

# 2001

ANNUAL REPORT



FIRST AVIATION SERVICES INC.



AN OLD SAW IN OUR INDUSTRY IS THAT  
"AN AIRCRAFT IS A LOT OF SPARE PARTS FLYING  
IN CLOSE FORMATION." IN TODAY'S WORLD,  
THE TRUTH IS THAT THE PARTS DO NOT COME  
TOGETHER IN A COORDINATED FASHION UNTIL  
THE AIRPLANE IS ROLLED OUT OF MAINTENANCE  
AND THE ENGINES ARE STARTED. SUPPLY CHAIN  
MANAGEMENT IS AN EFFORT TO BRING THESE  
PARTS TOGETHER IN A MORE PREDICTIVE AND  
COORDINATED FASHION. THIS WILL REDUCE  
PROCESS COSTS, IMPROVE PRODUCTIVITY AND  
INCREASE ASSET UTILIZATION.



**MISSION STATEMENT:**

TO BE A GLOBAL LEADER IN ALL THE MARKETS THAT WE SERVE. WE ARE DRIVEN BY OUR UNFAILING COMMITMENT TO QUALITY AND VALUE. IN MEETING THE CHALLENGE OF EMERGING AS THE PREMIER AVIATION SERVICES PROVIDER, WE WILL EMBRACE CHANGE BY CONSTANTLY BREAKING NEW GROUND, FOSTERING NEW IDEAS AND DEVELOPING NEW TECHNOLOGIES.

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**COMMITMENT TO ETHICS:**

FIRST AVIATION SERVICES INC. BELIEVES THAT ETHICS ARE EVERYONE'S RESPONSIBILITY. WE ARE COMMITTED TO THE HIGHEST ETHICAL STANDARDS, AND WE DEMONSTRATE THESE BELIEFS TO OUR EMPLOYEES, OUR CUSTOMERS, OUR COMMUNITY AND OUR SUPPLIERS. AT FAVS, OUR FOUNDATION IS INTEGRITY, OUR STRENGTH IS TEAMWORK, AND OUR GOAL IS EXCELLENCE.

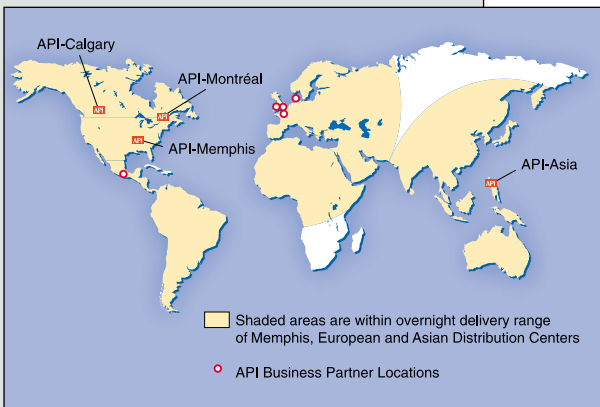
**FIRST AVIATION SERVICES INC.**

*(FAvS) is a worldwide leader in providing services to aircraft operators of some of the most widely used governmental, commercial, corporate and general aviation aircraft. Its operations include Aerospace Products International and AeroV.*



**AEROSPACE PRODUCTS INTERNATIONAL,** HEADQUARTERED IN MEMPHIS, TENNESSEE, IS A LEADER IN THE SUPPLY OF AEROSPACE PRODUCTS AND SERVICES WORLDWIDE. WITH LOCATIONS IN THE U.S., CANADA AND ASIA, PLUS GLOBAL PARTNERS THROUGHOUT THE WORLD, API CONTINUES TO BE THE FASTEST GROWING SUPPLIER OF AVIATION PRODUCTS AND SUPPLY CHAIN MANAGEMENT SOLUTIONS IN THE INDUSTRY.





**ASIA CONNECTION:**

API IS LEVERAGING THE STATE-OF-THE-ART INFRASTRUCTURE DEPLOYED BY OVERNIGHT EXPRESS CARRIERS TO REACH API'S CUSTOMERS WITH OUTSTANDING RESPONSE TIME.

As we sit down to write this year's letter to our fellow shareholders, we cannot help but think of the hundreds of similar letters that all of us have read over the years. They are usually a combination of self-congratulatory comments penned by the Investor Relations' department and edited by legal.

We have always tried not to fall into that trap. We want to provide a candid assessment of how the year went – good and bad. This past year has seen plenty of both. Additionally, we would like to share what we are planning to do this year with your support.

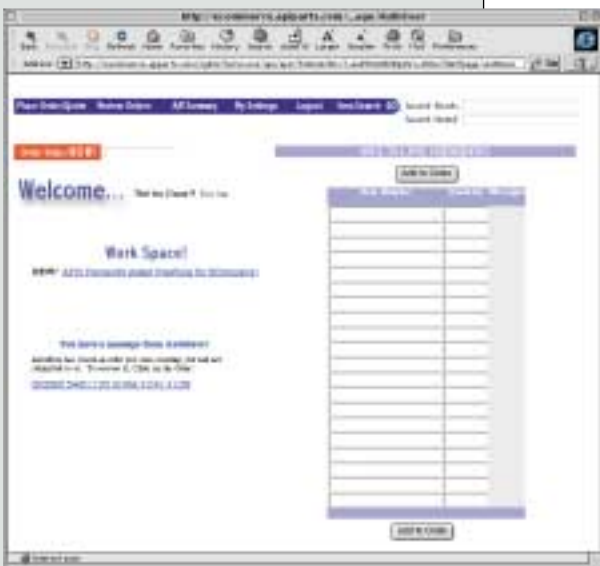
The team at Aerospace Products International (API), our principal subsidiary, had another great year, turning in the industry's best internal growth. Sales increased 20 percent – less than in recent past years but still four to five times the industry average. API took market share, opened its Asia/Pacific distribution center, added new product lines, enhanced its technology and set service level standards that far outstrip the competition's. Theirs was a job well done.

However, despite these achievements, API's margins were poor. They were impacted by our expansion costs in the Asia/Pacific region and by the competition's relentless, irrational discounting. In order to maintain market share with its outdated logistical model, the competition defends by cutting prices rather than by retooling its model. Although we have arguably the best cost position in our industry, we will not fight on those terms. Such a tactic inevitably leads to lower service in an industry strategically oriented to quality and performance. We also remain completely confident in our decisions to grow the business internationally. The API team correctly predicted future growth would come from outside the United States, and the operation's investment strategies to capture a key share of that growth remain sound.

While the impact of the world's slowing economy on our businesses is uncertain, we expect it will be more difficult next year to maintain our historically high growth rates. *Profitability over Growth* is our business mantra this year, and we are moving aggressively to keep our organization as lean as possible. Everyone is on board.

Nonetheless, we are in a race for market share and profitability, and one does not "cut back the oats before the Kentucky Derby." Supply Chain Management is a sweet spot within the industry, and we are investing to nurture this value-added sector of the Company. Our goal is to be where the market is going and to get there first.

First Aviation's Internet strategies, which largely are vested in the API and AeroV Inc. subsidiaries, also yielded both encouraging and disappointing results. The good news is our e-commerce penetration rate at API continued its strong growth trend during the year. Electronic order processing and Internet-based transactions, despite the recent "dot-com" collapse, remain among the most potent tools to wring costs out of the supply chain and redefine the interaction between the suppliers and end users of aircraft parts and services. We are pleased with our success in this critical technology and will continue to invest in this important growth engine.



**E-COMMERCE:**

API'S INVESTMENT IN SOPHISTICATED LOGISTICS TECHNOLOGY HAS BEEN A CATALYST FOR ITS RAPID GROWTH.



AeroV was formed to better focus the Internet's power to reshape the entire aerospace supply chain. Established in partnership with ARINC, a leader in aviation communication, AeroV was constructed on our assessment of the market dynamics. First, further cost savings will come from reducing process costs in the supply chain, not from volume or leveraged discounting at the manufacturing level. Second, since the industry will not quickly abandon its legacy procurement systems, a plan and mechanism to help companies migrate from their current sourcing infrastructure to the Internet is critical.

