quarter. Depreciation for the fourth quarter of 2006 was $0.5 million compared to $1.5 million in the same quarter last year. Operating cash use in the quarter, defined as "cash from operations before changes in non-cash working capital", was $2.0 million.

CONTRACTUAL OBLIGATIONS AND COMMITMENTS

Minimum annual payments due in
(in thousands of dollars)

	Minimum Annual Payments due by Period				
(in thousands of dollars)	**Less than 1 year**	**1 to 3 years**	**4 to 5 years**	**After 5 years**	**Total**
Capital lease obligations	172	146	9	-	327
Operating leases	817	1,720	262	293	3,092
Total contractual commitments	989	1,866	271	293	3,419

Contractual Commitments

Capital lease obligations related primarily to office equipment, have terms of two to five years and have interest rates ranging from 1.15% to 6.17%. Operating lease commitments represent our future minimum lease payments under leases related primarily to operating premises and office equipment located in Vancouver, Canada. We also have an outstanding letter of credit for $0.6 million.

Demand Instalment Loan

As of March 31, 2006, we had $2.5 million in a demand instalment loan outstanding, up $0.2 million from $2.3 million as at March 31, 2005. The loan is drawn against our line of credit of $13 million and bears interest at prime. The loan is being amortized over five years.

CONTINGENT OFF-BALANCE SHEET ARRANGEMENTS

Asset Acquisition from GVH Entwicklungsgesellschaft für Verbrennungsmotoren and Energietechnik mbH

Under the terms of our amended asset purchase and transfer agreement, one-third of 641,815 Euros (approximately $0.9 million) owing to GVH for the achievement of two milestones was paid in cash to GVH in January, 2006, one-third was paid in shares as of April 28, 2006 and one-third will be paid in shares on July 3, 2006.

Government Funding

We are continually exploring strategic opportunities to work with governments to provide them with alternative fuel solutions. As the result of our government partnerships, we recognised $8.7 million in government funding in 2006 and $6.0 million in funding in 2005. Under certain repayment terms, we are obligated to repay royalties as follows:

AGREEMENT	DESCRIPTION	ROYALTIES	TERM
TECHNOLOGY PARTNERSHIPS CANADA	Funded 30% of the eligible costs of, among other research projects, the adaptation of Westport's technology to diesel engines, up to $18.9 million.	Annual royalties equal to the greater of $1,350,000 or 0.33% of annual gross revenues from all sources, provided that gross revenues exceed $13.5 million. Share purchase warrants valued at $4 million under Black-Scholes.	Fiscal 2007 to fiscal 2013, inclusive; royalty period may be extended until the earlier of March 31, 2016 or until cumulative royalties total $28,189,000. To be issued no earlier than September 30, 2006.
DEPARTMENT OF NATURAL RESOURCES CANADA	Funded $1 million for demonstration of a low emissions natural gas power generator in Grand Prairie, Alberta.	1% of revenues from future sales of natural gas engines for power generators.	Earlier of 10 years from project completion date (August 30, 2004), or when cumulative royalties total $1 million.
GREEN ECONOMY DEVELOPMENT FUND	$0.6 million for low-emission, natural gas power generation demonstration project.	0.75% from gross revenue received by Westport on certain natural gas fuel systems.	Earlier of the seventh anniversary of the funding contribution date (April 10, 2001) or when the cumulative royalties paid by Westport equal $0.8 million.

As at March 31, 2006 and 2005, no royalties have been paid or were payable under these agreements.

BUSINESS RISKS AND UNCERTAINTIES

Our ability to generate revenue and profit from our technologies is dependent on a number of risks. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties, including those that we do not know about now or that we currently believe are immaterial may also adversely affect our ability to generate revenue and profit.

We Have Incurred, and Continue to Incur, Losses

We have incurred substantial losses since we were founded, and continue to incur losses. We had an accumulated deficit of $229 million as of March 31, 2006. We cannot predict when we will operate profitably, if ever. Without a significant new revenue stream, at our current spend rate, we expect to continue to incur net losses for at least the next year as we continue to invest in research and product development activities to achieve commercialization of our products.

We May Never Produce Commercially Viable Fuel Systems

We do not know when or whether we will successfully complete development of commercially viable fuel systems for any of our target and prospective markets on a mass market basis. Our patented high pressure direct injection (HPDI) technology has been demonstrated in engines in our heavy-duty trucking, light-duty vehicle, and high horsepower programs. However, there can be no assurance that these and other engines using our fuel systems will always perform as well as we expect, or that prototypes and commercial systems will be developed and sold in commercially viable numbers.

Potential Fluctuations in Our Financial Results Makes Financial Forecasting Difficult

We expect our revenues and operating results to vary significantly from quarter to quarter. Sales and margins may be lower than anticipated due to general economic and market-related factors, product quality, performance and safety issues and competitive factors. As a result, quarter-to-quarter comparisons of our revenues and operating results may not be meaningful. In addition, due to our early stage of development, we cannot accurately predict our future revenues or results of operations. It is likely that in one or more future quarters our operating results will fall below the expectations of securities analysts and investors. If this happens, the trading price of our shares might be materially and adversely affected.

We May Be Unable to Raise Additional Capital

Our product development and commercialization schedule could be delayed and our viability could be jeopardised if we are unable to raise additional money to fund our research, market and product development activities. We mitigate this risk by generating funds from a variety of sources including: through the sale of our commercial products, through funding from governments, industry and engine development partners, and through the issuance of shares or debt in the public equity markets or through strategic investors. In addition, we maintain reserves of cash and short-term investments, are conservative and prudent in our expenditures and seek to obtain funding commitments before we take on any significant incremental initiatives. There can, however, be no assurance that we will be able to secure additional funding, or funding on terms acceptable to us, to pursue our commercialization plans.

Warranty Claims Could Diminish our Margins

CWI's commercially available products and parts contributed revenues of $42.3 million and gross margins of $14.9 million during fiscal 2006. The margins contributed by these sales help offset our costs of product development and other operating expenses. There is a risk that the warranty accrual included in our cost of product revenue is not sufficient and that we may recognise additional expenses as a result of excessive warranty claims. We mitigate these risks through our sales and marketing initiatives and our product quality, development, support and service programs. However, there can be no assurance that sales of our commercial products will continue to grow and contribute financially.

We Must Lower the Cost of Our Fuel Systems and Demonstrate Their Reliability

Our prototype HPDI fuel systems presently have significantly higher initial capital costs than many established competing technologies. If we are unable to produce fuel systems that are competitive, on a life cycle costs basis, in terms of price, reliability and longevity, operators of commercial vehicle fleets and power generators will be unlikely to buy products containing our fuel systems. The cost competitiveness of our products may also be affected by the level of government incentives and the price differential between diesel and natural gas, two factors beyond our control.

Manufacturing costs of some of our products have not yet been confirmed. We cannot guarantee that we will be able to lower these costs to the level where we will be able to produce an economically competitive product or that any product produced using lower cost materials and manufacturing processes will not suffer from a reduction in performance, reliability and longevity. If a price premium is required to generate cash flow, customers may not accept it.

We are Dependent on Our Relationships with Our Strategic Partners

Our current strategy calls for cooperation, information exchanges and joint ventures with strategic partners, using patents and written agreements to advance our business and protect our intellectual property. The agreements governing these relationships allow for termination by our partners under a number of circumstances. Any change in our relationships with our strategic partners, whether as a result of economic or competitive pressures, including any decision by our strategic partners to reduce their commitment to our technology in favour of competing technologies, or to bring to an end our various alliances, could have a material adverse effect on our business and financial results.

There can be no assurance of the commercial success of joint ventures in which we are, or will become, involved. There can be no assurance that existing technology agreements with engine manufacturers will be renewed or advanced into commercialization agreements on a timely basis. There can also be no assurance that we will be able to develop successful relationships with other multinational OEMs. In addition, our contractual obligations to our strategic partners require that we provide financial, technical and human resources for the ongoing development of our products or expansion of our projects. Our failure or inability to work successfully with our strategic partners could cause us to incur unanticipated expenses and losses or could delay the development of our products. CWI is currently the only joint venture Westport has entered into.

We Fund Research and Development Programs with Government Funding

From time to time, we enter into agreements with government agencies to fund our research and development programs. There can be no assurance that we will be able to continue to receive funding at the same levels. Funds received from government agencies are also subject to government audits.

Our Field Tests Could Have Problems

We are currently field-testing a number of our products and as part of our product developments cycles, we plan to conduct additional field tests in the future. These field tests may encounter problems and delays for a number of reasons, including the failure of our technology, the failure of the technology of others, the failure to combine these technologies properly and the failure to maintain and service the test prototypes properly. Many of these potential problems and delays are beyond our control. In addition, field test programs, by their nature, will involve delays and modifications. Any problem or perceived problem with our field tests could hurt our reputation and the reputation of our products and delay their commercial launch.

