

FINANCIAL STATEMENTS

2010 ANNUAL REPORT



F L **Y** H T™

AeroMechanical Services Ltd.

MANAGEMENT'S REPORT

To the Shareholders of
AeroMechanical Services Ltd.

The accompanying consolidated financial statements of AeroMechanical Services Ltd. and all of the information in its annual report are the responsibility of Management and have been approved by the Board of Directors.

Management has prepared the consolidated financial statements in accordance with Canadian generally accepted accounting principles and where alternative accounting methods exist, Management has chosen those that it deems most appropriate.

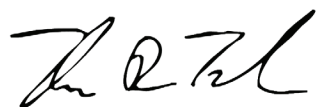
Financial statements are not precise since they include amounts based on estimates and judgments. Such amounts have been determined on a reasonable basis to ensure the financial statements are presented fairly in all material aspects. Management has prepared the financial information in this annual report and has ensured it is consistent with the consolidated statements.

The AeroMechanical Board of Directors is responsible for ensuring Management fulfills its responsibilities for financial reporting and for reviewing and approving the financial statements. This is carried out principally through the Audit Committee. AMA's auditors have access to the audit committee.

The Audit Committee of the Board of Directors, consisting of a majority of independent members, meets regularly with management, as well as external auditors, to discuss auditing, internal controls, accounting policy, and financial reporting matters. The Committee reviews the financial statements with both management and the independent auditors and reports its findings to the Board of Directors before such statements are approved by the Board.



William Tempany
Chief Executive Officer
April 6, 2011



Thomas R. French, CGA
Chief Financial Officer
April 6, 2011

AUDITORS' REPORT

To the Shareholders of
AeroMechanical Services Ltd.

Report on the Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of AeroMechanical Services Ltd. ("the Company"), which comprise the consolidated balance sheets as at December 31, 2010 and 2009, the consolidated statements of loss, deficit and cash flows for the years then ended, and notes, comprising a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with Canadian generally accepted accounting principles, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on our judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, we consider internal control relevant to the Company's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Company as at December 31, 2010 and 2009, and the results of its consolidated operations and its consolidated cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Emphasis of Matter

Without qualifying our opinion, we draw attention to Note 1 to the consolidated financial statements which describes that the Company has incurred a net loss of \$9,121,181 and has negative cash flows from operations of \$6,466,764 for the year ended December 31, 2010 and, as of that date, the Company's deficit amounted to \$43,979,026. These conditions, along with other matters described in Note 1, indicate the existence of a material uncertainty which may cast significant doubt on the Company's ability to continue as a going concern.

A handwritten signature in black ink that reads "KPMG LLP". The letters are written in a cursive, slightly slanted style.

Calgary, Canada
April 6, 2011

CONSOLIDATED BALANCE SHEETS

December 31, 2010 and 2009

	2010	2009
Assets		
Current assets:		
Cash and cash equivalents	\$ 6,617,852	\$ 7,161,427
Restricted cash (note 8)	250,000	250,000
Accounts receivable	883,319	529,869
Deposits and prepaid expenses	140,304	288,177
Inventory (note 3)	2,234,760	2,418,375
	<u>10,126,235</u>	<u>10,647,848</u>
Property and equipment (note 4)	402,535	478,968
Rental assets (note 5)	155,101	143,539
Intangible assets (note 6)	339,810	478,403
	<u>\$ 11,023,681</u>	<u>\$ 11,748,758</u>
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 3,508,175	\$ 1,270,748
Current portion unearned revenue	2,105,409	1,589,313
Current portion of loans payable (note 7)	86,557	109,536
Current portion of obligation under capital lease (note 10)	86,118	105,804
	<u>5,786,259</u>	<u>3,075,401</u>
Unearned revenue	726,469	1,534,529
Loans payable (note 7)	157,006	202,896
Convertible debenture – debt component (note 9)	2,224,966	-
Obligation under rental lease	36,927	-
Obligation under capital lease (note 10)	32,029	118,147
Warranty	61,239	-
	<u>3,238,636</u>	<u>4,930,973</u>
Shareholders' equity:		
Share capital (note 11)	36,730,844	35,550,028
Convertible debenture – equity component (note 9)	389,110	-
Warrants (note 11)	5,134,018	4,181,685
Contributed surplus (note 11)	3,723,840	1,943,917
Deficit	(43,979,026)	(34,857,845)
	<u>1,998,786</u>	<u>6,817,785</u>
Going concern (note 1)		
Commitments (note 12)		
Subsequent event (note 18)		
Contingencies (note 19)		
	<u>\$ 11,023,681</u>	<u>\$ 11,748,758</u>

See accompanying notes to the consolidated financial statements.