These assumptions remain fundamentally correct, and AeroV addresses their criteria rather well. However, a plethora of new entrants have clogged the market with many divergent systems chasing the same large users. What has emerged is a technical "Tower of Babel" that has muddled AeroV's focused message. We expected more of these networks to fade away. This didn't happen as quickly as we had anticipated.

We are evaluating several alternatives for AeroV, which include using its substantial technology in a proprietary system or merging it with a competing network that we believe has a high probability of being successful. While we remain optimistic about AeroV's value to the industry, we are taking the conservative approach of considering it a discontinued, stand-alone entity.

The current stock market conditions present First Aviation with perhaps the best opportunity we have had in recent years to realize an acquisition. The multiples of the past few years defied gravity, with the cost of most potential assets surpassing levels that could be justified. We now see attractive businesses at fair valuations. Unlike most in our peer group who are highly leveraged, First Aviation enjoys a very liquid balance sheet. With \$32 million in cash, we are well-positioned to respond to a good opportunity.

The flip side of this market-valuation coin is that First Aviation's shares, like those of many small cap companies, do not reflect the business' intrinsic value. Our stock price nearly mirrors our cash per share and is 30 percent less than book value. As we gain mass, we believe our stock price will better reflect economic reality.

During this year's challenging business cycle, it has been both gratifying and reassuring to work with the best team in the business. Guided by the discipline and energy of our Board of Directors, First Aviation's managers and employees across the organization secured our successes through the strength of their dedication and determination. We extend a special thanks to Mr. Joshua Friedman, who stepped down from the board in November. An early investor and a director when First Aviation went public, Joshua has been a constant source of sage advice, and we look forward to again calling upon him in the future. We also extend a formal welcome to Mr. Stanley Hill who, since his election to the board last year, quickly proved himself to be an asset to the Company.

Finally, we extend our deepest appreciation to you, our shareholders, for your continued support. We hope you will join us at our annual meeting on July 10, 2001.

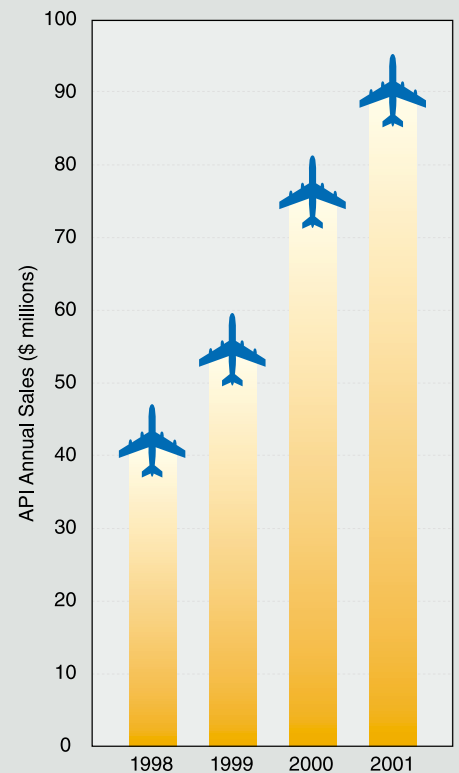
Sincerely,



Aaron P. Hollander  
Chairman of the Board



Michael C. Culver  
President & CEO



**GROWTH:**

API, ACQUIRED IN 1997, HAS ENJOYED FIVE YEARS OF OVER 25% COMPOUNDED ANNUAL GROWTH.



**MARKET:**

API HAS BEEN SUCCESSFUL IN GAINING SHARE IN THE FAST GROWING REGIONAL AIRLINE MARKET.





## MARKETING:

API STRIVES TO BE A GLOBAL LEADER IN ALL THE MARKETS THAT WE SERVE.



## PRODUCTS:

API'S TECHNICAL CAPABILITY HELPS ORIGINAL EQUIPMENT MANUFACTURERS SUPPORT SOPHISTICATED PRODUCTS IN THE AFTERMARKET.

Aerospace Products International (API), based in Memphis, Tennessee, remains completely focused on increasing the efficiency of the aerospace supply chain. The Company offers the aerospace aftermarket the most effective distribution system based on its single point logistics model. API leverages its capabilities in systems technology, developed for distribution, to create supply chain management (SCM) solutions that meet the needs of its customers. The Company's organic growth, consistently at four to five times the market's rate, is the industry's fastest and underscores the soundness of API's strategy.

Availability, service, and price have always been the drivers for customers' purchase decisions. The single point distribution model that underpins API's strategy allows the Company to provide its customers with not only superior parts availability, but also a service level that is difficult to match on a distributed branch basis. In addition, the single point concept creates excellent economies of scale in systems, inventory, and human resources, giving API the lowest cost structure in the industry.

Through this model, API provides its customers with 97 percent of their parts requirements on a next day basis. API's customers can place orders as late as midnight and receive parts on the shop floor by 8:00 AM the next morning. As a result, API customers, such as aircraft repair stations, need not hold inventory nor incur the risks associated with inventory management. This illustrates a profound difference in the respective business approaches of API and its competitors. API measures its performance by the breadth of its service and how quickly and reliably it can meet its customers' needs. The competition measures its success by how frequently it can ship an in-stock product for an order that is placed during its narrow band of working hours.

API's approach takes process costs and working capital out of the supply chain, thus reducing customer expenses. It is a sound strategy.

API is also focused on extending its SCM solutions-based approach to other industry opportunities. While API's distribution business competes primarily and ably in the \$2.5 billion consumables and expendables market, this segment comprises only five percent of the overall aerospace aftermarket. Rotable components and proprietary aircraft parts, which original equipment manufacturers (OEMs) sell directly to large end users, such as airlines and governments, compose the vast majority of this \$50 billion market. API is leveraging its distribution expertise to capture a larger share of this market by offering an integrated portfolio of SCM services.

API has cause to be very optimistic about its future. Industry trends and strategic imperatives point to increased supply chain opportunities. Some of the more important trends include:

- **De-coupling of Labor and Parts:** As labor costs increase, the industry seeks solutions that decrease total shop floor costs. Kitting, Just-in-Time Inventory, and shelf life limited programs all increase the emphasis on efficient inventory management and material sourcing.
- **Value Proposition:** The OEMs are focusing on the value proposition and total ownership experience as a way to differentiate themselves from their competitors. Supporting the product during its total life cycle is becoming the minimum service level that is expected.



- **Flight to Quality:** Only 10 percent of the lifecycle cost of an aircraft is made up of the original purchase price. Flight to quality recognizes that total life cycle costs are more significant than first costs, and that the product (hardware) cannot be divorced from all the soft inputs and services that both bring it to market and support its operations. API provides high quality services to the market, not just hardware.
- **Overnight Delivery:** Next-day package service is shortening the supply chain, re-optimizing infrastructure investments, and increasing asset utilization. It is rendering the legacy, distributed-branch network obsolete and expensive.
- **Alternatives:** The availability of alternative materials, such as PMA (parts manufacturing authority), and surplus parts is further pressuring OEMs to differentiate their product offerings by providing total life cycle support. Availability, coupled with technical support, is a critical differentiator in this more competitive marketplace.
- **Time-based Competition:** Time-based competition is a strong impetus to reduce product development cycles, shorten the supply chain, and increase market responsiveness.
- **E-commerce:** E-commerce is changing the way OEMs and distributors interact with their customers. Sales and marketing, parts sourcing, order entry, and electronic funds transfer are increasing supply chain efficiency. In terms of moving the product to the customer, local market presence is no longer essential and can be an unnecessary expense.