A Mass Market for Engines with Our Fuel Systems May Never Develop or May Take Longer to Develop than We Anticipate

Engines with our fuel systems represent an emerging market, and we do not know whether end-users will ultimately want to use them or pay for their initial incremental cost. The development of a mass market for our fuel systems may be affected by many factors, some of which are beyond our control, including:

- the emergence of newer, more competitive technologies and products;
- the future cost of natural gas and other fuels used by our systems;
- regulatory requirements / government incentives and penalties;
- customer perceptions of the safety of our products; and
- customer reluctance to try a new product.

If a mass market fails to develop or develops more slowly than we anticipate, we may be unable to recover the losses we will have incurred in the development of our products and may never achieve profitability.

We are Dependent on Our Relationship with Cummins and other Engine OEMs for Manufacturing and Distribution

The majority of our revenues are currently derived from the operations of CWI, which in turn purchases all of its current and foreseeable engine products from Cummins affiliated plants. Moreover, CWI distributes and supports its engine products and parts through Cummins distributors, many of which are independently owned and operated. Although the factories operate with modern technology and experienced management, there can be no assurance that the factory and distribution systems will always be able to perform on a timely and cost-effective basis.

To be commercially useful, our fuel systems must be integrated into engines and our engines must be integrated into chassis manufactured by OEMs. We can offer no guarantee that OEMs will manufacture engines with our fuel systems or chassis for our engines, or if they do manufacture such products, that customers will choose to purchase them. Any integration, design, manufacturing or marketing problems encountered by OEMs could adversely affect the market for our products and our financial results.

We are Dependent on Fuel Price Differentials that are Hard to Predict

The acceptance of natural gas-fuelled engines by customers depends in part on the price differential between natural gas and diesel fuel. Natural gas has generally been, and currently is, less expensive than diesel fuel in many jurisdictions. This price differential is affected by many factors, including changes in the resource base for natural gas compared with crude oil, pipeline transportation capacity for natural gas, refining capacity for crude oil and government excise and fuel tax policies. There can be no assurance that natural gas will remain less expensive than diesel fuel.

We are Dependent on Growth in Natural Gas Refuelling Infrastructure That May Not Take Place

For motor vehicles, natural gas must be carried on board in liquefied or compressed form and there are few public or private refuelling stations available in most jurisdictions. We are involved in developing such infrastructure through our minority ownership interest in Clean Energy, the largest natural gas refuelling company for vehicles in North America. However, there can be no assurance that Clean Energy will continue to be successful in expanding the availability of natural gas as a vehicle fuel, and there can be no assurance that other natural gas distributors and/or petroleum companies will develop refuelling stations to meet projected demand. If customers are unable to obtain fuel conveniently and affordably, a mass market for vehicles powered by our technology is unlikely to develop.

Changes in Environmental and Regulatory Policies Could Hurt the Market for Our Products

We currently benefit from, and hope to continue to benefit from, certain government environmental policies, mandates and regulations around the world, most significantly in the automotive markets and in the United States. Examples of such regulations include those that provide economic incentives, subsidies, tax credits and other benefits to purchasers of low emission vehicles, restrict the sale of engines that don't meet emission standards, fine the sellers of non-compliant engines, tax the operators of diesel engines and require the use of more expensive ultra-low sulphur diesel fuel. There can be no assurance that these regulations and incentives will not be relaxed or abandoned before they are implemented, materially impacting our competitive position.

We Currently Face and Will Continue to Face Significant Competition

Our products face and will continue to face significant competition. New developments in technology may negatively affect the development or sale of some or all of our products or make our products uncompetitive or obsolete. Other companies, many of which have substantially greater customer bases, businesses and other resources than us, are currently engaged in the development of products and technologies that are similar to, or may be competitive with, certain of our products and technologies.

Competition for our products will come from current power technologies, from improvements to current power technologies and from new alternative power technologies, including other fuel systems. Each of our target markets is currently serviced by existing manufacturers with existing customers and suppliers using proven and widely accepted technologies. Additionally, there are competitors working on developing technologies such as fuel cells, advanced batteries and hybrid battery/internal combustion engines in each of our targeted markets. Each of these competitors has the potential to capture market share in various markets, which could have a material adverse effect on our position in the industry and our financial results. For our products to be successful against competing technologies, especially diesel engines, they must offer advantages in one or more of these areas: emissions performance, fuel economy, engine performance, power density, engine and fuel system weight, and engine and fuel system price. There can be no assurance that our products will be able to offer advantages in all or any of these areas.

We Depend on Our Intellectual Property and Our Failure to Protect That Intellectual Property Could Adversely Affect Our Future Growth and Success

Failure to protect our existing and future intellectual property rights may result in the loss of our ability to exclude others from practicing our technology or our own right to practice our technologies. If we do not adequately ensure our freedom to use certain technology, we may have to pay others for rights to use their intellectual property, pay damages for infringement or misappropriation and/or be enjoined from using such intellectual property. Our patents do not guarantee us the right to practice our technologies if other parties own intellectual property rights that we need in order to practice such technologies. Our patent position is subject to complex factual and legal issues that may give rise to uncertainty as to the validity, scope and enforceability of a particular patent. Accordingly, we cannot assure that:

- any of the rights we have under U.S. patents or foreign patents owned by us or other patents that third parties license to us will not be curtailed, for example through invalidation, circumvention, challenge, being rendered unenforceable or by license to others;
- we were the first inventors of inventions covered by our issued patents or pending applications or that we were the first to file patent applications for such inventions;
- any of our pending or future patent applications will be issued with the breadth of claim coverage sought by us, or be issued at all;
- if we wish to use technology developed by a third party, or are found to be infringing third party patents, that we will be able to obtain licenses on acceptable terms, if at all;
- our competitors will not independently develop or patent technologies that are substantially equivalent or superior to our technologies; or
- any of our trade secrets will not be learned independently by our competitors.

In addition, effective patent, trademark, copyright and trade secret protection may be unavailable, limited or not applied for in certain foreign countries.

We also seek to protect our proprietary intellectual property, including intellectual property that may not be patented or patentable, in part by confidentiality agreements and, if applicable, inventors' rights agreements with our strategic partners and employees. We cannot assure that these agreements will not be breached, that we will have adequate remedies for any breach or that such persons or institutions will not assert rights to intellectual property arising out of these relationships.

Certain of our intellectual property has been licensed to us on a non-exclusive basis from third parties who may also license such intellectual property to others, including our competitors. If necessary or desirable, we may seek further licenses under the patents or other intellectual property rights of others. However, we can give no assurances that we will obtain such licenses or that the terms of any offered licenses will be acceptable to us. The failure to obtain a license from a third party for intellectual property we use at present could cause us to incur substantial liabilities and to suspend the manufacture, shipment of products or our use of processes requiring such intellectual property.

We Could Become Engaged in Intellectual Property Litigation That May Negatively Affect Our Business

While we are not currently engaged in any intellectual property litigation, we could become subject to lawsuits in which it is alleged that we have infringed the intellectual property rights of others or commence lawsuits against others who we believe are infringing upon our rights. Our involvement in intellectual property litigation could result in significant expense to us, adversely affecting the development of sales of the challenged product or intellectual property and diverting the efforts of our technical and management personnel, whether or not such litigation is resolved in our favour. In the event of an adverse outcome as a defendant in any such litigation, we may, among other things, be required to:

- pay substantial damages;
- cease the development, manufacture, use, sale or importation of products that infringe upon other patented intellectual property;
- expend significant resources to develop or acquire non-infringing intellectual property;
- discontinue processes incorporating infringing technology; or
- obtain licenses to the infringing intellectual property.

We cannot assure that we would be successful in such development or acquisition or that such licenses would be available upon reasonable terms. Any such development, acquisition or license could require the expenditure of substantial time and other resources and could have a material adverse effect on our business and financial results.

We May Have Difficulty Managing the Expansion of Our Operations

We may require rapid growth in the number of our employees, the size of our physical facilities and the scope of our operations. Such rapid expansion may place a significant strain on our senior management team and other resources. Difficulties in effectively managing the budgeting, forecasting and other process control issues presented by such a rapid expansion could harm our business, prospects, results of operations or financial condition.

We Could Lose or Fail to Attract the Personnel Necessary to Run Our Business

Our success depends in large part on the ability of ourselves and that of our affiliates to attract and retain key management, engineering, scientific, manufacturing and operating personnel. As we develop additional capabilities we will require more skilled personnel. Recruiting personnel for the alternative fuel industry is highly competitive. Although to date we have been successful in recruiting and retaining executive, managerial and technical personnel, there can be no assurance that we will continue to attract and retain the qualified personnel needed for our business. The failure to attract or retain qualified personnel could have a material adverse effect on our business.