On behalf of the board



Director – William Tempany



Director – Paul Takalo

CONSOLIDATED STATEMENTS OF LOSS AND DEFICIT

Years ended December 31, 2010 and 2009

	2010	2009
Revenue:		
AFIRS UpTime revenue	\$ 4,056,822	\$ 4,286,423
Product sales revenue	121,674	359,355
Services revenue and interest	789,365	460,716
	<u>4,967,861</u>	<u>5,106,494</u>
Cost of sales	1,961,745	2,244,601
Gross margin	<u>3,006,116</u>	<u>2,861,893</u>
Expenses:		
Salaries and benefits	4,678,302	4,147,003
Research and development	4,857,495	574,444
General and administrative	1,501,603	1,542,365
Marketing	460,163	415,795
Stock based compensation	252,098	407,820
Amortization	220,324	186,666
Bad Debts	131,199	41,089
Interest, accretion and bank charges	48,692	41,319
Foreign exchange loss (gain)	(26,848)	42,768
	<u>12,123,028</u>	<u>7,399,269</u>
Net loss before income taxes	(9,116,912)	(4,537,376)
Current income taxes	4,269	2,342
Net loss and comprehensive loss	(9,121,181)	(4,539,718)
Deficit, beginning of year	(34,857,845)	(30,318,127)
Deficit, end of year	<u>\$ (43,979,026)</u>	<u>\$ (34,857,845)</u>
Net loss per share:		
Basic and diluted	\$ (0.09)	\$ (0.05)
Weighted average shares:		
Basic and diluted	103,932,637	85,415,370

See accompanying notes to the consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended December 31, 2010 and 2009

	2010	2009
Cash provided by (used in):		
Operating activities:		
Net loss	\$ (9,121,181)	\$ (4,539,718)
Add items not affecting cash		
Amortization	220,324	186,666
Amortization of rental assets	35,460	60,306
Amortization of intangibles	138,593	23,099
Accretion of convertible debenture	8,741	-
Amortization of debt issue cost	1,931	-
Stock based compensation	252,098	407,820
Write down of rental assets	-	83,289
Warranty expense	61,239	-
Rental obligation	36,927	-
-	-	-
Unrealized foreign exchange loss (gain)	(18,417)	69,791
	(8,384,285)	(3,708,747)
Net change in non-cash working capital balances (note 17)	1,917,521	1,693,326
	(6,466,764)	(2,015,421)
Financing:		
Issuance of common shares	3,779,620	9,843,467
Issuance of convertible debentures	3,159,000	-
Repayment on capital leases	(105,804)	(75,262)
Share issue costs	(369,764)	(742,744)
Convertible debenture issue costs	(304,478)	-
Loan repayment	(68,869)	(80,079)
	6,089,705	8,945,382
Investments:		
Purchase of property and equipment	(143,891)	(159,513)
Purchase of intangibles	-	(466,509)
Purchase of rental assets	(47,022)	-
	(190,913)	(626,022)
Effect of foreign currency exchange rates on cash balances	24,397	56,084
Change in cash and cash equivalents	(543,575)	6,360,023
Cash and cash equivalents, beginning of year	7,161,427	801,404
Cash and cash equivalents, end of year	\$ 6,617,852	\$ 7,161,427

Supplemental cash flow information (note 17)

See accompanying notes to the consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years ended December 31, 2010 and 2009

AeroMechanical Services Ltd. (the “Company”) is a public company incorporated under the Canada Business Corporations Act. The Company is listed on the TSX Venture Exchange, trading under the symbol “AMA”.

AMA is a designer, developer, and service provider to the global aerospace industry. The Company’s major products are the Automated Flight Information Reporting System (“AFIRS™”), UpTime™, AeroQ™, FIRST, FLYHT Fuel Management System, FLYHTStream™, and Underfloor Stowage Unit.

1. Going concern:

These consolidated financial statements have been prepared on the basis that the Company will continue to realize its assets and meet its obligations in the ordinary course of business. At December 31, 2010, the Company had working capital of \$4,339,976 (2009 – \$7,572,447), a deficit of \$43,979,026 (2009 - \$34,857,845), a net loss of \$9,121,181 (2009 - \$4,539,718), and negative cash flow from operations of \$6,466,764 (2009 - \$2,015,421).

The Company has incurred significant operating losses and negative cash flows from operations over the past years and has positive working capital due to its ability to obtain additional financing to fund its on-going operations (note 16). The Company’s ability to continue as a going concern is dependent upon attaining profitable operations and/or obtaining additional financing to fund its on-going operations. The Company’s ability to attain profitable operations and positive cash flow in the future is dependent upon various factors including its ability to acquire new customer contracts, the success of management’s continued cost containment strategy, the completion of research and development project, and general economic conditions.

There is no assurance that the Company will be successful in attaining and sustaining profitable operations and cash flows or raising additional capital to meet its working capital requirements. If the Company is unable to satisfy its working capital requirements from these sources, the Company’s ability to continue as a going concern and to achieve its intended business objectives will be adversely affected. These financial statements do not reflect adjustments that would otherwise be necessary if the going concern assumption was not valid, such as revaluation to liquidation values and reclassification of balance sheet items.