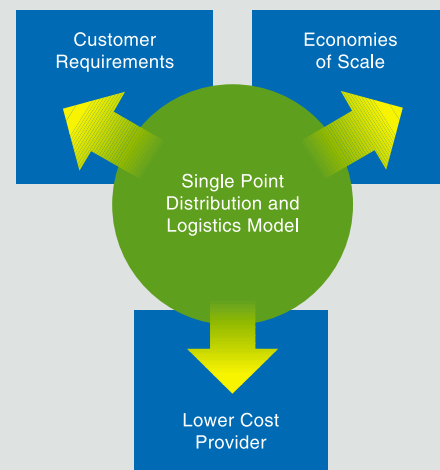
These trends, combined with the OEMs' need to focus on their core competencies, augur well for API. OEMs are starting to outsource elements of their supply chain to supply chain specialists like API in an effort to gain competitive and economic advantages. Airlines spend an estimated 40 to 50 percent of every maintenance dollar on administration and overhead costs – not parts and direct labor. Last year, US airlines spent \$35 billion on maintenance, representing a huge opportunity to reduce process costs. This is API's primary focus.

API continues to develop its presence in the supply chain market. While CEOs typically understand their organizations' "soft costs," our challenge is to drive that comprehension deeper into the organizations' management culture. The "buy in" and support of the entire organization is vital to the success of this type of initiative.

Although API's distribution and SCM businesses share the same infrastructure and technology, the dynamics of their respective markets are very different. Traditional distribution is a commodity business with a focus on hardware. The margins on parts drive profitability and competition is based on price. SCM, on the other hand, offers software and systems solutions. Competition is differentiated by services provided and value added. This is a fee-based business with a focus on long-term contracts and, unlike traditional distribution, the ability to develop proprietary services.

This year API will pursue growth in both traditional distribution and supply chain management. One key success factor in distribution is bulk, and API is examining all logical acquisition candidates in traditional distribution. Our goal is to add scale to API's infrastructure without adding significant fixed costs. Similarly, API is approaching acquisition targets in the SCM market that bring new expertise and add to its service offerings.

API continues to direct its efforts at increasing customers' profitability by reducing their costs and working capital investments. The Company's profitability is linked directly to its success in meeting this objective. We expect 2002 will be a year of increased market share with improving margins.



#### SINGLE POINT DISTRIBUTION:

API'S CENTRAL DISTRIBUTION SYSTEM IS IDEALLY SUITED TO TAKE ADVANTAGE OF THE GROWING DEMAND FOR INTERNET AND E-COMMERCE ORDERING.



#### INNOVATION:

API ACQUIRED IMPORTANT NEW PRODUCT LINES, INCLUDING GOODRICH DE-ICING SYSTEMS.



America's Distribution Center



# CONSOLIDATED FINANCIAL STATEMENTS:



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## REPORT OF INDEPENDENT AUDITORS

The Board of Directors and Stockholders  
First Aviation Services Inc.

We have audited the accompanying consolidated balance sheets of First Aviation Services Inc. as of January 31, 2001 and 2000, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended January 31, 2001. 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 auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about 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. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of First Aviation Services Inc. as of January 31, 2001 and 2000, and the consolidated results of its operations and its cash flows for each of the three years in the period ended January 31, 2001, in conformity with accounting principles generally accepted in the United States.

*Ernst & Young LLP*

Stamford, Connecticut  
April 9, 2001



**CONSOLIDATED BALANCE SHEETS**

(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

	January 31,	
	2001	2000
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 31,855	\$ 50,104
Trade receivables, net of allowance for doubtful accounts of \$947 and \$820, respectively	15,860	13,810
Inventories, net of allowance for obsolete and slow moving inventory of \$376 and \$414, respectively	21,803	14,142
Deferred and refundable income taxes	3,388	1,284
Prepaid expenses and other	1,461	1,298
Total current assets	74,367	80,638
Plant and equipment, net	4,638	3,980
Goodwill, net	1,709	1,774
	<u>\$ 80,714</u>	<u>\$ 86,392</u>
<b>Liabilities and stockholders' equity</b>		
Current liabilities:		
Accounts payable	\$ 13,496	\$ 8,264
Accrued compensation and related expenses	1,111	3,156
Other accrued liabilities	3,210	4,752
Income taxes payable	2,120	6,858
Revolving line of credit and current portion of obligations under capital leases	11,757	163
Total current liabilities	31,694	23,193
Revolving line of credit	—	7,900
Minority interest	1,041	1,041
Obligations under capital leases	147	115
Total liabilities	32,882	32,249
Stockholders' equity:		
Common stock, \$0.01 par value, 25,000,000 shares authorized, 7,184,704 and 8,133,997 shares outstanding at January 31, 2001 and 2000, respectively	91	91
Additional paid-in capital	38,625	38,615
Retained earnings	19,476	21,306
	<u>58,192</u>	<u>60,012</u>
Less: Treasury stock, at cost	(10,360)	(5,869)
Total stockholders' equity	47,832	54,143
Total liabilities and stockholders' equity	<u>\$ 80,714</u>	<u>\$ 86,392</u>

See accompanying notes.



## CONSOLIDATED STATEMENTS OF OPERATIONS

(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

	Year ended January 31,		
	2001	2000	1999
Net sales	\$ 97,550	\$ 82,999	\$ 61,015
Cost of sales	76,682	65,015	47,874
Gross profit	20,868	17,984	13,141
Selling, general and administrative expenses	19,733	16,014	11,612
Corporate expenses	3,435	1,652	2,105
Non-recurring charge	—	410	800
Loss from operations	(2,300)	(92)	(1,376)
Interest income	1,955	723	1
Interest expense	(538)	(612)	(269)
Minority interest in subsidiary	(42)	(42)	(42)
Loss before provision for income taxes	(925)	(23)	(1,686)
Benefit for income taxes	349	190	675
Net income (loss) from continuing operations	(576)	167	(1,011)
Income (loss) from discontinued operations, net of provision (benefit) for income taxes of \$(1,100), \$1,037, and \$(25) for the years ended January 31, 2001, 2000 and 1999, respectively	(1,847)	5,170	(703)
Net gain from disposition of subsidiaries, net of provision (benefit) for income taxes of \$(199) and \$5,829 for the years ended January 31, 2001 and 2000, respectively.	593	10,193	—
Net income (loss)	\$ (1,830)	\$ 15,530	\$ (1,714)
<i>Basic net income (loss) per common share:</i>			
Basic net income (loss) from continuing operations	\$ (0.08)	\$ 0.02	\$ (0.11)
Basic net income (loss) from discontinued operations	(0.24)	0.58	(0.08)
Basic net income from disposition of subsidiaries	0.08	1.14	—
Basic net income (loss) per common share	\$ (0.24)	\$ 1.74	\$ (0.19)
Weighted average common shares outstanding	7,720,520	8,908,756	8,972,953
<i>Net income (loss) per common share – assuming dilution:</i>			
Net income (loss) from continuing operations – assuming dilution	\$ (0.08)	\$ 0.02	\$ (0.11)
Net income (loss) from discontinued operations – assuming dilution	(0.24)	0.57	(0.08)
Net income from disposition of subsidiaries – assuming dilution	0.08	1.13	—
Net income (loss) per common share – assuming dilution	\$ (0.24)	\$ 1.72	\$ (0.19)
Weighted average common shares outstanding – assuming dilution	7,720,520	9,005,677	8,972,953

See accompanying notes.