We Have Foreign Currency Risk

The majority of our revenue is in US dollars while many of our operating expenses, other than cost of sales, are in Canadian dollars. Foreign exchange gains and losses are included in results from operations. A large decline in the value of the US dollar relative to the Canadian dollar could impair revenues, margins and other financial results. However, this risk is mitigated by US dollar expenses in CWI and CWI warranty balances, which are denominated in US dollars. We have not entered into foreign exchange contracts to hedge against gains and losses from foreign currency fluctuations.

If We Do Not Properly Manage Foreign Sales and Operations, Our Business Could Suffer

We expect a substantial portion of our future revenues will be derived from foreign sales and we operate where we may lack the expertise, local knowledge, or contacts. Our international activities may be subject to inherent risks, including unexpected changes in government policies, trade barriers, difficulty in staffing and managing foreign operations, longer payment cycles, and foreign exchange controls that restrict or prohibit repatriation of funds. As a result, if we do not properly manage foreign sales and operations, our business could suffer. We mitigate this risk by partnering with knowledgeable and reputable local companies and people and by making incremental investments.

We May Not Realise the Anticipated Benefits from Investments or Acquisitions

In connection with any investment or acquisition we make, there may be liabilities that we fail to discover or that we are unable to discover (including liabilities arising from non-compliance with environmental laws by prior owners) and for which we, as successor owner, may be responsible.

In addition, acquisitions often result in difficulties in integration, which adversely affect our results. The integration process may also divert the attention of, and place significant demands on, our managerial resources, which may disrupt our current business operations. As a result, we may fail to meet our current product development and commercialization schedules.

We Could be Liable for Environmental Damages Resulting From Our Research, Development or Manufacturing Operations

The nature of our business and products expose us to the risk of harmful substances escaping into the environment, resulting in personal injury or loss of life, damage to or destruction of property and natural resource damage. Depending on the nature of the claim, our current insurance policies may not adequately reimburse us for costs incurred in settling environmental damage claims, and in some instances, we may not be reimbursed at all. Our business is subject to numerous laws and regulations that govern environmental protection and human health and safety. These laws and regulations have changed frequently in the past and it is reasonable to expect additional and more stringent changes in the future. Our operations may not comply with future laws and regulations, and we may be required to make significant unanticipated capital and operating expenditures. If we fail to comply with applicable environmental laws and regulations, governmental authorities may seek to impose fines and penalties on us or to revoke or deny the issuance or renewal of operating permits and private parties may seek damages from us. Under those circumstances, we might be required to curtail or cease operations, conduct site remediation or other corrective action, or pay substantial damage claims.

Our Products Use Inherently Dangerous, Flammable Fuels, Which Could Subject Our Business to Product Liability Claims

Our business exposes us to potential product liability claims that are inherent in natural gas, propane, and hydrogen and products that use these gases. Natural gas, propane, and hydrogen are flammable gases and therefore potentially dangerous products. We also produce fuel processors that generate hydrogen from certain raw fuels such as natural gas, which are also flammable. Any accidents involving our products or other natural gas, propane, or hydrogen-based products could materially impede widespread market acceptance and demand for our engines and fuel systems. In addition, we may be held responsible for damages beyond the scope of our insurance coverage. We also cannot predict whether we will be able to maintain our insurance coverage on acceptable terms.

Consolidated Financial Statements
(Expressed in Canadian dollars)

WESTPORT INNOVATIONS INC.

Years ended March 31, 2006 and 2005

KPMG LLP
Chartered Accountants
PO Box 10426 777 Dunsmuir Street
Vancouver BC V7Y 1K3
Canada

Telephone (604) 691-3000
Fax (604) 691-3031
Internet www.kpmg.ca

AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the consolidated balance sheets of Westport Innovations Inc. as at March 31, 2006 and 2005 and the consolidated statements of operations and deficit and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the 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 evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Company as at March 31, 2006 and 2005 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

KPMG LLP (signed)

Chartered Accountants

Vancouver, Canada

May 5, 2006 except as to note 19
which is as of June 13, 2006

WESTPORT INNOVATIONS INC.

Consolidated Balance Sheets
(Expressed in Canadian dollars)

March 31, 2006 and 2005

	2006	2005
Assets		
Current assets:		
Cash and cash equivalents	$ 1,045,752	$ 319,806
Short-term investments	6,786,182	19,970,877
Accounts receivable	6,136,760	6,040,026
Inventory	852,945	1,481,513
Prepaid expenses	721,583	552,231
	15,543,222	28,364,453
Long-term investments (note 3)	9,133,876	9,133,876
Equipment, furniture and leasehold improvements (note 4)	3,960,173	5,774,875
Intellectual property (note 6)	863,223	1,168,416
	$ 29,500,494	$ 44,441,620
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	$ 3,270,553	$ 4,466,661
Deferred revenue	1,425,328	2,639,316
Demand instalment loan (note 7)	2,506,935	2,252,720
Current portion of long-term debt obligations (note 8)	169,227	104,975
Current portion of warranty liability	3,117,881	3,665,175
Current portion of financial instruments (note 10)	4,100,060	335,745
	14,589,984	13,464,592
Long-term debt and other long-term obligations (note 8)	844,990	1,545,064
Warranty liability	2,652,221	3,063,678
Financial Instruments (note 10)	-	2,621,458
Joint Venture Partner's share of income from joint venture (note 15)	1,661,664	68,870
Shareholders' equity:		
Share capital (note 11):		
Authorised:		
Unlimited common shares, no par value		
Unlimited preferred shares in series, no par value		
Issued:		
74,391,779 (2005 - 73,964,088) common shares	231,180,069	230,378,934
Other equity instruments (note 12)	2,359,483	2,078,460
Additional paid in capital	4,770,252	2,918,568
Deficit	(228,558,169)	(211,698,004)
	9,751,635	23,677,958
	$ 29,500,494	$ 44,441,620

Commitments and contingencies (notes 9 and 16)
Subsequent events (notes 10(b) and 19)

See accompanying notes to consolidated financial statements.

Approved on behalf of the Board:

"Henry Bauermeister" Director **"John Beaulieu"** Director

WESTPORT INNOVATIONS INC.

Consolidated Statements of Operations and Deficit
(Expressed in Canadian dollars)

Years ended March 31, 2006 and 2005

	2006	2005
Product revenue	$ 29,932,153	$ 25,660,939
Parts revenue	13,620,224	8,775,417
	43,552,377	34,436,356
Cost of revenue and expenses:		
Cost of revenue	28,642,133	23,762,246
Research and development (notes 12 and 13)	16,938,502	18,422,831
General and administrative (note 12)	4,866,227	5,627,112
Sales and marketing (note 12)	5,849,127	3,883,553
Foreign exchange gain	(92,591)	(603,382)
Depreciation and amortization	2,752,409	6,323,407
Bank charges and interest	313,896	276,524
	59,269,703	57,692,291
Loss before undernoted	(15,717,326)	(23,255,935)
Interest, investment and other income	380,842	453,202
Gain on disposal of equipment, furniture and leasehold improvements	69,113	138,366
Write down of equipment, furniture and leasehold improvements (note 5)	-	(402,966)
Write off of long-term investment (note 3)	-	(3,072,410)
Joint Venture Partner’s share of income from joint venture (note 15)	(1,592,794)	(68,870)
Loss for the year	(16,860,165)	(26,208,613)
Deficit, beginning of year	(211,698,004)	(185,489,391)
Deficit, end of year	$ (228,558,169)	$ (211,698,004)
Basic and diluted loss per share (note 11(f))	$ (0.23)	$ (0.38)
Weighted average common shares outstanding	74,228,495	69,381,968

See accompanying notes to consolidated financial statements.

WESTPORT INNOVATIONS INC.