2. Significant accounting policies:

The consolidated financial statements of the Company have been prepared in accordance with Canadian generally accepted accounting principles within the framework of the accounting policies as summarized below.

(a) Basis of presentation:

These financial statements consolidate the accounts of the Company and its wholly-owned subsidiaries, FLYHT Inc., AeroMechanical Services USA Inc., FLYHT Corp., and FLYHT India Corp. The latter three subsidiaries were inactive for the reporting period and currently remain inactive. All inter-company transactions have been eliminated upon consolidation.

2. Significant accounting policies (continued):

(b) Use of estimates:

The preparation of the financial statements in accordance with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from and affect the results reported in these consolidated financial statements as future confirming events occur.

Amounts recorded for stock-based compensation are based on management's estimates of share price volatility and the expected life of the options. By their nature, these estimates are subject to uncertainty, and the impact on the consolidated financial statements of future periods could be material.

Amounts recorded for the warranty provision are based on historical warranty information regarding the costs associated with replacing components that are not functioning related to AFIRS units.

Amounts recorded for provisions for obsolete inventory are based on management's estimates, which consider a variety of factors that may affect the carrying values of inventories. These factors include, but are not limited to, market demand, technology changes, and design changes.

(c) Revenue recognition:

The Company's main revenue sources are derived from the sale and rental of AFIRS units and related UpTime usage fees, licensing fees and the provision of technical services. There are two types of revenue streams: sales and rentals, depending on the type of services agreement. Under the terms of rental type agreements, revenue from AFIRS is derived from an upfront fee which is recorded as unearned revenue and recognized into revenue over the term of the rental agreement. For sales type services agreements, AFIRS fees are deferred as unearned revenue and corresponding expenses are recorded as work in progress. When the system is fully functional and customer acceptance has been obtained, the full deferred amount is recognized in revenue along with the installations in progress as cost of sales. Under both forms of agreement, revenue from UpTime usage fees is recognized at the end of each month and is based on actual usage during that month.

Revenue from the sale of Underfloor Stowage Units is recognized when the unit is shipped, title is transferred, and collection is reasonably assured. Certain customers have prepaid for products or services not yet delivered. These amounts are recorded as accounts payable and accrued liabilities on the balance sheet, and are recorded as revenue in the period in which such products or services are delivered.

Technical services are provided based upon orders and contracts with customers that include fixed or determinable prices that are based upon, daily, hourly or contracted rates. Revenue is recognized as services are rendered and when collectability is reasonably assured.

2. Significant accounting policies (continued):

(d) Property and equipment:

Property and equipment is recorded at cost. Amortization is provided annually at rates calculated to write-off assets over their estimated useful lives as follows:

Computers	30% declining balance
Software	12 months straight-line
Equipment	20% declining balance
Leasehold improvements	Term of lease

(e) Rental assets:

Rental assets are recorded at cost and consist of AFIRS units that are rented and in use in customer aircraft. Amortization is provided for units that are rented on a straight line basis over six years.

(f) Future income taxes:

The Company uses the asset and liability method to account for income taxes. Future income taxes are calculated based on temporary differences arising between the financial statement carrying values and tax bases of assets and liabilities. Future income tax assets and liabilities are measured using substantively enacted income tax rates expected to apply in the years in which temporary differences are expected to be recovered or settled. Changes in income tax rates that are substantively enacted are reflected in the accumulated future tax balances in the period the change occurs. To the extent that future income taxes are not considered more likely than not to be realized, a valuation allowance is provided.

(g) Foreign currency translation:

Transactions denominated in US dollars have been translated into Canadian dollars at the rate of exchange prevailing at the time of the transactions. Monetary assets and liabilities denominated in foreign currencies have been translated into Canadian dollars at the year end exchange rates.

The operations of the Company's foreign active subsidiary are considered self sustaining and therefore its accounts are translated into Canadian dollars under the current method of accounting whereby the assets and liabilities are translated into Canadian dollars using the exchange rate in effect at the consolidated balance sheet date. Revenues and expenses are translated at rates in effect at the time of the transactions. Exchange gains or losses on translation of the Company's net investment in the foreign operation are deferred in the cumulative adjustment component of shareholders' equity. Due to the timing and limited nature of the activities in the subsidiary in the current year, there were no exchange gains or losses on translation of the Company's net investment in the foreign operation. Other exchange gains and losses are included in the consolidated statement of loss and deficit.

2. Significant accounting policies (continued):

(h) Research and development costs:

Research costs are expensed as incurred. Development costs incurred in the design and development of new products are capitalized if certain defined criteria are met. The criterion for capitalization of development costs is met when the product is clearly identified, the technical feasibility has been established, management has indicated its intention to market the product, the future market is identified, and adequate resources exist or are expected to be available to complete the project. Upon commercial production or use of the product, deferred costs will be amortized over the estimated useful life of the product. If the criteria are no longer met, costs for a specific product are charged against earnings. To date, all development costs have been expensed as incurred.