**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

	<u>Common Stock</u>		<u>Additional Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Subtotal</u>	<u>Treasury Stock</u>	<u>Total</u>
	<u>Number of Shares</u>	<u>Amount</u>					
Balances at January 31, 1998	8,928,925	\$ 89	\$ 38,378	\$ 7,490	\$ 45,957	\$ -	\$ 45,957
Exercise of stock options to purchase common shares	40,000	1	-	-	1	-	1
Shares issued under qualified plans	32,971	-	137	-	137	-	137
Net (loss)	<u>-</u>	<u>-</u>	<u>-</u>	<u>(1,714)</u>	<u>(1,714)</u>	<u>-</u>	<u>(1,714)</u>
Balances at January 31, 1999	9,001,896	90	38,515	5,776	44,381	-	44,381
Exercise of stock options to purchase common shares	110,000	1	-	-	1	-	1
Shares issued under qualified plans	22,101	-	100	-	100	-	100
Common shares repurchased (1,000,000)		-	-	-	-	(5,869)	(5,869)
Net income	<u>-</u>	<u>-</u>	<u>-</u>	<u>15,530</u>	<u>15,530</u>	<u>-</u>	<u>15,530</u>
Balances at January 31, 2000	8,133,997	91	38,615	21,306	60,012	(5,869)	54,143
Shares issued under qualified plans	<b>1,702</b>	-	<b>10</b>	-	<b>10</b>	-	<b>10</b>
Common shares repurchased	<b>(1,023,398)</b>	-	-	-	-	<b>(4,834)</b>	<b>(4,834)</b>
Proceeds from issuance of common stock from treasury, and shares issued under qualified plans	<b>72,403</b>	-	-	-	-	<b>343</b>	<b>343</b>
Net (loss)	<u>-</u>	<u>-</u>	<u>-</u>	<u>(1,830)</u>	<u>(1,830)</u>	<u>-</u>	<u>(1,830)</u>
Balances at January 31, 2001	<u><b>7,184,704</b></u>	<u><b>\$ 91</b></u>	<u><b>\$ 38,625</b></u>	<u><b>\$ 19,476</b></u>	<u><b>\$ 58,192</b></u>	<u><b>\$ (10,360)</b></u>	<u><b>\$ 47,832</b></u>

See accompanying notes.



## CONSOLIDATED STATEMENTS OF CASH FLOWS

(IN THOUSANDS)

	Year ended January 31,		
	<u>2001</u>	<u>2000</u>	<u>1999</u>
<b>Cash flows from operating activities</b>			
Net income (loss) from continuing operations	\$ (576)	\$ 167	\$ (1,011)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	1,251	846	533
Deferred income taxes	(148)	1,354	(257)
Stock compensation	72	50	-
Changes in assets and liabilities:			
Trade receivables	(2,050)	(4,251)	(2,728)
Inventories	(7,661)	(1,941)	(4,630)
Deferred and refundable income taxes	(1,499)	-	-
Prepaid expenses and other	(163)	210	(187)
Accounts payable	5,232	3,990	487
Accrued litigation costs	-	(2,840)	2,840
Accrued compensation and related expenses, and other accrued liabilities	(3,587)	298	56
Income taxes payable	(4,225)	4,775	(693)
Net cash provided by (used in) operating activities of continuing operations	(13,354)	2,658	(5,590)
Net cash provided by (used in) operating activities of discontinued operations	(730)	218	2,607
Net cash provided by (used in) operating activities	(14,084)	2,876	(2,983)
<b>Cash flows from investing activities</b>			
Proceeds from sale of subsidiary	-	73,000	-
Purchases of plant and equipment and other assets – continuing operations	(1,529)	(1,592)	(2,213)
Proceeds from disposals of plant and equipment	-	-	14
Purchases of plant and equipment – discontinued operations	(1,494)	(3,530)	(3,842)
Net cash provided by (used in) investing activities	(3,023)	67,878	(6,041)

See accompanying notes.

**CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)**

(IN THOUSANDS)

	<b>Year ended January 31,</b>		
	<b>2001</b>	<b>2000</b>	<b>1999</b>
<b>Cash flows from financing activities</b>			
Net borrowings (repayments) on API line of credit	\$ 3,600	\$ (950)	\$ 8,850
Principal payments on capital lease obligations	(189)	(136)	(93)
Repurchases of common stock for treasury	(4,834)	(5,869)	-
Proceeds from issuance of common stock from treasury and shares issued from treasury under qualified plans	271	-	-
Proceeds from exercise of common stock options and issuance of stock under employee stock purchase plan	10	51	138
Net borrowings (repayments) on NAC line of credit	-	(13,895)	41
Net cash provided by (used in) financing activities	<b>(1,142)</b>	(20,799)	8,936
Net change in cash and cash equivalents	<b>(18,249)</b>	49,955	(88)
Cash and cash equivalents at the beginning of the year	<b>50,104</b>	149	237
Cash and cash equivalents at the end of the year	<b>\$ 31,855</b>	\$ 50,104	\$ 149
Supplemental cash flow disclosures:			
Cash paid for:			
Interest	<b>\$ 455</b>	\$ 575	\$ 224
Income taxes paid, net of refunds	<b>\$ 4,196</b>	\$ 90	\$ 600
Acquisition of equipment through incurrence of capital lease obligation	<b>\$ 315</b>	\$ -	\$ 495

See accompanying notes.



## NOTES TO 2001 CONSOLIDATED FINANCIAL STATEMENTS

(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

### 1. Business and Basis of Presentation

First Aviation Services Inc. ("First Aviation"), through its subsidiaries, Aerospace Products International Inc. ("API"), Aircraft Products International Ltd. ("API Ltd.") and API Asia Pacific Inc. ("API Asia"), (collectively the "Company"), is one of the leading suppliers of aircraft parts and components to the aviation industry worldwide, and is a provider of third party logistics and inventory management services to the aerospace industry. The Company is headquartered in Westport, Connecticut.

The accompanying consolidated financial statements include the accounts of First Aviation Services Inc. and its subsidiaries. Significant intercompany balances and transactions have been eliminated in consolidation.

First Aviation was formed in March 1995 to acquire the capital stock of National Airmotive Corporation ("NAC"). On March 5, 1997, the Company acquired API's business from AMR Combs Inc. ("AMR Combs").

### 2. Summary of Significant Accounting Policies

#### Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

#### Net Sales

The Company's net sales consist of sales of parts and components, and the provision of component overhaul and repair services, third party logistics services and inventory management services. Sales are recorded net of discounts, allowances and commissions, and are recorded generally when the parts, components and repaired items are shipped. Revenues from logistics and inventory management services provided are recorded when the services are provided.

The Company provides credit in the form of trade accounts receivable to its customers. The Company generally does not require collateral to support domestic customer receivables. Receivables arising from export activities may be supported by foreign credit insurance. The Company performs ongoing credit evaluations of its customers and maintains allowances that management believes are adequate for potential credit losses.

Sales to unaffiliated foreign customers were approximately 13 percent, 9 percent and 4 percent of net sales for the years ended January 31, 2001, 2000 and 1999, respectively. The majority of these customers were located in Canada, Southeastern Asia, Latin America, and Europe.

#### Stock Based Compensation

The Company recognizes compensation expense on stock option grants to the extent a difference exists between the exercise price of the stock option and the fair market value per share at the date of grant.

#### Cash and Cash Equivalents

Cash and cash equivalents consist of demand deposits, money market funds, short-term certificates of deposit, and short-term commercial paper with maturities of three months or less when purchased.

#### Inventories

Inventories generally consist of general aircraft parts and components and are stated at the lower of cost or market, with cost determined using the first-in, first-out and specific identification methods. Provisions are made in each period for the estimated effect of excess and obsolete inventories. Actual excess and obsolete inventories may differ significantly from such estimates, and such differences could be material to the financial statements.

#### Plant and Equipment

Plant and equipment are stated at cost, less allowances for accumulated depreciation. Additions and improvements that materially increase the productive capacity or extend the useful life of an asset are added to the cost of the asset. Expenditures for normal maintenance and repairs are charged to expense as incurred.

Depreciation of plant and equipment is computed using the straight-line method over the estimated useful lives of the assets, which ranges from 3 to 15 years. Leasehold improvements are amortized over the shorter of the estimated life of the improvement or the term of the related lease.

#### Goodwill

The excess of purchase price of API over the fair value of the net assets acquired is being amortized using the straight-line method over a thirty-year period. Accumulated amortization was \$257 and \$192, respectively at January 31, 2001 and 2000.