Consolidated Statements of Cash Flows
(Expressed in Canadian dollars)

Years ended March 31, 2006 and 2005

	2006	2005
Cash flows from operations:		
Loss for the year	$ (16,860,165)	$ (26,208,613)
Items not involving cash:		
Depreciation and amortization	2,752,409	6,323,407
Stock-based compensation expense	2,933,842	1,746,819
Accretion of TPC warrants (notes 9 and 10(a))	1,142,857	1,142,857
Change in deferred lease inducements	(153,971)	18,244
Write down of equipment, furniture, and leasehold improvements	-	402,966
Write off of long-term investment	-	3,072,410
Gain on disposal of equipment, furniture and leasehold improvements	(69,113)	(138,366)
Joint Venture Partner's share of income from joint venture	1,592,794	68,870
	(8,661,347)	(13,571,406)
Changes in non-cash operating working capital:		
Accounts receivable	(96,734)	(966,642)
Inventory	628,568	(1,481,513)
Prepaid expenses	(169,352)	(19,383)
Accounts payable and accrued liabilities	(1,196,108)	921,053
Deferred revenue	(1,213,988)	2,105,712
Warranty liability	(958,751)	(1,145,054)
	(11,667,712)	(14,157,233)
Cash flows from investments:		
Purchase of equipment, furniture and leasehold improvements	(396,106)	(558,898)
Proceeds on sale (purchase) of short-term investments, net	13,184,695	(623,913)
Proceeds on disposition of equipment, furniture and leasehold improvements	92,854	138,366
	12,881,443	(1,044,445)
Cash flows from financing:		
Issue of common shares, net of issuance costs	-	15,214,347
Issue of demand instalment loan	1,235,000	-
Repayment of demand instalment loan	(980,785)	(954,035)
Repayment of long-term debt and other long-term obligations	(742,000)	(265,466)
Leasehold inducement	-	90,000
	(487,785)	14,084,846
Increase (decrease) in cash and cash equivalents	725,946	(1,116,832)
Cash and cash equivalents, beginning of year	319,806	1,436,638
Cash and cash equivalents, end of year	$ 1,045,752	$ 319,806
Supplementary information:		
Interest paid	$ 221,736	$ 163,675
Non-cash transactions:		
Purchase of equipment, furniture and leasehold improvements by assumption of capital lease obligation	260,149	-
Shares issued on exercise of performance share units	801,135	1,145,968
Leasehold improvements acquired through leasehold inducements	-	551,000
Intellectual property acquired for shares to be issued and accounts payable and accrued liabilities	-	1,007,234

See accompanying notes to consolidated financial statements.

1. Nature of operations:

Westport Innovations Inc. (the "Company") was incorporated under the Business Corporations Act (Alberta) on March 20, 1995.

The Company is involved in the research, development and commercialization of environmental technologies, including high-pressure direct injection ("HPDI") combustion technology that allows diesel engines to operate on cleaner burning gaseous fuels such as natural gas without sacrificing performance or fuel economy.

The Company entered into a joint venture with Cummins Inc. ("Cummins") on March 7, 2001. The joint venture agreement was amended on December 16, 2003 (note 15). The joint venture, Cummins Westport Inc. ("CWI"), develops, supports and markets a comprehensive product line of low-emission, high performance engines and ancillary products using proprietary intellectual property developed by the Company and Cummins.

These consolidated financial statements have been presented on a going concern basis, which assumes the realisation of assets and the settlement of liabilities in the normal course of operations. To date, the Company has financed its operations primarily by equity financing and margins on the sale of products and parts. If the Company does not have sufficient funding from internal or external sources, it may be required to delay, reduce or eliminate certain research and development programs and forego acquisition of certain equipment. Subsequent to March 31, 2006, the Company agreed to issue up to $22.1 million of convertible notes and entered into an agreement to reorganize one of its wholly owned subsidiaries (note 19). This transaction is expected to realize at least $10 million in proceeds. The future operations of the Company are dependent upon its ability to produce, distribute and sell an economically viable product to attain profitable operations.

2. Significant accounting policies:

(a) Basis of presentation:

The consolidated financial statements include the accounts of the Company, its wholly owned subsidiaries and CWI. Intercompany accounts and transactions have been eliminated.

In June 2003, the CICA issued Accounting Guideline 15, "*Consolidation of Variable Interest Entities*", which applies to annual or interim periods beginning on or after November 1, 2004. A Variable Interest Entity ("VIE") is any type of legal structure not controlled by voting equity, but rather by contractual and/or other financial arrangements. Interests in VIE's are consolidated by the company if the company is the primary beneficiary. The Company has identified CWI as a VIE and determined that the Company is the primary beneficiary. Accordingly, the Company has consolidated CWI. The other 50% interest held by Cummins is reflected as "Joint Venture Partner's share of income from joint venture" in these consolidated financial statements.

These financial statements are presented in accordance with Canadian generally accepted accounting principles. Material measurement differences between these principles and accounting principles generally accepted in the United States are disclosed in note 20.

2. Significant accounting policies (continued):

(b) Cash and cash equivalents:

Cash and cash equivalents includes cash and term deposits with maturities of ninety days or less when acquired.

(c) Short-term investments:

Short-term investments, consisting principally of investment grade commercial paper, are recorded at cost plus accrued interest.

(d) Long-term investments:

The Company accounts for long-term investments in entities which are not consolidated using the equity method to the extent that the Company has significant influence over the investee's strategic operating, financing and investing policies. Under the equity method, the Company's proportionate share of income or loss is included in the statement of operations and any dividends received are recorded as a reduction of the investment. All other long-term investments are accounted for using the cost method, whereby income is recorded in the accounts only to the extent dividends are received during the year. All long-term investments are currently carried at cost.

Long-term investments are reduced to their fair value only to the extent that the loss in value is other than temporary.

(e) Inventory:

The Company's inventory consists of CWI engine products. Inventory is stated at the lower of cost, on a specific identification basis, or net realisable value.

(f) Equipment, furniture and leasehold improvements:

Equipment, furniture and leasehold improvements are stated at cost. Depreciation is provided as follows:

Assets	Basis	Rate
Computer equipment and software	Straight-line	3 years
Furniture and fixtures	Straight-line	5 years
Machinery and equipment	Straight-line	8 years
Leasehold improvements	Straight-line	Lease term

In 2006, the Company revised its estimate of the useful life of its research and development machinery and equipment from five to eight years. The impact of this change in estimate resulted in lower depreciation expense for the year ended March 31, 2006 of $1,092,038.

2. Significant accounting policies (continued):

(g) Research and development costs:

Research costs are expensed as incurred and are recorded net of government funding received or receivable. Development costs are deferred only if they meet certain stringent criteria generally related to technical feasibility, market definition and financing availability for future development; otherwise they are expensed as incurred. Related investment tax credits reduce research and development expenses in the same year in which the related expenditures are charged to earnings, provided there is reasonable assurance the benefits will be realised. As at March 31, 2006 and 2005, no development costs had been deferred.

(h) Government assistance:

The Company periodically applies for financial assistance under available government incentive programs which is recorded in the period it is received or receivable. Government assistance relating to the purchase of equipment, furniture and leasehold improvements is reflected as a reduction of the cost of such assets. Government assistance related to research and development activities is recorded as a reduction of the related expenditures.

(i) Intellectual property:

Intellectual property, consisting primarily of the cost of acquired patents, licenses and other intellectual property, is amortized over periods ranging from three to seven years.

(j) Impairment of long-lived assets:

The Company reviews for impairment of long-lived assets, including equipment, furniture, and leasehold improvements and intellectual property, to be held and used whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. If such conditions exist, assets are considered impaired if the sum of the undiscounted expected future cash flows expected to result from the use and eventual disposition of an asset is less than its carrying amount. An impairment loss is measured at the amount by which the carrying amount of the asset exceeds its fair value. When quoted market prices are not available, the Company uses the expected future cash flows discounted at a rate commensurate with the risks associated with the recovery of the asset as an estimate of fair value.

2. Significant accounting policies (continued):

(k) Warranty liability:

Estimated warranty costs are recognised at the time CWI sells its products, and are included in cost of revenue. CWI provides warranty coverage on its products sold for a period of two years from the date the products are put into service by customers. Warranty liability represents CWI's best estimate of warranty costs expected to be incurred during the warranty period. Furthermore, the current portion of warranty liability represents CWI's best estimate of the costs to be incurred in the next twelve month period. CWI uses historical failure rates and cost to repair defective products together with information on known product issues to estimate the warranty liability. The ultimate amount payable by CWI and the timing will depend on actual failure rates and cost to repair failures of its products. Since many of CWI's products are new in the market, historical data may not necessarily reflect actual costs to be incurred and exposes CWI to the potential for significant fluctuations in the warranty liability.

(l) Revenue recognition:

Product and parts revenue is recognised, net of estimated costs of returns, allowances, and sales incentives, when the products are shipped and title passes to the customers. Shipments of most products and parts sold by CWI originate from Cummins' facilities. Revenue also includes fees earned from performing research and development activities for third parties. Revenue from research and development activities is recognised as the services are performed. Amounts received in advance of revenue recognition are recorded as deferred revenue.

(m) Income taxes:

The Company uses the asset and liability method of accounting for income taxes. Under this method, future income tax assets and liabilities are determined based on temporary differences between the accounting and tax basis of the assets and liabilities and for loss carry forwards, and are measured using the tax rates expected to apply when these tax assets and liabilities are recovered or settled. The effect on future tax assets and liabilities of a change in tax rate is recognised in income in the period that includes the substantive enactment date. A valuation allowance is recorded against any future income tax asset if it is not "more likely than not" that the benefit of these assets will be realised.

(n) Stock-based compensation plans:

The Company accounts for stock-based compensation related to stock options granted to employees and directors using the fair value method and recognised as stock-based compensation in results from operations over the vesting period. The Company has an employee share purchase plan, which is described in note 11(e). The Company matches the employees' contribution and recognizes this cost as an expense in the period it is incurred.