(i) Financial instruments:

Financial instruments are initially classified into one of five categories: (i) held-for-trading, (ii) held-to-maturity, (iii) loans and receivables, (iv) available-for-sale, and (v) other financial liabilities. All financial instruments including all derivative instruments are recognized on the balance sheet initially at fair value. Subsequent measurement of all financial assets and liabilities – except those in the held-for-trading and available-for-sale categories – must be determined at amortized cost using the effective interest rate method. Held-for-trading financial instruments are measured at fair value with changes in fair value recognized in earnings. Available-for-sale financial instruments are measured at fair value with changes in fair value recognized in comprehensive income until the investment is derecognized or impaired, at which time the amounts would be recorded in net earnings.

The Company classifies its cash and cash equivalents and restricted cash as held-for-trading, accounts receivable are classified as loans and receivables. Accounts payable and accrued liabilities, loans payable and convertible debentures are classified as other liabilities, all of which are measured at amortized cost

(j) Inventory:

Raw material inventory is stated at the lower of cost and net realizable value. Management evaluates raw material inventory for obsolescence and charges obsolescence to cost of goods sold. Cost is determined using the first in first out method. Raw material inventories include Underfloor Stowage Units and general parts which are held pending installation and sale to the customer.

AFIRS completed inventory is stated at the lower of cost and net realizable value. Cost is determined based on the cost of the raw material components plus a standard labour allocation.

Management evaluates AFIRS completed inventory for obsolescence and charges obsolescence to cost of goods sold. AFIRS completed inventory consists of AFIRS units that have been assembled and are held pending sale to the customer.

Installations in progress are stated at the lower of cost or net realizable value. Cost is determined based on the cost of the AFIRS unit and direct installation project costs. Labour is not allocated to installation projects. Installations in progress are recognized as cost of sales when the system is fully functional, customer acceptance has been obtained, and the full deferred revenue amount is then recognized in revenue.

(k) Cash and cash equivalents:

Cash and cash equivalents consist of deposits in banks, redeemable deposits, Guaranteed Investment Certificates, and short-term investments with initial maturities of three months or less.

2. Significant accounting policies (continued):

(l) Warranty:

Amounts recorded for warranty are based on historical warranty data and are recognized when the underlying products or services are sold.

(m) Per share amounts:

The treasury stock method is used to determine the dilutive effect of stock options and other dilutive instruments. The treasury stock method assumes that proceeds received from the exercise of in-the-money instruments are used to repurchase common shares at the average market price for the period.

(n) Stock-based compensation:

The Company has a stock option plan for directors, officers, employees, and consultants of the Company. Under the terms of the stock option plan, the options shall be granted at an exercise price not less than market price of the stock on the date of issuance, less a discount up to a percentage permitted by the rules and policies of the stock exchange.

The Company records compensation expense in the consolidated statement of loss and deficit for stock options using the fair value method. Compensation costs are recognized over the vesting period, and are determined using the Black-Scholes option pricing model.

(o) Intangible assets:

Intangible assets are stated at cost and are comprised of a license and customer relationships. The license has an indefinite life. The customer relationships are amortized using the straight line method over the remaining life of the contract that was assumed on acquisition. Indefinite life intangible assets are subject to an annual impairment test or more frequent if events or changes in circumstances indicate that the carrying value may not be recoverable. Intangible assets subject to amortization are tested for impairment if events or circumstances indicate that the underlying value of the contract or relationship has changed.

3. Inventory:

	2010	2009
Raw material	\$ 1,065,714	\$ 1,139,816
AFIRS completed	490,662	561,268
Installations in progress	678,384	717,291
	<u>\$ 2,234,760</u>	<u>\$ 2,418,375</u>

Inventory amounting to \$883,086 was charged to cost of sales in 2010 (2009 - \$1,425,518).

4. Property and equipment:

2010	Cost	Accumulated amortization	Net book value
Computers	\$ 565,547	\$ 389,611	\$ 175,936
Software	285,663	258,481	27,182
Equipment	235,349	120,495	114,854
Leasehold improvements	126,592	42,029	84,563
	<u>\$ 1,213,151</u>	<u>\$ 810,616</u>	<u>\$ 402,535</u>
2009			
Computers	\$ 539,853	\$ 319,509	\$ 220,344
Software	228,120	158,073	70,047
Equipment	197,436	95,401	102,035
Leasehold improvements	103,850	17,308	86,542
	<u>\$ 1,069,259</u>	<u>\$ 590,291</u>	<u>\$ 478,968</u>

Included in computers, software and equipment are capital leases with a cost of \$292,751 (2009 - \$292,751), accumulated amortization of \$213,044 (2009 - \$114,185) and a net book value of \$79,707 (2009 - \$178,566).