#### Noncurrent Assets

The Company records impairment losses on long-lived assets when events and circumstances indicate that the assets might be impaired and the undiscounted cash flows estimated to be generated by those assets are less than the carrying amounts of those assets. No asset impairments relating to continuing operations were recorded during the years ended January 31, 2001, 2000 and 1999, respectively.

#### Principal Suppliers

API has five suppliers of parts, components and supplies from whom approximately 49 percent and 45 percent of its total purchases were made during the years ended January 31, 2001 and 2000, respectively. Accounts payable to these vendors totaled \$5,140 and \$1,737 at January 31, 2001 and January 31, 2000, respectively. An inability to maintain timely access to parts and components from these vendors on commercially reasonable terms would have a material adverse effect on the Company's consolidated business, financial condition and results of operations.



**NOTES TO 2001 CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

**Income Taxes**

The Company uses the liability method to account for income taxes. Under this method, deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities, and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse.

**New Accounting Announcement**

In October 2000 the Emerging Issues Task Force ("EITF") issued EITF 00-10, "Accounting for Shipping and Handling Revenues and Costs" ("Issue 00-10"), that requires fees billed to customers associated with shipping and handling to be classified as revenue, and costs associated with shipping and handling to be classified either as cost of sales or as a part of selling, general and administrative expenses with a disclosure of such in the notes to the financial statements. Accordingly, during the three months ended January 31, 2001 the Company adopted EITF 00-10 and reclassified, for all periods presented, shipping and handling fees and associated costs as required by the EITF. The costs of shipping and handling included in selling, general and administrative expenses were \$3,729, \$3,129 and \$2,816 for the years ended January 31, 2001, 2000 and 1999, respectively.

**Reclassifications**

Certain amounts in the accompanying consolidated financial statements have been reclassified to conform to the current year's presentation.

**3. Plant and Equipment**

Plant and equipment consist of the following:

	<b>January 31,</b>	
	<u>2001</u>	<u>2000</u>
Machinery and equipment	\$ 1,502	\$ 918
Buildings and leasehold improvements	1,033	725
Computer equipment, software, office furniture, fixtures and other office equipment	4,802	3,832
Construction-in-process	<u>53</u>	<u>89</u>
	7,390	5,564
Less: accumulated depreciation	<u>(2,752)</u>	<u>(1,584)</u>
	<u>\$ 4,638</u>	<u>\$ 3,980</u>

Certain of the equipment has been pledged as collateral under capital lease obligations.

**4. Revolving Line of Credit and Current Portion of Obligations Under Capital Leases**

	<b>January 31,</b>	
	<u>2001</u>	<u>2000</u>
<b>Short Term Debt</b>		
Revolving line of credit	\$ 11,500	\$ -
Current portion of obligations under capital leases	<u>257</u>	<u>163</u>
	<u>\$ 11,757</u>	<u>\$ 163</u>

On March 30, 2000, API entered into a \$20,000 commercial revolving loan and security agreement. Borrowings under this credit facility bear interest equal to the LIBOR rate plus 1.5 percent and are limited to specified percentages of eligible trade receivables and inventories of API. The credit agreement contains a number of covenants, including restrictions on mergers, consolidations and acquisitions, the incurrence of indebtedness, transactions with affiliates, the creation of liens and limitations on capital expenditures. The credit agreement also requires API to maintain minimum levels of net worth and specified interest expense coverage ratios, and restricts the payment of dividends on API's common stock. Substantially all of API's domestic assets are pledged as collateral under this credit facility, and borrowings under the facility are guaranteed by First Aviation. Borrowings under this credit facility bore interest at approximately 8.1 percent at January 31, 2001. Approximately \$7,200 was available under the facility at January 31, 2001. The agreement expires May 1, 2001. Management expects to renew or replace the facility on substantially similar terms and conditions.

Borrowings under API's prior revolving credit facility bore interest based upon certain market rates plus a premium. Borrowings under this credit line bore interest at 7.4 percent at January 31, 2000. As a result of the revolving loan and security agreement entered into on March 30, 2000, borrowings under this previous line of credit were classified as long term as of January 31, 2000.

Management believes that the carrying amount of the Company's borrowings approximates fair value because the interest rate is variable and resets frequently.

The Company leases certain equipment under leases that have been classified as capital leases. The obligations under the capital leases are recorded at the net present value of the future minimum lease payments. Obligations due over one year are classified as long term.



## NOTES TO 2001 CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

### 5. Stockholders' Equity

In a series of authorizations commencing November 3, 1999, the Company's Board of Directors authorized a repurchase program of up to 2,118,817 shares of the Company's common stock. The repurchases were funded from a portion of the proceeds from the sale of NAC, and were made from time to time in open market transactions, block purchases, privately negotiated transactions or otherwise at prices prevailing at the time of the repurchase.

At January 31, 2001 and 2000, respectively, the Company had issued 9,135,699 and 9,133,997 of its common shares. During the years ended January 31, 2001 and 2000, respectively, the Company repurchased 1,023,398 and 1,000,000 shares of its common stock for a total of 2,023,398 shares. During the year ended January 31, 2001 the Company reissued 72,403 shares from treasury stock. Total shares outstanding at January 31, 2001 and 2000 were 7,184,704, and 8,133,997 shares, respectively. The aggregate cost of the common shares repurchased was approximately \$10,703 and \$5,869, or \$5.29 and \$5.87 per share at January 31, 2001 and 2000, respectively. Approximately 95,000 shares still may be repurchased under this program.

Certain of the Company's directors elected to receive their compensation for the years ended January 31, 2001, 2000 and 1999 in the form of shares of the Company's common stock. The fair value of the shares at the date of issuance was charged to expense with a corresponding increase to common stock and additional paid-in capital.

The Company has an Employee Stock Purchase Plan ("ESPP"). Under the ESPP, 250,000 shares of common stock have been reserved for issuance. The plan allows for eligible employees to purchase stock at 85% of the lower of the fair market value of the Company's common stock as of the first day of each semi-annual offering period or the fair market value of the stock at the end of the offering period. For the years ended January 31, 2001 and 2000, the Company issued 8,690 and 13,008 shares to employees under the ESPP, respectively.

The Company also has a stock option plan (the "Plan"). The Plan provides for the grant of incentive stock options, nonqualified stock options, stock appreciation rights and stock purchase rights. A total of 800,000 shares of common stock have been reserved for issuance under the Plan. During the year ended January 31, 2001, 180,500 options were granted to various employees of the Company at exercise prices ranging from \$5.00 to \$6.25 per share. During the year ended January 31, 2000, 102,500 options were granted to various employees of the Company at an exercise price of \$4.50 per share. In addition, during the year ended January 31, 2000, 110,000 options were exercised. During the years ended January 31, 2001 and 2000, respectively, 57,500 and 101,950 options were forfeited. At January 31, 2001 and 2000, respectively, 375,500 and 252,500 options were outstanding under the Plan.

The stock options vest over two- to four-year periods, beginning one year after the date of the grant, and expire ten years after issuance. Since the exercise price of all of the options granted during the years ended January 31, 2001, 2000 and 1999 was at or above the fair market value per share at the dates of grant, no compensation expense relating to stock options was recorded.

The Company is required to disclose the fair value, as defined, of options granted to employees and the related compensation expense. The fair value

of the stock options granted was estimated at the date of grant using a Black-Scholes option pricing model. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. In management's opinion, because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

The fair value of the options granted during the years ended January 31, 2001, 2000 and 1999 was determined using risk-free interest rates of 5.0 percent, 5.15 percent and 6.0 percent, dividend yields of 0 percent, an average volatility factor of 0.493, 0.398 and 0.516, and weighted average expected lives of two to four years, respectively. Under these assumptions the weighted average fair value of each option granted during the years ended January 31, 2001, 2000 and 1999 was approximately \$2.24, \$1.81 and \$1.90 per share, respectively. For the years ended January 31, 2001, 2000 and 1999, respectively, the pre-tax additional pro forma compensation expense that would have been recorded was approximately \$247, \$155 and \$246, or \$0.02, \$0.01 and \$0.02 per share, respectively. The weighted average remaining contractual life of all outstanding stock options is approximately 8.1 years. At January 31, 2001, 132,500 options were exercisable at prices ranging from \$4.50 to \$10.00 per share.