The Company has a Performance Share Unit ("PSU") Plan as described in note 12. The value of the units is calculated based on the market price of the Company's common shares on the date of grant and is recorded as compensation expense in the period earned, which generally is the period over which the PSU's vest.

2. Significant accounting policies (continued):

(o) Financial Instruments:

Effective for the Company's fiscal year beginning April 1, 2005, the Company adopted amended Handbook Section 3860 - *"Financial Instruments - Disclosure and Presentation"* ("HB 3860") related to financial instruments that are contractual obligations of a fixed amount but are settleable with a variable number of the Company's common shares. Amendments to HB 3860 require that these financial instruments be classified as liabilities rather than shareholders' equity because they do not represent a residual interest in the Company until the common shares are issued. Accordingly, the value assigned to the Technology Partnerships Canada ("TPC") warrants and the GVH Entwicklungsgesellschaft für Verbrennungsmotoren und Energietechnik mbH ("GVH") obligation to issue shares, both of which were included in "Other Equity Instruments" in fiscal 2005, are in substance a liability to the Company because the number of common shares to be issued is determined based on a fixed contractual amount of fair value due to TPC and the vendors of GVH. These fixed contractual amounts will be settled using equity instruments with the number of such instruments to be determined based on the market value of the Company's common shares on the date these instruments are settled. Accordingly, these amounts have been reclassified as liabilities and prior period financial statements have been reclassified to reflect this change in accounting policy.

(p) Post-retirement benefits:

The Company has implemented a group registered retirement savings plan ("RRSP") in which full-time employees of the Company are eligible to participate. Eligible employees may make contributions up to their personal eligible contribution room under the Canadian Income Tax Act. The Company contributes up to a maximum combined total of 5% of the employee's regular base pay to the RRSP and/or the employee share purchase plan and recognizes this cost as an expense in the period it is incurred. During the year ended March 31, 2006, the Company recognised $317,113 (2005 - $156,971) of expense associated with the RRSP.

(q) Foreign currency:

The Company and its subsidiaries located outside of Canada, including CWI, are treated as integrated operations with the Canadian dollar as their functional currency. Monetary items denominated in foreign currency are translated into Canadian dollars at exchange rates in effect at the balance sheet date and non-monetary items are translated at rates of exchange in effect when the assets were acquired or obligations incurred. Revenue and expenses are translated at rates in effect at the time of the transactions. Foreign exchange gains and losses are included in results from operations.

(r) Use of estimates:

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the period. Significant areas requiring the use of estimates include amortization of equipment, furniture and leasehold improvements, the determination of future cash flows and discount rates for impairment of long-lived assets, valuation of long-term investments and the accrual of warranty liability. Actual results could differ from estimates used in the preparation of the consolidated financial statements.

(Expressed in Canadian dollars)

2. Significant accounting policies (continued):

(s) Loss per share:

Basic loss per share is calculated using the weighted average number of shares outstanding during the period. Diluted loss per share is computed similarly to basic loss per share, except that the weighted average shares outstanding are increased to include additional shares from the assumed exercise of stock options, warrants, and performance share units, if dilutive. The number of additional shares is calculated by assuming that outstanding stock options, warrants, and performance share units were exercised at the beginning of the year or when granted and that the proceeds from such exercises were used to repurchase shares of common stock at the average market price during the period.

(t) Comparative amounts:

Certain comparative amounts have been reclassified to conform with the presentation adopted in the current year.

3. Long-term investments:

The Company owns 8.14% (2005 - 10%) interest in Clean Energy Fuels Corp., a private Company that is an owner and operator of natural gas refueling facilities, and is carried at a cost of $9,133,876. In March 2005 the Company's investment in Edge Technologies Inc. was written off as the Company determined that the decline in value was other than temporary.

4. Equipment, furniture and leasehold improvements:

2006	Cost	Accumulated depreciation	Net book value
Computer equipment and software	$ 4,945,991	$ 4,677,347	$ 268,644
Furniture and fixtures	1,163,256	1,010,545	152,711
Machinery and equipment	19,709,074	16,554,947	3,154,127
Leasehold improvements	8,021,813	7,637,122	384,691
	$ 33,840,134	$ 29,879,961	$ 3,960,173

2005	Cost	Accumulated depreciation	Net book value
Computer equipment and software	$ 4,751,713	$ 4,375,768	$ 375,945
Furniture and fixtures	1,107,627	908,137	199,490
Machinery and equipment	19,653,700	15,589,234	4,064,466
Leasehold improvements	8,012,139	6,877,165	1,134,974
	$ 33,525,179	$ 27,750,304	$ 5,774,875

As at March 31, 2006, equipment with a cost of $464,394 (2005 - $320,210) and a net book value of $252,246 (2005 - $102,125) is held under capital lease.

(Expressed in Canadian dollars)

5. Write down of equipment, furniture and leasehold improvements:

In December 2004, the Company renegotiated its long-term lease agreements for its corporate offices and moved into a new location. The former corporate premises had an unamortized balance of $58,678 in leasehold improvements which was written off during the year ended March 31, 2005. In March 2005, the Company also wrote down its assets in Germany having an unamortized balance of $344,288, the value of which has been impaired as a result of the return of these assets to the vendor.

6. Intellectual property:

	2006	2005
Intellectual property acquired from:		
University of British Columbia	$ 1,550,000	$ 1,550,000
Edge Technologies, Inc.	750,100	750,100
GVH (note 10(b))	1,697,214	1,697,214
Other	324,080	324,080
	4,321,394	4,321,394
Accumulated amortization	(3,458,171)	(3,152,978)
Intellectual property, net of amortization	$ 863,223	$ 1,168,416

7. Demand instalment loan:

The Company has a credit facility for maximum borrowings of $13,000,000. Borrowings may be drawn in the form of demand instalment loans, lease financing, letters of credit, foreign exchange contracts, corporate credit cards and operating lines of credit. Outstanding amounts of the demand instalment loans drawn under this credit facility bear interest at prime and are repayable over a 60-month period. As at March 31, 2006, the outstanding amount payable of $2,506,935 is included in current liabilities as it is repayable on demand by the bank.

8. Long-term debt and other long-term obligations:

	2006	2005
Capital lease obligations (a)	$ 319,660	$ 190,975
Other debt obligations (b)	-	610,536
Deferred lease inducements (c)	694,557	848,528
	1,014,217	1,650,039
Current portion	169,227	104,975
	$ 844,990	$ 1,545,064

(Expressed in Canadian dollars)

8. Long-term debt and other long-term obligations (continued):

(a) The Company has capital lease obligations which have terms of two to five years at interest rates ranging from 1.15% to 6.17%. The capital lease obligations require the following minimum annual payments during the respective fiscal years:

2007	$ 171,903
2008	86,228
2009	60,366
2010	4,895
2011	3,672
	327,064
Amount representing interest	(7,404)
	$ 319,660

(b) As at March 31, 2005, other debt obligations consisted of long-term bank indebtedness bearing interest at a rate of 4.25% and secured by a term deposit of 415,000 Euros. In 2006, the debt obligation was fully repaid.

(c) The Company renegotiated its existing long-term lease agreements for its corporate offices and research facilities in 2004 and 2005 which included certain lease inducements. These inducements included leasehold improvements and other costs funded by the lessor and periods with reduced rental payments. The amounts related to leasehold improvements funded by the lessor are amortized on a straight-line basis over the term of the lease as a reduction to rent expense. For lease contracts with escalating lease payments, total rent expense for the lease term is expensed on a straight line basis over the lease term. The difference between amounts expensed and amounts paid is recorded as an increase or reduction in deferred lease inducements.

9. Government assistance:

From time to time, the Company enters into agreements for financial assistance with government agencies. During the years ended March 31, 2006 and 2005, government assistance of $8,689,159 and $5,978,930, respectively, was received or receivable by the Company, which has been recorded as a reduction of related research and development expenditures (note 13).

Included in the above amounts is funding of $2,623,346 (2005 - $1,853,406) from Technology Partnerships Canada (“TPC”), of which $1,574,450 is included in accounts receivable at March 31, 2006 (2005 - $1,210,438). Under the terms of the TPC funding agreement entered into on March 27, 2003, TPC will fund 30% of the eligible costs of, among other research projects, the adaptation of the Company’s technology to diesel engines. From fiscal 2007 to fiscal 2013, inclusive, the Company is obligated to pay annual royalties equal to the greater of $1,350,000 or 0.33% of the Company’s annual gross revenue from all sources, provided that gross revenue exceed $13,500,000 in any of the aforementioned fiscal years. The royalty period may be extended until the earlier of March 31, 2016 or until cumulative royalties total $28,189,000. In addition, on September 30, 2006, the Company is required to provide TPC with common share purchase warrants having a value of $4,000,000 calculated based on the Black-Scholes option pricing model. The value of the warrants is being accreted on a straight-line basis to September 30, 2006 as a charge to research and development expenses.