5. Rental assets:

2010	Cost	Accumulated amortization	Net book value
Rental assets	\$ 206,718	\$ 51,617	\$ 155,101
	<u>\$ 206,718</u>	<u>\$ 51,617</u>	<u>\$ 155,101</u>
2009			
Rental assets	\$ 198,637	\$ 55,098	\$ 143,539
	<u>\$ 198,637</u>	<u>\$ 55,098</u>	<u>\$ 143,539</u>

In 2010, it was determined that certain rental assets in the amount of \$Nil (2009 - \$83,289) were obsolete. The 2009 obsolescence was recorded in cost of sales.

The remaining net book value of rental assets as at December 31, 2010 relates to assets currently rented under two rental type agreements.

6. Intangible assets:

	Cost	Accumulated amortization	Net book value
2010			
License	\$ 34,992	\$ -	\$ 34,992
Customer relationships	466,510	161,692	304,818
	<u>\$ 501,502</u>	<u>\$ 161,692</u>	<u>\$ 339,810</u>
2009			
License	\$ 34,992	-	\$ 34,992
Customer relationships	466,510	23,099	443,411
	<u>\$ 501,502</u>	<u>\$ 23,099</u>	<u>\$ 478,403</u>

7. Loans payable:

	2010	2009
The Industrial Research Assistance Program "IRAP" loan is non-interest bearing and is repaid annually, based on 1.11% of gross revenues, commencing October 2005 and is unsecured. The current portion is calculated based on the actual gross revenues in the previous quarter plus the Company's revenue projections for the next nine months.	\$ 196,377	\$ 246,134
The Technology Partnerships Canada "TPC" loan is non-interest bearing and unsecured. The loan is repayable annually, based on 15% of the initial contribution when the Company has achieved more than 10% growth in gross revenues above the previous year's gross revenue and the gross revenue for the year is greater than the base amount. The base amount is defined as the Company's gross revenue in fiscal 2004, which was at \$556,127.	47,186	66,298
	<u>243,563</u>	<u>312,432</u>
Less: current portion	(86,557)	(109,536)
	<u>\$ 157,006</u>	<u>\$ 202,896</u>

8. Bank loan:

The Company has available to it an operating demand loan up to a maximum of \$250,000 (2009 – \$250,000). The operating demand loan bears interest at Canadian chartered bank prime plus 1.5%. The operating demand loan is secured by an assignment of cash collateral in the amount of \$250,000 and a general security agreement including a first ranking security interest in all personal property. The amount of the cash collateral has been disclosed as restricted cash. As at December 31, 2010 and 2009, the facility had not been drawn.

9. Convertible secured subordinate debenture:

On December 23, 2010, the Company issued 3,159 debenture units pursuant to a brokered private placement at \$1,000 per debenture unit resulting in gross proceeds of \$3,159,000. Each debenture consists of one \$1,000 convertible secured subordinate debenture of the Company (“Debenture”) and 1,250 common share purchase warrants. The Debentures will mature on December 23, 2014 (if not otherwise converted or redeemed in accordance with their terms) and bear interest at a rate of 8% per annum, which shall be accrued and paid annually in arrears commencing December 31, 2011. The Debentures are convertible into common shares at a conversion rate of \$0.40 per share at any time prior to maturity, subject to adjustment in certain events. The Debentures are secured against all personal property of the Company, with the exception of the Company’s intellectual property, and are subordinated in right of payment to all existing and future bank and/or governmental indebtedness of the Company. The Company, may, at its option, subject to providing no more than 60 and no less than 30 days’ prior notice, redeem the Debentures, in whole or, from time to time, in part, at any time prior to December 23, 2010 at a redemption price equal to 125% of the principal amount of the Debentures then outstanding plus accrued and unpaid interest and, during the period from December 23, 2013 until maturity, at a redemption price equal to the principal amount of the Debentures then outstanding plus accrued and unpaid interest.

The Debentures have been classified as debt, net of issue costs and net of fair value of the conversion feature and warrants at the date of issue which have been classified as part of shareholders’ equity. The issue costs will be amortized over the term of the Debentures and the debt portion will accrete up to the principal balance at maturity. The accretion, amortization of issue costs and the interest paid are expensed within the interest and bank charges expense on the consolidated statements of loss and deficit. The fair value of the conversion feature was determined at the time of issue as the difference between the principal value of the Debentures and the discounted cash flows assuming a 15% rate which was the estimated rate for debt with similar terms at the time (note 11e). If the Debentures are converted to shares, a portion of the value of the conversion feature under shareholders’ equity will be classified to shareholders’ capital along with the conversion price paid.

Total interest and issue cost amortization charged to earnings for the year ended December 31, 2010 was \$10,672 (2009 - \$nil) which included \$8,741 of debenture accretion (2009 - \$Nil) and \$1,931 of amortized issue costs (2009 - \$Nil).