In conjunction with the API acquisition, AMR Combs purchased 10,407 shares of API Series A Cumulative Convertible Preferred Stock, \$0.001 par value (the "Preferred Stock"), at a price of \$100 per share. Total adjusted proceeds to the Company were \$1,041. This transaction has been accounted for as minority interest in the accompanying consolidated balance sheets. Dividends are payable on a quarterly basis on the Preferred Stock at an annual rate of \$4.00 per share. Dividends of \$42 were paid during each of the years ended January 31, 2001, 2000 and 1999, respectively, and have been reflected as minority interest in subsidiary in the accompanying consolidated statements of operations. The Preferred Stock is convertible into ten percent of the common stock of API as of the date of conversion.

Also in conjunction with the API acquisition, First Aviation, API and AMR Combs entered into a Stockholders Agreement. Pursuant to this agreement, API has the right to redeem the Preferred Stock at any time. Subject to certain terms and conditions, AMR Combs has the right to cause the Company to repurchase the Preferred Stock commencing three years after the closing of the API acquisition. The redemption price is equal to the fair market value of the Preferred Stock as determined by an independent appraisal. The Stockholders Agreement also contains certain other rights, including: (i) a right of first refusal on the part of First Aviation with respect to any proposed sale of the Preferred Stock; (ii) the right of First Aviation to require AMR Combs to participate, on a pro rata basis, with it in the sale of the capital stock of API to a third party; (iii) the right of AMR Combs to elect to participate, on a pro rata basis, in the sale of the capital stock of API to a third party; and (iv) piggyback and demand registration rights granted to AMR Combs with respect to the



**NOTES TO 2001 CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

Preferred Stock. The demand registration rights became exercisable in March 2000. If API has not previously closed an underwritten public offering of its common stock at the time AMR Combs elects to exercise its demand registration rights, API may elect to treat the demand as an exercise by AMR Combs of its put option with respect to the Preferred Stock. There are no plans to cause API to conduct a public offering of its securities.

On March 5, 1999, AMR Combs was acquired by Signature Flight Support, an affiliate of BBA Group PLC.

**6. Non-Recurring Charge**

During the three months ended October 31, 1999, API Ltd. established a sales facility in Montreal, Canada. Several of the initial employees were individuals previously employed by a competitor of API Ltd. The competitor commenced litigation against API Ltd. and the individuals. On November 17, 1999, API Ltd. and the competitor filed with the court a consent to a limited injunction that affected API Ltd.'s marketing operations in Canada. As a result of the consent and settlement, the Company recorded a pre-tax non-recurring charge of \$410 during the three months ended October 31, 1999 to cover the estimated cost of the settlement, including legal fees related to the matter. As part of the settlement, the limited injunction terminated on March 16, 2000.

During the three months ended January 31, 1999, the Company recorded a pre-tax charge of \$800 to record costs in connection with terminated acquisitions. Costs incurred included legal, advisory and accounting fees, bank charges and travel.

**7. Income Taxes**

The provision (benefit) for income taxes on continuing operations is as follows:

	<b>Year ended January 31,</b>		
	<b>2001</b>	<b>2000</b>	<b>1999</b>
Current:			
Federal	\$ (201)	\$ 236	\$ (530)
State	<u>          —</u>	<u>          30</u>	<u>          30</u>
	<b>(201)</b>	266	(500)
Deferred:			
Federal	\$ (191)	\$ (370)	\$ (150)
State	<u>          43</u>	<u>          (86)</u>	<u>          (25)</u>
	<b>(148)</b>	(456)	(175)
Total benefit	<u><u>\$ (349)</u></u>	<u><u>\$ (190)</u></u>	<u><u>\$ (675)</u></u>

A reconciliation between the income tax benefit computed at the U.S. federal statutory rate and the effective rate reflected in the consolidated statements of operations is as follows:

	<b>Year ended January 31,</b>		
	<b>2001</b>	<b>2000</b>	<b>1999</b>
Benefit at federal statutory rate	<b>(34.0)%</b>	(34.0)%	(34.0)%
State tax provision, net of federal benefit	<b>3.1</b>	(161.0)	1.2
Change in valuation allowance	—	(1,065.0)	(10.4)
Foreign losses with no income tax benefit	—	385.0	—
Non-deductible items and other	<u><b>(6.8)</b></u>	<u>48.9</u>	<u>3.2</u>
	<u><b>(37.7)%</b></u>	<u>(826.1)%</u>	<u>(40.0)%</u>

Deferred tax assets result from temporary differences in the recognition of income and expenses for tax and financial statement purposes. These differences are set forth below:

	<b>January 31,</b>	
	<b>2001</b>	<b>2000</b>
Financial statement accruals not currently deductible for income tax purposes	<u>\$ 2,080</u>	\$ 1,284
	<b>2,080</b>	1,284
Valuation allowance	<u>          —</u>	<u>          —</u>
Net deferred income tax assets	<u><b>\$ 2,080</b></u>	<u>\$ 1,284</u>

Based upon a number of factors, including the nature of the temporary differences and the timing of their reversal, the Company believes that the utilization of the deferred tax benefit at January 31, 2001 was more likely than not, and therefore, a valuation reserve was not provided.

## NOTES TO 2001 CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

### 8. Employee Benefits Plan

API maintains a defined contribution savings plan, qualified under Section 401(k) of the Internal Revenue Code, that covers substantially all of its full-time employees. The savings plan allows employees to defer up to 15 percent of their salary, with the Company partially matching employee contributions. Employees vest in the Company contribution ratably over three years. The Company expensed \$143, \$102 and \$99 related to the savings plan in the years ended January 31, 2001, 2000 and 1999, respectively.

### 9. Related Parties

Upon the authorization of the independent members of the Board of Directors, the Company entered into an advisory agreement with a related party, First Equity Development Inc. ("First Equity"). The advisory agreement, which was effective February 1, 2000, has a two-year term, and was a renewal on substantially the same terms and conditions, of a prior agreement. Pursuant to the terms of this agreement, First Equity provides the Company with investment and financial advisory services relating to potential acquisitions and other financial transactions. The Company pays First Equity a \$30 monthly retainer. In addition, upon the successful completion of certain transactions, the Company will pay a fee to First Equity (the "Success Fee"), and will reimburse First Equity for its out-of-pocket expenses. The amount of any Success Fee will be established by the independent members of the Board of Directors and will be dependent upon a variety of factors, including, but not limited to, the services to be provided and the size and type of transaction. Up to one year's worth of retainer fees paid can be applied as a credit against any Success Fee, subject to certain limitations. During each of the years ended January 31, 2001, 2000 and 1999, the Company paid First Equity retainer fees of \$360, for a total of \$1,080. Upon the consummation of the sale of NAC (Note 10), the Company paid First Equity a Success Fee of \$945. The Success Fee was net of \$360 of retainer fees previously paid and expensed by the Company. The gross amount of the fee was charged against net income from disposition of subsidiaries while the amount previously expensed was credited against corporate expenses in the fourth quarter of the year ended January 31, 2000. The agreement may be terminated by either party upon 30-days written notice to the other party.

In 1997 the Company entered into a ten-year sublease with an affiliate for office space. The lease is cancelable upon six months notice by either party. The Company has the option of renewing the sublease for two additional five-year periods. Lease payments under the lease totaled approximately \$95, \$102 and \$98, respectively, for the years ended January 31, 2001, 2000 and 1999.