(Expressed in Canadian dollars)

9. Government assistance (continued):

The Company is also obligated to pay royalties to the Government of Canada's Department of Natural Resources and British Columbia's Green Economy Development Fund relating to funding received in prior years. The royalty to the Department of Natural Resources is 1% of future revenue from engines for power generators until the earlier of ten years from the project completion date (August 30, 2004) or when cumulative royalties total $1 million. As at March 31, 2006, there have been no revenue from the sales of engines for power generators and, therefore, no royalty payments have been paid or are payable. The royalty to the Green Economy Development Fund is 0.75% of gross revenue received by the Company on certain natural gas fuel systems and the obligation will cease on the earlier of the seventh anniversary of the funding contribution date (April 10, 2001) or when the cumulative royalties paid by the Company equal $800,000. As at March 31, 2006, no royalties have been paid or are payable.

10. Financial Instruments:

	March 31, 2006	March 31, 2005
Value assigned to TPC warrants (a)	$ 3,428,571	$ 2,285,714
Shares to be issued (b)	671,489	671,489
	4,100,060	2,957,203
Current portion	4,100,060	335,745
	$ -	$ 2,621,458

(a) TPC warrants:

Under the terms of an agreement with TPC (note 9), warrants with a fair value of $4,000,000 based on the Black-Scholes pricing model will be issued on September 30, 2006. The value of the warrants is being accreted on a straight-line basis to September 30, 2006. For the year ended March 31, 2006, accretion totaling $1,142,857 (2005 - $1,142,857) has been included in research and development expenses.

(b) Shares to be issued:

Under the terms of an asset purchase agreement with GVH, the Company has an obligation to pay GVH $671,489 through the issuance of shares as part of certain milestone payments. On April 28, 2006, 239,924 shares were issued to GVH with a value of $302,660. The balance of the shares owing is expected to be issued no later than July 2006.

(Expressed in Canadian dollars)

11. Share capital:

(a) Authorised:
Unlimited common shares, no par value
Unlimited preferred shares issuable in series, no par value

(b) Issued and outstanding:

	Number of shares		Amount
Balance, March 31, 2004	64,340,430	$	213,965,067
Cumulative effect of change in accounting policy for stock-based compensation expense (note 2(n))	-		52,474
Options exercised	86,277		159,073
Performance share units exercised for no additional consideration	537,331		1,145,968
Warrants exercised for cash	50		105
Public offering	9,000,000		16,200,000
Share issue costs	-		(1,143,753)
Balance, March 31, 2005	73,964,088		230,378,934
Performance share units exercised for no additional consideration	427,691		801,135
Balance, March 31, 2006	74,391,779	$	231,180,069

(c) Common shares and warrants issued:

On September 10, 2004, the Company entered into a bought deal financing agreement with a syndicate of investment dealers for 9,000,000 units consisting of 9,000,000 common shares and 4,500,000 common share purchase warrants (the “Warrants”). The units were priced at $1.80 per unit for gross proceeds of $16,200,000 and net proceeds of $15,056,247, which net proceeds were received on September 29, 2004. Each Warrant entitled the holder to acquire, on or before March 29, 2006, one common share of the Company upon payment of $2.10 per share. On March 29, 2006, 4,499,950 warrants expired and as at March 31, 2006, no warrants remain outstanding.

(d) Share options:

The Company has an incentive share option plan for employees, directors, officers and consultants. The options are granted with an exercise price not less than the market price of the Company’s common shares on the date immediately prior to the date of grant. The exercise period of the options may not exceed eight years from the date of grant and, subject to certain exceptions, vest in three equal annual amounts on the anniversary date of the grant. Vesting periods of the options are at the discretion of the board of directors and may be based on fixed terms, achieving performance milestones or reaching specified share price targets.

(Expressed in Canadian dollars)

11. Share capital (continued):

(d) Share options (continued):

A summary of the status of the Company's share option plan as of March 31, 2006 and 2005 and changes during the years then ended is presented as follows:

	2006		2005	
	Shares	Weighted average exercise price	Shares	Weighted average exercise price
Outstanding, beginning of year	2,402,415	$ 3.63	3,254,688	$ 3.93
Granted	3,178,218	1.48	356,810	2.34
Exercised	-	-	(86,277)	(1.83)
Cancelled	(612,070)	(5.24)	(1,122,806)	(4.21)
Outstanding, end of year	4,968,563	$ 2.05	2,402,415	$ 3.63
Options exercisable, end of year	1,544,266	$ 3.22	1,982,260	$ 3.98

The following table summarises information about share options outstanding at March 31, 2006:

Range of exercise prices	Number outstanding, March 31, 2006	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable March 31, 2006	Weighted average exercise price
$0.92 to $1.40	381,630	7.2	$ 1.21	115,852	$ 1.26
$1.50 to $ 1.79	3,131,352	7.0	1.51	326,163	1.56
$1.80 to $2.22	601,740	5.9	1.90	248,410	1.87
$2.61 to $3.94	378,682	4.6	3.31	378,682	3.31
$4.14 to $5.89	350,475	1.8	4.66	350,475	4.66
$4.66 to $8.80	124,684	3.6	7.75	124,684	7.75
	4,968,563	6.2	$ 2.05	1,544,266	$ 3.22

The fair value of the options granted was determined using the Black-Scholes option pricing model using the following weighted average assumptions: expected dividend yield - nil% (2005 - nil%); expected stock price volatility - 65% (2005 - 69%); risk free interest rate - 4.20% (2005 - 3.57%); expected life of options - 5 years (2005 - 4 years). The weighted average grant date fair value was $0.87 for options granted for the year ended March 31, 2006 (2005 - $1.11). During the year ended March 31, 2006, the Company recognized $1,851,684 (2005 - $387,199) in stock-based compensation related to stock options.

11. Share capital (continued):

(e) Employee share purchase plan:

The Company has an employee share purchase ("ESPP") in which full-time employees of the Company are eligible to participate. Eligible employees may make contributions to the ESPP of up to 10% of their regular base pay. The Company contributes up to a maximum combined total of 5% of the employee's regular base pay to the RRSP and/or the ESPP. Shares contributed to the ESPP are purchased by the Company on a semi-monthly basis on the open market. Shares purchased on behalf of the employee with the employee's contribution vest with the employee immediately. Shares purchased with the Company's contribution vest on December 31st of each year, so long as the employee is still employed with the Company.

(f) Loss per share:

Diluted loss per share does not differ from basic loss per share as the impact of dilutive securities, including all stock options, warrants, and performance share units, is anti-dilutive.

12. Other equity instruments:

Other equity instruments consists of the value assigned to performance share units ("Units") granted pursuant to the Company's 2003 Performance Share Unit Plan ("2003 Unit Plan").

At the Company's 2003 annual general meeting, the shareholders of the Company ratified and approved the 2003 Performance Share Unit Plan (the "2003 PSU Plan") and reserved 2,500,000 common shares under this plan. The 2003 PSU Plan is in addition to the Performance Share Unit Plan approved by the shareholders on September 10, 2001 (the "2001 PSU Plan"). Each unit ("PSU") issued pursuant to the 2003 PSU Plan or the 2001 PSU Plan is exercisable into one common share of the Company for no additional consideration. Any employee, contractor, director or executive officer of the Company who is selected by the Board of Directors of the Company is eligible to participate in the 2003 PSU Plan. The Executive Plan sets out provisions where the PSU's will be granted to the Company's executive management if performance milestones are achieved as determined at the discretion of the Human Resources and Compensation Committee of the Company's Board of Directors in consultation with the Company's management. These performance milestones are focused on achievement of key cash management, profitability and revenue growth objectives. Vesting periods for each PSU granted pursuant to the 2003 PSU Plan is at the discretion of the Board of Directors and may include time based, share price or other performance targets.

The value assigned to issued PSU's and the amounts accrued are recorded as other equity instruments. As PSU's are exercised and the underlying shares are issued from treasury of the Company, the value is reclassified to share capital. During the year ended March 31, 2006, the Company recognised $1,082,158 (2005 - $1,359,620) of stock-based compensation associated with the 2001 PSU Plan and 2003 PSU Plan.