10. Obligations under capital lease:

The Company is party to various capital leases for computer hardware and software that expire in 2012 or earlier. Future minimum lease payments under the capital leases are as follows:

	2010	2009
2010	\$ -	\$ 119,165
2011	90,328	90,328
2012	32,319	32,319
	122,647	241,812
Less: imputed interest	(4,500)	(17,861)
Less: current portion	(86,118)	(105,804)
	\$ 32,029	\$ 118,147

11. Share capital:

(a) Authorized:

Unlimited numbers of:

Common shares

Classes A, B and C preferred shares, issuable in series

The preferred shares may be issued in one or more series and the directors are authorized to fix the number of shares in each series and to determine the designation, rights, privileges, restrictions, and conditions attached to the shares in each series.

(b) Issued and outstanding:

	Number of shares	Value
Common shares:		
Balance December 31, 2008	82,500,219	\$ 28,982,059
Issued for cash	20,175,000	9,670,000
Bifurcation of warrants	-	(2,240,000)
Exercise of employee options	823,167	173,468
Contributed surplus from exercise of employee options	-	101,485
Share issue costs	-	(1,136,984)
Balance December 31, 2009	103,498,386	35,550,028
Issued for cash	14,985,080	3,746,270
Bifurcation of warrants	-	(2,082,925)
Exercise of employee options	132,000	33,350
Contributed surplus from exercise of employee options	-	19,620
Share issue costs	-	(535,499)
Balance December 31, 2010	118,615,466	\$ 36,730,844

11. Share capital (continued):

(c) Stock option plan:

The Company grants stock options to its directors, officers, employees and consultants. The Company has a policy of reserving up to 10% of the outstanding common shares for issuance to eligible participants. As at December 31, 2010, there were 11,861,547 (2009 – 10,349,839) common shares reserved for this purpose. All options vest immediately at the grant date with the exception of 75,000 (2009 – 75,000) options granted to consultants during 2010 which have not yet vested. The options are granted at an exercise price not less than

fair market value of the stock on the date of issuance. A summary of the Company's outstanding and exercisable stock options, as at December 31, 2010 and 2009 and changes during these years is presented below:

	2010		2009	
	Number of shares	Weighted average exercise price	Number of shares	Weighted average exercise price
Outstanding, beginning of year	2,784,496	\$ 0.42	2,308,998	\$ 0.52
Granted	975,000	0.41	1,955,000	0.31
Exercised	(132,000)	0.25	(823,167)	0.21
Forfeited/expired	(1,128,519)	0.51	(656,335)	0.69
Outstanding, end of year	2,498,977	\$ 0.39	2,784,496	\$ 0.42
Exercisable, end of year	2,423,977	\$ 0.39	2,709,496	\$ 0.43

Weighted average life remaining for the options outstanding and exercisable is 2.2 years.

The weighted average fair value of the options granted during the year was \$0.27 (2009 - \$0.31) per option. The fair value of the options granted was estimated using the Black-Scholes option pricing model with the following weighted average assumptions:

	2010	2009
Risk-free interest rate	2.18%	1.34%
Expected life (years)	3.4	2.5
Volatility in the price of the Company's common shares	112%	124%
Dividend yield rate	0.00%	0.00%

(d) Contributed surplus:

	2010	2009
Balance, beginning of year	\$ 1,943,917	\$ 1,467,350
Employee stock options exercised	(19,620)	(101,486)
Warrants expired	1,448,291	170,233
Agent options expired	99,154	-
Stock based compensation	252,098	407,820
Balance, end of year	\$ 3,723,840	\$ 1,943,917

11. Share capital (continued):

(e) Warrants:

A summary of the Company's outstanding warrants and changes during the years are presented below:

	2010	2009
Balance, beginning of year	\$ 4,181,685	\$ 1,717,678
Finder fee warrants exercised	-	-
Warrants issued on private placement	2,082,925	2,240,000
Warrants issued on debenture	163,771	-
Warrants expired	(1,448,291)	-
Agent warrants issued	253,082	394,240
Agent warrants expired	(99,154)	(170,233)
Balance, end of year	\$ 5,134,018	\$ 4,181,685

	2010		2009	
	Number of warrants	Weighted average exercise price	Number of warrants	Weighted average exercise price
Outstanding, beginning of year	11,377,499	\$ 0.84	2,572,500	\$ 1.31
Granted on private placement	14,985,080	0.40	9,119,999	0.72
Granted on debenture	3,948,750	0.75	-	-
Expired	(2,100,000)	1.30	(315,000)	1.00
Agent warrants granted	1,601,780	0.40	-	-
Agent warrants expired	(157,500)	1.30	-	-
Outstanding, end of year	29,655,609	\$ 0.73	11,377,499	\$ 0.84

On December 23, 2010 the Company issued 14,985,080 units at \$0.25 per unit in connection with a brokered private placement with each unit consisting of one common share and one purchase warrant for net cash proceeds of \$3,484,031.

In connection with this brokered private placement 14,985,080 warrants were issued entitling the holder to acquire one common share of the Company at \$0.40 until December 23, 2013. In the event that the 20 day moving average trading price of the Common Shares on the TSX Venture Exchange equals or exceeds \$1.00, the Company shall be entitled to accelerate the exercise period to a period ending in at least 30 days from the date notice of such acceleration is provided to the holders of the warrants.