### 10. Discontinued Operations

Details of the results of operations of discontinued operations and net gain from disposition of subsidiaries are as follows:

	Year ended January 31,		
	2001	2000	1999
Net income (loss) of discontinued operations:			
AeroV	\$ (1,847)	\$ -	\$ -
NAC	<u>-</u>	<u>5,170</u>	<u>(703)</u>
	<u>\$ (1,847)</u>	<u>\$ 5,170</u>	<u>\$ (703)</u>
Net gain from disposition of subsidiaries:			
AeroV	\$ (386)	\$ -	\$ -
NAC	<u>979</u>	<u>10,193</u>	<u>-</u>
	<u>\$ 593</u>	<u>\$ 10,193</u>	<u>\$ -</u>

#### E-Commerce Initiative

In February 2000 the Company established AeroV Inc. ("AeroV"). The purpose of AeroV was to design an electronic procurement platform to enable easy communication between the Internet and airlines' legacy systems, and to reduce supply chain costs. The proprietary software platform developed by AeroV is an operational system. In December 2000 the Board of Directors of the Company reassessed its strategic position with respect to AeroV, and approved a plan to sell AeroV. Management has had discussions with a number of interested parties, and is continuing to pursue all logical alternatives. The Company took an impairment charge of \$1,245 pre-tax to write down its investment in AeroV. AeroV has been accounted for as a discontinued operation and its results of operations and cash flows, and the estimated net loss on disposal have been condensed and shown separately in the accompanying consolidated financial statements. AeroV had no significant sales during the year ended January 31, 2001.

In connection with the disposition of AeroV, the Company accrued for certain costs directly relating to the disposition. Transaction, legal and other costs relating to the disposition (\$600) were included in other accrued liabilities at January 31, 2001 in the accompanying consolidated balance sheets.

#### Sale of NAC

On November 1, 1999, the Company consummated the sale of the stock of NAC to Rolls-Royce North America, Inc. for \$73 million in cash, subject to adjustment, pursuant to a Stock Purchase Agreement between First Aviation Services Inc. and Rolls-Royce North America, Inc. dated as of September 9, 1999 (the "Agreement"). NAC's operations included the repair and overhaul of gas turbine engines and accessories, and the remanufacturing of engine components and accessories. NAC has been accounted for as a discontinued



**NOTES TO 2001 CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

operation for all years presented in the accompanying consolidated financial statements and its results of operations and cash flows through the date of sale, and the net gain on the sale have been reported separately.

Pursuant to the Agreement, Rolls-Royce North America, Inc. acquired substantially all of the assets and assumed certain liabilities of NAC, excluding income tax liabilities, debt, amounts due to parent (First Aviation) and any contingent liabilities resulting from the Company's liquidation of its former defined benefit plan. During the year ended January 31, 2001 the sale price was adjusted by \$2,050 to reflect a decrease in the amount of net assets sold. The amount paid had been accrued previously.

Summarized results of operations information for NAC are as follows.

	<b>Nine months ended October 31, 2000</b>	<b>Year ended January 31, 1999</b>
Net sales	\$ 85,400	\$ 94,074
Earnings before interest and taxes	7,458	820
Net interest expense	<u>1,251</u>	<u>1,548</u>
Earnings before income taxes	6,207	(728)
Net income	<u>\$ 5,170</u>	<u>\$ (703)</u>

Pursuant to the Agreement, First Aviation is liable, subject to certain limitations, for any losses incurred by NAC related to environmental matters. NAC is liable for the initial \$1 million of such losses (the "Environmental Threshold"). Any losses above the Environmental Threshold will be shared, with First Aviation assuming 80% of the losses. First Aviation's maximum liability for such losses cannot exceed \$5 million in the aggregate. First Aviation shall have liability for only those claims for losses where notice of the claim is submitted on or prior to the third anniversary of the closing date.

First Aviation also is liable, subject to certain limitations, for certain non-income tax and non-environmental related losses (as specified in the Agreement) that may be incurred by NAC subsequent to the sale. NAC is liable for the initial \$1 million of such losses (the "Basic Threshold"). Any losses above the Basic Threshold will be borne by First Aviation. First Aviation's maximum liability for such losses cannot exceed \$5 million in the aggregate. First Aviation has no liability for any claims for losses not submitted prior to March 1, 2001.

With respect to income taxes, First Aviation is liable, without limitation, for any and all income taxes that may be imposed upon NAC for all taxable periods ending on or prior to the closing date.

On February 28, 2001, the day prior to the expiration of most of the Company's representations and warranties under the Agreement, Rolls-Royce North America Inc. ("RRNA") filed a \$10 million claim for indemnification with the American Arbitration Association. The claim seeks indemnification under

provisions of the Agreement relating to environmental and non-environmental covenants and representations. Pursuant to the terms of the Agreement, the Company's liability for indemnification claims is limited to \$5 million for environmental and \$5 million for non-environmental claims (with limited exceptions related to taxes and other specified items). The Company has requested RRNA to provide factual support for the indemnification sought. As of April 27, 2001 RRNA has not responded. The Company believes the claim to be without merit, and will vigorously contest the claim.

Both First Aviation and Rolls-Royce are liable, without limitation, for any losses incurred relating to any breach of any representation or warranty made in the Agreement, and for any loss that occurs relating to matters specifically retained by the parties.

During the year ended January 31, 2000, the Company accrued for certain costs relating to the sale of NAC. Transaction costs and other costs directly relating to the sale, approximately \$3,700, excluding the estimated sales price adjustment and liabilities under NAC's liquidated pension plan (see below), were charged against net income from disposition of subsidiaries. These costs were included in accrued compensation and related expenses (\$2,300) and other accrued liabilities (\$1,400) at January 31, 2000 in the accompanying consolidated balance sheets.

During the year ended January 31, 2001, \$2,469 was charged against the accruals for compensation and other expenses. At January 31, 2001 approximately \$1,500 of accruals remain relating to the sale of NAC. In addition, the Company paid approximately \$5,200 of estimated income tax liabilities that arose as a result of the sale. The difference between the estimated income tax liabilities and the actual income tax liabilities reported, approximately \$1,000, was recorded as net income (loss) from discontinued operations in the accompanying consolidated statements of operations.

On July 28, 1997, the Company replaced NAC's qualified defined benefit retirement plan (the "NAC Plan") with a defined contribution savings plan, qualified under Section 401(k) of the Internal Revenue Code. The Company previously had purchased guaranteed annuities for all retirees who were receiving benefits under the NAC Plan and provided for distributions in cash or rollovers to an IRA or other qualified retirement plan for all other participants in the NAC Plan. The Company used an outside consulting firm for assistance in calculating the amount of benefits or distributions due, and in liquidating the NAC Plan. The Company believes that the NAC Plan was liquidated according to regulatory guidelines.

In 1998, the Pension Benefit Guarantee Corporation ("PBGC") audited the liquidation of the NAC Plan. The PBGC disagreed with certain of the assumptions used by the consultants in calculating benefits due to the participants. As a result, the PBGC assessed the Company approximately \$500, excluding interest. In June 1999, the PBGC rejected the Company's appeal and confirmed its finding. The Company also is liable for interest on the assessment, which the Company estimates to be approximately \$100. Accordingly, the Company has provided \$600 pre-tax to cover the liability related to this matter. The charge was classified against net income from disposition of subsidiaries in the accompanying consolidated statements of operations.



## NOTES TO 2001 CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

### 11. Net Income (Loss) per Common Share

The following sets forth the denominator used in the computation of basic earnings per share and earnings per share – assuming dilution.

	Years ended January 31,		
	2001	2000	1999
Denominator for basic net income (loss) per common share – weighted average shares	7,720,520	8,908,756	8,972,953
Effect of dilutive warrants and employee stock options	<u>–</u>	<u>96,921</u>	<u>–</u>
Denominator for net income (loss) per common share – assuming dilution – adjusted weighted average shares and assumed conversions	<u>7,720,520</u>	<u>9,005,677</u>	<u>8,972,953</u>

For the years ended January 31, 2001 and 1999, respectively, the denominator used in the calculation of net loss per common share from continuing operations – assuming dilution, was the same as the denominator used for basic loss per common share because the effect of warrants and options would have been antidilutive.