(Expressed in Canadian dollars)

12. Other equity instruments (continued):

The stock-based compensation associated with the PSU plans and the stock option plan as described in note 11(d) is included in operating expenses as follows:

	2006	2005
Research and development	$ 1,603,525	$ 400,628
General and administrative	946,025	1,313,211
Marketing	384,292	32,980
	$ 2,933,842	$ 1,746,819

A summary of the status of the PSU's issued under the 2001 PSU Plan and the 2003 PSU Plan as of March 31, 2006 and 2005, and changes during the years then ended is as follows:

	Units
Outstanding, March 31, 2004	381,500
Units exercised	(537,331)
Units granted	1,197,728
Outstanding, March 31, 2005	1,041,897
Units exercised	(427,691)
Units granted	816,919
Outstanding, March 31, 2006	1,431,125

As at March 31, 2006, 587,142 PSU's are exercisable.

13. Research and development expenses:

Research and development expenses are recorded net of program funding received or receivable. For the years ending March 31, 2006 and 2005, the following research and development expenses had been incurred and program funding received or receivable:

	2006	2005
Research and development expenses	$ 25,627,661	$ 24,401,761
Program funding	(8,689,159)	(5,978,930)
Research and development	$ 16,938,502	$ 18,422,831

In 2006, program funding is comprised mainly of funding from TPC, National Renewable Energy Laboratory, and South Coast Air Quality Management District, which was used to fund research and demonstration projects including the adaptation of the Company's technology to diesel engines. In 2005, program funding is comprised mainly of funding from the National Research Council of Canada's Industrial Research Assistance Program, Sustainable Development Technology Canada, National Renewable Energy Laboratory, and TPC.

(Expressed in Canadian dollars)

14. Income taxes:

(a) The Company's income tax recovery differs from that calculated by applying the combined Canadian federal and provincial statutory income tax rates for manufacturing and processing companies of 34.48% (2005 - 35.62%) as follows:

		2006		2005
Loss before income taxes	$	(16,860,165)	$	(26,208,613)
Expected income tax recovery	$	(5,813,385)	$	(9,335,508)
Increase in income taxes resulting from:				
Non-deductible Joint Venture Partner's share of income from joint venture		564,748		24,531
Non-deductible stock-based compensation		1,011,589		622,217
Non-deductible expenses		425,958		442,032
Change in enacted rates		11,966		-
Foreign tax rate differences		168,383		25,694
Losses and other deductions for which no benefit has been recorded		3,630,741		8,221,034
	$	-	$	-

(b) The tax effect of the significant temporary differences which comprise tax assets and liabilities, at March 31, 2006 and 2005, are as follows:

		2006		2005
Future tax assets:				
Net operating loss carry forwards	$	36,049,145	$	35,418,845
Scientific research and development expenditures carry forwards		27,377,225		24,698,425
Equipment, furniture and leasehold improvements		3,488,532		2,902,866
Warranty liability		2,267,650		2,355,099
Share issue costs		452,273		967,603
Intellectual property		849,233		778,378
Capital lease obligations		109,004		285,498
Long-term investments		807,778		843,785
Total gross future tax assets		71,400,840		68,250,499
Valuation allowance		(71,400,840)		(68,250,499)
Total future tax asset	$	-	$	-

In determining the valuation allowance, management considers whether it is more likely than not that some portion or all of the future tax assets will not be realised. The ultimate realisation of future tax assets is dependent on the generation of income during the future periods in which those temporary differences become deductible. Since evidence does not exist that the future income tax assets will be fully realised, a valuation allowance has been recorded.

(Expressed in Canadian dollars)

14. Income taxes (continued):

(c) The Company has non-capital loss carry forwards in Canada available to offset future taxable income which expire as follows:

2007	$	5,147,876
2008		11,787,724
2009		1,504,498
2010		2,360,332
2014		5,466,018
2015		13,676,046
2016		13,363,237
	$	53,305,731

CWI has net operating loss carry forwards in the United States totalling $41,479,137 of which $4,408,688 expire in 2021, $17,789,025 expire in 2022, $17,413,513 expire in 2023, and $1,867,911 expire in 2024. The Company's German subsidiary has loss carry forwards of $4,037,505 which may be carried forward indefinitely to offset taxable income in Germany.

(d) Unclaimed scientific and experimental development expenditures total approximately $80,285,116 and carry forward indefinitely.

(e) Unclaimed investment tax credits expire in:

2007	$	4,596
2008		52,945
2009		99,026
2010		1,226,182
2011		6,953,905
2012		4,593,780
2013		2,273,808
2014		1,757,238
	$	16,961,480

15. Investment in Cummins Westport Inc.:

The Company entered into a joint venture with Cummins on March 7, 2001. The joint venture, CWI, was formed to explore a range of product and technology opportunities using natural gas as the primary fuel. The Company provided personnel, financing and key technologies for the venture, while Cummins provided an existing product line, manufacturing, product distribution and customer service functions, as well as key management and engineering personnel.

From inception until December 31, 2003, the Company was responsible for all capital contributions to fund operations. Initially and to December 31, 2003, the Company owned 100% of the common shares and Cummins owned 100% of the non-participating preferred shares which were convertible into common shares for no consideration at the option of Cummins.

(Expressed in Canadian dollars)

15. Investment in Cummins Westport Inc. (continued):

On December 16, 2003, the Company and Cummins amended the joint venture agreement to have CWI focus on and develop markets for alternative fuel engines. In addition, the two companies signed a Technology Partnership Agreement that creates a flexible arrangement for future technology development between Cummins and the Company. Under the terms of the amended joint venture agreement, Cummins exercised the conversion feature of the preferred shares effective January 1, 2004. However, the Company remained responsible for funding the profit and loss of CWI through CWI's fiscal 2004 year which ran from January 1 to December 31, 2004. Based on its economic interest in CWI, the Company continued to consolidate 100% of the results of operations from CWI until December 31, 2004.

From January 1, 2005 forward, Cummins shares equally in the profits and losses of CWI. However, the Company has determined that CWI is a VIE and that the Company is the primary beneficiary as the Company's variable interests in CWI, comprising of its equity, debt and royalty interests, will absorb more than 50% of the expected losses of CWI and that CWI's business activities are more integral to those of the Company. Accordingly, the Company continues to consolidate CWI with Cummins' share of CWI's income and losses included as "Joint Venture Partner's share of income from joint venture".

Assets, liabilities, revenue and expenses of CWI as at and for the periods presented are as follows:

	2006	2005
Current assets:		
Cash and cash equivalents	$ 146,656	$ 1,146
Accounts receivable	2,766,068	1,983,790
Inventory	852,945	1,481,513
Prepaid expenses	219,659	84,150
	3,985,328	3,550,599
Equipment, furniture and leasehold improvements	60,249	-
	$ 4,045,577	$ 3,550,599
Current liabilities:		
Accounts payable and accrued liabilities	$ 511,196	$ 559,748
Deferred revenue	1,383,363	2,448,612
Current portion of warranty liability	3,117,881	3,665,175
	$ 5,012,440	$ 6,673,535
Long term liabilities:		
Warranty liability	$ 2,652,221	$ 3,063,678

(Expressed in Canadian dollars)

15. Investment in Cummins Westport Inc. (continued):

	2006	2005
Product revenue	$ 28,633,983	$ 24,467,385
Parts revenue	13,620,224	8,775,417
	42,254,207	33,242,802
Cost of revenue and expenses:		
Cost of revenue	27,343,963	22,591,859
Research and development	6,576,840	6,556,826
General and administrative	1,249,168	1,175,007
Sales and marketing	4,005,743	3,653,875
	39,175,714	33,977,567
Income (loss) before undernoted	3,078,493	(734,765)
Effect of foreign currency translation	107,095	920,409
Income for the year	3,185,588	185,644
Joint Venture Partner’s share of income from joint venture	(1,592,794)	(68,870)
Company’s share of income	$ 1,592,794	$ 116,774

16. Commitments and contingencies:

(a) The Company has obligations under operating lease arrangements which require the following minimum annual payments during the respective fiscal years:

2007	$ 817,229
2008	855,951
2009	863,812
2010	168,069
2011	94,154
Thereafter	292,500
	$ 3,091,715

(b) The Company has an outstanding letter of credit of $600,000.

17. Financial instruments:

(a) Fair values:

The carrying amounts reported in the balance sheets for cash and cash equivalents, short-term investments, accounts receivable, and accounts payable and accrued liabilities approximate their fair values, due to the short terms to maturity of these instruments. The carrying value of the warranty obligation represents management's best estimate of its fair value.

The carrying value reported in the balance sheets for obligations under capital lease, which is based upon discounted cash flows, approximates its fair value. The fair value of the Company's demand instalment loan and other long-term debt obligations is not materially different from its carrying value based on market rates of interest.

The fair value of the Company's financial instruments as described in note 10 represent management's best estimate of its fair value.

The fair value of the Company's long-term investments in Clean Energy Fuels Corp, a private company, as described in note 3 is not determinable with sufficient reliability due to the absence of a readily available market for the shares of these investees.