The estimated fair value of these warrants is \$2,082,926 or \$0.14 per warrant. The fair value of these warrants was estimated using the Black-Scholes option pricing model with average risk-free interest rate of 2.24%, expected life of 3.0 years, volatility in the price of the Company's common shares of 110% and dividend yield of 0.00%.

11. Share capital (continued):

In connection with a debenture placement (note 9) on December 23, 2010 3,948,750 warrants were issued entitling the holder to acquire one common share of the Company at \$0.75 until December 23, 2014. In the event that the 20 day moving average trading price of the Common Shares on the TSX Venture Exchange equals or exceeds \$1.00, the Company shall be entitled to accelerate the exercise period to a period ending in at least 30 days from the date notice of such acceleration is provided to the holders of the warrants.

The estimated fair value of these warrants is \$163,771 (net of issue costs). The fair value of these debenture warrants were estimated using the residual method with a discount rate of 15% (note 9). The equity conversion feature of the debenture is \$389,110 (net of allocated issue costs).

In connection with the brokered private placement and debenture placement completed on December 23, 2010 1,601,780 agent warrants were issued entitling the holder to acquire one common share of the Company at \$0.40 until December 23, 2014. In the event that the 20 day moving average trading price of the Common Shares on the TSX Venture Exchange equals or exceeds \$1.00, the Company shall be entitled to accelerate the exercise period to a period ending in at least 30 days from the date notice of such acceleration is provided to the holders of the warrants.

These agent warrants are accounted for as a charge to share issuance costs of \$253,082 or \$0.16 per warrant. The fair value of the agent warrants were estimated using the Black-Scholes option pricing model with a weighted average risk-free interest rate of 2.24%, expected life of 4.0 years, volatility in the price of the Company's common shares of 108%, and a dividend yield rate of 0.00%.

12. Commitments:

The Company is party to various leases for its operating premises and equipment. Future minimum annual payments under these operating leases are as follows:

2011	\$	522,980
2012		478,004
2013		458,718
2014		76,815
	\$	1,536,517

13. Related party transactions:

During the year, the Company contracted with a company owned by a director to supply consulting services totaling \$92,944 (2009 - \$113,101). All of the transactions were measured at the exchange amounts, that being the amount of consideration established and agreed upon by the related parties which approximated fair market value.

14. Income taxes:

- (a) The income tax expense differs from the amounts which would be obtained by applying the expected Federal and provincial income tax rate of 28.00% (2009 – 29.00%) as follows:

	2010	2009
Computed "expected" tax (recovery)	\$ (2,555,683)	\$ (1,321,798)
Non-deductible expenses	17,337	11,303
Stock-based compensation	70,587	118,268
Rate change and other	(1,048,456)	352,873
Valuation allowance	3,520,484	841,696
	\$ 4,269	\$ 2,342

- (b) The components of the Company's future income tax assets are as follows:

	2010	2009
Capital assets	\$ 94,157	\$ 30,304
Intangibles	52,218	17,607
Inventory	7,681	7,706
Non-capital loss carry-forwards	8,565,882	7,084,002
Share issue costs	301,329	278,104
Scientific research and experimental development expenditures	3,053,254	1,125,987
Other	45,834	56,212
Valuation allowance	(12,120,355)	(8,599,922)
	\$ -	\$ -

- (c) The Company has non-capital losses for income tax purposes of approximately \$32,861,629 which are available to be applied against future year's taxable income. The benefit of these non-capital losses has not been recognized in the consolidated financial statements. These losses will expire as follows:

2014	\$ 2,570,288
2015	2,461,959
2026	3,390,309
2027	5,596,948
2028	6,997,140
2029	2,791,748
2030	9,053,237
	\$ 32,861,629

15. Financial instruments and financial risk management:

The carrying values of cash and cash equivalents, accounts receivable, accounts payable, and accrued liabilities approximate their fair value due to the relatively short periods to maturity of these instruments. The fair value of the loans payable could not be determined as the timing of repayment is difficult to estimate since they are dependant on future revenues. The fair value of the convertible secured subordinate debenture outstanding at December 31, 2010 was approximately \$2,972,039 (2009 – Nil).

The nature of these instruments and the Company's operations expose the Company to the following risks:

(a) Credit risk:

Credit risk reflects that the Company may be unable to collect amounts due to the Company from customers for its services, products, or other transactions that may be entered into by the Company. The extent of risk depends on the credit quality of the party from which the amount is due.

The Company employs established credit approval and monitoring practices to mitigate this risk, including evaluating the creditworthiness of new customers and monitoring customer payment performance. The Company also has the ability to receive payments in advance for both services and products in its agreements with customers as well as the ability to suspend services and ongoing support. The Company establishes an allowance for doubtful accounts that corresponds to the credit risk of its customers, historical trends, and economic circumstances.