### 12. Commitments and Contingencies

#### Commitments

The Company leases certain warehouse facilities, equipment and office space. Certain of the Company's operating leases have options which allow the Company, at the end of the initial lease term, to renew the leases for periods ranging from three to five years. Certain lease agreements also contain escalation clauses that are based on the consumer price index. Future minimum rental payments under operating leases that have initial noncancelable lease terms in excess of one year as of January 31, 2001 are as follows:

Fiscal year 2002	\$ 665
Fiscal year 2003	665
Fiscal year 2004	639
Fiscal year 2005	612
Fiscal year 2006	490
Thereafter	<u>3,415</u>
	<u>\$ 6,486</u>

Rental expense under noncancelable operating leases amounted to \$830, \$515, and \$467 for the years ended January 31, 2001, 2000 and 1999, respectively.

#### Contingencies

During the year ended January 31, 2001, the Company incurred legal costs of approximately \$700 relating to litigation previously initiated by the Company for a copyright infringement suit against Oracle Corporation and Avanti Systems, Inc., and a claim against Gulf Insurance Corporation ("Gulf"), the Company's former provider of Directors and Officers insurance. The litigation with Gulf seeks reimbursement for costs incurred in the Company's successful defense against claims made by John F. Risko, a former officer and director.

In the ordinary course of business, the Company is subject to many levels of governmental inquiry and investigation. Among the agencies that oversee the Company's business activities are the Federal Aviation Administration, the Department of Transportation, and the Environmental Protection Agency. The Company does not anticipate that any action as a result of such inquiries and investigations would have a material adverse affect on its consolidated financial position, results of operations or its ability to conduct business.

In the normal conduct of its business, the Company also is involved in various claims and lawsuits, none of which, in the opinion of the Company's management, will have a material adverse impact on the Company's consolidated financial position. The Company maintains what it believes is adequate liability insurance to protect it from such claims. However, depending on the amount and timing, unfavorable resolution of any of these matters could have a material effect on the Company's consolidated financial position, results of operations or cash flows in a particular period.

**NOTES TO 2001 CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

**13. Quarterly Financial Information (unaudited)**

	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>
<b>Year ended January 31, 2001</b>				
Net sales	\$22,335	\$24,039	\$26,221	\$24,955
Gross profit	4,760	5,354	5,606	5,148
Net income (loss) from continuing operations	13	(71)	(29)	(489)
Net income (loss)	\$ (116)	\$ (362)	\$ 613	\$ (1,965)
Basic net loss per share from continuing operations	\$ –	\$ (0.01)	\$ –	\$ (0.07)
Basic net income (loss) per common share	\$ (0.01)	\$ (0.04)	\$ 0.08	\$ (0.26)
Net loss per share from continuing operations – assuming dilution	\$ –	\$ (0.01)	\$ –	\$ (0.07)
Net income (loss) per common share – assuming dilution	\$ (0.01)	\$ (0.04)	\$ 0.08	\$ (0.26)
<b>Year ended January 31, 2000</b>				
Net sales	\$ 18,414	\$ 20,511	\$ 21,530	\$ 22,544
Gross profit	3,953	4,103	4,415	5,513
Non-recurring charge	–	–	410	–
Net income (loss) from continuing operations	(400)	(107)	(296)	970
Net income (loss)	\$ 1,327	\$ 1,446	\$ 1,594	\$ 11,163
Basic net income (loss) per share from continuing operations	\$ (0.04)	\$ (0.01)	\$ (0.03)	\$ 0.11
Basic net income per common share	\$ 0.15	\$ 0.16	\$ 0.18	\$ 1.29
Net income (loss) per share from continuing operations – assuming dilution	\$ (0.04)	\$ (0.01)	\$ (0.03)	\$ 0.11
Net income per common share – assuming dilution	\$ 0.15	\$ 0.16	\$ 0.18	\$ 1.29

## SHAREHOLDER INFORMATION

### Corporate Headquarters

First Aviation Services Inc.  
15 Riverside Avenue  
Westport, CT 06880-4214  
Phone: (203) 291-3300  
Fax: (203) 291-3330  
E-mail: [investorrelations@firstaviation.com](mailto:investorrelations@firstaviation.com)  
Website: [www.firstaviation.com](http://www.firstaviation.com)

### Transfer Agent and Registrar

American Stock Transfer & Trust Company  
40 Wall Street  
New York, NY 10005  
(212) 936-5100  
Website: [www.amstock.com](http://www.amstock.com)

### Independent Auditors

Ernst & Young LLP  
Stamford, CT 06905

### Common Stock

The common stock of First Aviation Services Inc. is listed on NASDAQ under the symbol FAVS.

### SEC Forms and Shareholder Inquiries

First Aviation Services welcomes inquiries from stockholders, analysts, and prospective investors. A copy of the Company's Annual Report on Form 10-K and Quarterly Reports on Form 10-Q as filed with the Securities and Exchange Commission may be furnished upon request to our headquarters. In addition, research analysts are invited to join our fax list to receive recent news and information about upcoming conference calls.

### Analyst Coverage

*John V. Pincavage*  
Pincavage & Associates, LLC  
Westport, CT 06880

### Board of Directors

*Aaron P. Hollander*<sup>2,3</sup>  
Chairman of the Board  
First Aviation Services Inc.

*Michael C. Culver*<sup>3</sup>  
Chief Executive Officer  
First Aviation Services Inc.

*Stanley J. Hill*<sup>1,2</sup>  
Retired President and  
Chief Executive Officer  
Kaiser Aerospace and Electronics

*Robert L. Kirk*<sup>1,2</sup>  
Retired Chairman of the Board  
British Aerospace Holdings, Inc.

*John A. Marsalisi*  
Chief Financial Officer  
First Aviation Services Inc.

*Charles Ryan*<sup>1,2</sup>  
President and Chief Operating Officer  
Nordam Group Inc.

<sup>1</sup> *Audit Committee*

<sup>2</sup> *Compensation Committee*

<sup>3</sup> *Executive Committee*

### Principal Officers

*Michael C. Culver*  
President  
Chief Executive Officer and  
Chief Operating Officer,  
First Aviation Services Inc.

*Gerald E. Schlesinger*  
Senior Vice President,  
First Aviation Services Inc.  
President and Chief Executive Officer, API

*John A. Marsalisi*  
Vice President  
Chief Financial Officer,  
First Aviation Services Inc.



#### **Join the Team**

First Aviation Services is a leader in supplying parts and components to the aviation industry worldwide, and is a provider of supply chain management services to the aerospace industry. Due to our continued growth, we are always looking for experienced and energetic individuals who are seeking an excellent career opportunity. If you would like to be a member of "Team FAvS," please contact us directly. We look forward to hearing from you.

*For opportunities with API,  
our parts distribution subsidiary,  
please call:*

*(901) 259-4523*

*[www.apiparts.com](http://www.apiparts.com)*

*[www.apeworldwide.com](http://www.apeworldwide.com)*

*For opportunities with the  
FAvS corporate office,  
please call:*

*(203) 291-3300*

*[www.firstaviation.com](http://www.firstaviation.com)*

Information included in this Annual Report may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not statements of historical facts, but rather reflect the Company's current expectations concerning future events and results. Such forward-looking statements, including those concerning the Company's expectations, involve known and unknown risks, uncertainties and other factors, some of which are beyond the Company's control, that may cause the Company's actual results, performance or achievements, or industry results, to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. In evaluating such statements as well as the future prospects of the Company, specific consideration should be given to various factors, including the Company's ability to obtain parts from its principal suppliers on a timely basis, market and economic conditions, the effects of increases in fuel costs on the Company's customers, aircraft operators and freight carriers utilized by the Company, the ability to consummate suitable acquisitions and other items that are beyond the Company's control and may cause actual results to differ from management's expectations. In evaluating such forward looking statements, as well as the future prospects of the Company, specific consideration should be given to the various factors discussed in this Annual Report.

Images courtesy of Goodrich De-icing Products and Specialty Systems Division, Bombardier and Scott Aviation.

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