(b) Concentrations of credit risk:

The Company is exposed to credit risk only with respect to uncertainties as to timing and amount of collectability of accounts receivable. 57% (2005 - 58%) of accounts receivable relates to government grants receivable and 38% (2005 - 25%) is due from Cummins relating to proceeds for the sale of products collected by Cummins on the Company's behalf.

(c) Foreign currency risk:

Foreign currency risk is the risk to the Company's results from operations that arises from fluctuations in foreign currency exchange rates. All of the revenue realised and a significant portion of the expenses incurred by CWI, and recorded by the Company, are denominated in United States dollars. The warranty liability is also denominated in United States dollars. The Company has not entered into foreign exchange contracts to hedge against gains and losses from foreign currency fluctuations.

18. Segmented information:

The Company currently operates in one operating segment which involves the research and development and the related commercialization of engines and fuel systems operating on gaseous fuels. The majority of the Company's equipment, furniture and leasehold improvements are located in Canada. For the year ended March 31, 2006, 82% (2005 - 61%) of the Company's revenue was from sales in North America, 4% (2005 - 24%) from sales in China, and 14% (2005 - 15%) from sales elsewhere.

19. Subsequent events:

On June 12, 2006, the Company agreed to issue up to $22.1 million in five year secured, subordinated convertible notes with a coupon rate of 8% to Perseus, L.L.C. ("Perseus") of Washington, DC, a private equity fund management group. The notes are to be issued in two tranches of $13.8 million and $8.3 million, respectively. Interest will be payable semi-annually in arrears in additional convertible notes or shares at the option of the Company for the first two years. After the first two years, interest will be calculated at a rate of 8% on the outstanding principal amount only for the number of trading days in the period on which the share price of the Company's common shares is below $3.00 and is payable semi-annually in cash, additional convertible notes or shares at the option of the Company. The first tranche is convertible to common shares at a conversion price of $1.30 at any time during the term of the notes and the second tranche is convertible to common shares at a conversion price of $1.40. At the time of issuance, the note holder will also receive warrants to acquire, at an exercise price equal to the conversion price of the accompanying notes, common shares of the Company equal to 25% of the number of common shares into which the notes are convertible. The term to expiry of the warrants is four years from the date of issuance and the warrants include a cashless exercise provision which would allow the note holder to receive the number of common shares having a value equal to the net gain that would be realized by the note holder if the warrants had been exercised for cash and the related shares sold at the market price on the date the warrants are exercised under the cashless exercise provision. Any warrants converted under the cashless exercise option will be cancelled. For so long as Perseus continues to hold notes and warrants convertible into a specified percentage of the Company's issued and outstanding shares, Perseus will also be entitled to nominate two of seven board seats. The notes will be secured with a second charge on all of the Company's assets.

$5.5 million of the first tranche of $13.8 million has been received with the balance due by July 15, 2006. The second tranche of $8.3 million, the proceeds of which are to be used for a new business venture, is subject to receiving Company shareholder approval and the Company meeting certain milestones within 180 days of the receipt of such shareholder approval.

On June 13, 2006, the Company also entered into an agreement with Matco Capital Ltd. ("Matco") to reorganize Westport Research Inc. ("WRI"), a wholly owned subsidiary of the Company. The Company will transfer all of the assets, liabilities and operations of WRI to other wholly owned subsidiaries. Matco will then acquire a 45% equity interest in WRI from the Company, following which the Company and Matco will source and pursue other opportunities to maximize the value of their respective interests in WRI. The reorganization and share sale is expected to close on or before July 31, 2006. The Company expects to access at least $10 million in cash on closing with the ultimate amount to be determined by the value of the reorganized WRI, including any new ventures.

20. United States generally accepted accounting principles:

These consolidated financial statements have been prepared in accordance with generally accepted accounting principles in Canada ("Canadian GAAP") which differ in certain respects with accounting principles generally accepted in the United States ("US GAAP"). Material issues that could give rise to measurement differences to these consolidated financial statements are as follows:

(a) Income taxes:

Under both Canadian and United States GAAP, future income tax assets and liabilities are measured using the income tax rates and income tax laws that, at the balance sheet date, are expected to apply when the assets are realised or the liabilities are settled. In Canada, announcements of changes in income tax rates and tax laws by the government can have the effect of being substantially enacted at the balance sheet date even though they are not yet proclaimed into law. When persuasive evidence exists that the government is able and committed to enacting proposed changes in the foreseeable future, the substantively enacted rate is used to measure the future tax assets and liabilities. Under US GAAP, only the income tax rates and income tax laws enacted at the balance sheet date are used to measure the future income tax assets and liabilities. For the years ended March 31, 2006 and 2005, enacted rates for US GAAP purposes were equal to rates used for Canadian GAAP purposes.

(b) Investments in securities:

For US GAAP purposes, the Company's short-term investments would be classified as "available-for-sale" securities. This requires that unrealised gains and losses be recognised as a separate component in shareholders' equity. As described in note 17(a), the fair value of the short-term investments is not materially different from carrying value and no adjustment is required.

(c) Stock-based compensation:

As described in note 11(d), the Company has granted share options to certain directors, consultants and employees. These options are granted for services provided to the Company. Effective April 1, 2004, the Company changed its accounting policy for recognising stock-based compensation for US GAAP purposes from the intrinsic value method to the fair value method using the transition provisions of Statement of Financial Accounting Standard No. 148, *Accounting for Stock-Based Compensation - Transition and Disclosure* (“SFAS 148”). As permitted by SFAS 148, the Company adopted the fair value method retroactively without restatement using the modified prospective method. However, for Canadian GAAP, only options granted on or after April 1, 2002 are accounted for using the fair value method and a cumulative adjustment is made to deficit for stock based compensation that would have been recognised prior to April 1, 2004 had the Company always applied the fair value method. For U.S. GAAP purposes, all options granted subsequent to December 15, 1995 would have been measured using the fair value method but, for the Company, only the effect of those options outstanding and unvested as of April 1, 2004 on the results from operations in the year in which SFAS 148 is adopted would be recognised. Accordingly, on adoption of the fair value method for US GAAP purposes, adjustments to deficit of $2,493,153, share capital of $67,753, and additional paid in capital of $2,425,400 recognized for Canadian GAAP purposes would not have been made. In addition, for US GAAP purposes in years prior to 2005, the Company would have recognised stock-based compensation of $2,164,551 relating to stock options issued to non-employees prior to April 1, 2002.

(Expressed in Canadian dollars)

20. United States generally accepted accounting principles (continued):

(c) Stock-based compensation (continued):

Under US GAAP, an additional $210,698 would have been recognized prior to 2005 as a result of certain option modifications.

(d) Research and development costs:

For US GAAP purposes, research and development costs are expensed as incurred. In these consolidated financial statements, intellectual property, consisting mainly of the cost of acquired patents, licenses and intellectual property acquired on business combinations in prior years, is considered to be used in research and development activities and would be expensed as incurred under US GAAP. Accordingly, amortization of intellectual property recorded under Canadian GAAP, would not be required to be recognised under U.S. GAAP.

(e) Restructuring and write down of equipment, furniture and leasehold improvements:

For US GAAP purposes, write-down of equipment, furniture and leasehold improvements of $402,966 in 2005 would be included in cost of revenue and expenses.

(f) Effect of US GAAP differences:

The effect of these accounting differences on total assets, shareholders' equity, deficit, loss and loss per share under United States accounting principles are as follows:

	2006	2005
Total assets, Canadian GAAP	$ 29,500,494	$ 44,441,620
Intellectual property (d)	(863,223)	(1,168,416)
Total assets, US GAAP	$ 28,637,271	$ 43,273,204
Shareholders' equity, Canadian GAAP	$ 9,751,635	$ 23,677,958
Intellectual property (d)	(863,223)	(1,168,416)
Shareholders' equity, US GAAP	$ 8,888,412	$ 22,509,542
Deficit, Canadian GAAP	$ (228,558,169)	$ (211,698,004)
Difference in accounting for:		
Effect of difference in adoption of fair value accounting for stock-based compensation (c)	2,493,153	2,493,153
Stock-based compensation for non-employees (c)	(2,164,551)	(2,164,551)
Effect of repricing of share options (c)	(218,698)	(218,698)
Intellectual property (d)	(863,223)	(1,168,416)
Deficit, US GAAP	$ (229,311,488)	$ (212,756,516)

(Expressed in Canadian dollars)

20. United States generally accepted accounting principles (continued):

(f) Effect of US GAAP differences (continued):

		2006		2005
Loss for the year, Canadian GAAP	$	(16,860,165)	$	(26,208,613)
Amortization of intellectual property (d)		305,193		686,668
Intellectual property acquired (d)		-		(1,007,234)
Loss for the year, US GAAP	$	(16,554,972)	$	(26,529,179)
Loss per share, US GAAP	$	(0.22)	$	(0.38)

Loss for the years ended March 31, 2006 and 2005 equals comprehensive loss under US GAAP.