The aging of the accounts receivable as at year end is as follows:

	2010	2009
Current, 1 – 30 days	\$ 782,494	\$ 428,012
31 – 60 days	90,015	53,672
61 – 90 days	4,635	1,264
Greater than 90 days	6,176	46,921
	\$ 883,319	\$ 529,869

The movement in the allowance for doubtful accounts as at year end is as follows:

	Provision
Balance, December 31, 2009	\$ 40,407
Provision	131,199
Accounts receivable written off	(167,788)
Balance, December 31, 2010	\$ 3,818

15. Financial instruments and financial risk management (continued):

(b) Interest risk:

The Company is exposed to interest rate risk on cash balances earning interest income and to the extent that it may draw on its operating line of credit which calculates interest as a function of variable interest rates. The convertible secured subordinate debenture carries a fixed interest rate. As at December 31, 2010, the Company does not carry material liabilities that are exposed to variable interest rates.

(c) Liquidity risk:

The Company is exposed to liquidity risk to the extent it is unable to collect its trade receivable balances on a timely basis and generate additional services revenue, which in turn could impact the Company's ability to meet commitments to creditors. The Company manages its liquidity risks by carrying cash on its balance sheet, by maintaining a conservative capital structure, by prudently managing its credit risks, and by maintaining its relationship with the capital markets to meet any near-term liquidity requirements.

(d) Foreign exchange risk:

The Company is exposed to foreign exchange risk primarily in the following ways:

- (i) Cash flow – a significant portion of the Company's revenues and a portion of its expenses are denominated in US dollars. Management estimates that a 1% weakening of the Canadian dollar would increase net earnings by approximately \$47,553 (2009 - \$48,512) and a strengthening of the Canadian dollar would decrease net earnings by approximately \$47,553 (2009 - \$48,512).
- (ii) Working capital – the Company has exposure to foreign exchange risk for working capital items denominated in US dollars. At December 31, 2010, working capital denominated in US dollars was approximately negative \$569,793 (2009 - positive \$139,928). As a result a 1% weakening of the Canadian dollar would decrease net earnings by approximately \$5,698 (2009 – increase \$1,399) and a strengthening of the Canadian dollar would increase net earnings by approximately \$5,698 (2009 – decrease \$1,399).
- (iii) The Company mitigates its exposure to foreign exchange risk in the following ways: Cash flow – the Company mitigates its cash flow exposures by the international nature of the business where a significant portion of its marketing costs are in currencies that naturally hedge a portion of US dollar revenue. The Company has not engaged in activities to manage its cash flow foreign currency exposure through the use of financial instruments.
- (iv) Working capital – the Company mitigates its working capital exposure by managing its US dollar denominated working capital items to limit the requirement to convert either to or from US dollars to fulfill working capital payment requirements.

16. Capital management:

The Company's objectives when managing capital are to safeguard the Company's ability to continue as a going concern (note 1) so that it can continue to seek to provide returns for shareholders and benefits for other stakeholders, to maintain optimal structure to reduce the cost of capital, and to facilitate the growth strategy of the Company.

The Company monitors its capital management through analysis of cash flow expectations to ensure an adequate amount of liquidity and through the monthly review of financial results and business expectations. The Company considers the shareholders' equity to be the capital of the Company.

Based upon the dynamic nature of the aviation and technology markets that the Company engages in, and the low level of tangible assets required, the capital strategy is to carry a low level of debt, including capital leases. Although a formal debt to equity ratio has not been established by the Company, the ratio of debt to equity at December 31, 2010 was 129.4% (2009 – 7.9%)

17. Supplemental cash flow information:

Change in non-cash working capital:

	2010	2009
Changes in non-cash working capital:		
Accounts receivable	\$ (363,767)	\$ 471,050
Deposits and prepaid expenses	152,215	60,827
Inventory	183,610	429,810
Accounts payable and accrued liabilities	2,237,427	(287,848)
Unearned revenue	(291,964)	1,021,768
Deferred lease inducement	-	(2,281)
	<u>\$ 1,917,521</u>	<u>\$ 1,693,326</u>
Interest (paid)/earned	<u>\$ 4,095</u>	<u>\$ (11,139)</u>
Taxes Paid	<u>\$ 4,269</u>	<u>\$ 2,342</u>
Cash and cash equivalents:		
	2010	2009
Cash in bank	<u>\$ 6,617,852</u>	<u>\$ 7,161,427</u>

18. Subsequent event:

On February 23, 2011, the Company signed a contribution agreement with Industry Canada under the Strategic Aerospace & Defense Initiative ("SADI") for the development of the next generation product, AFIRS 228. Under the terms of the agreement, SADI will make a repayable unsecured contribution to the Company of the lesser of 30% of the eligible project costs to December 30, 2012 or \$1,967,507. The amount is repayable over 15 years commencing April 30, 2014. The payments are on a stepped basis starting April 30, 2014 of 3.5% of the contribution and increasing 15% yearly until April 30, 2028 when the final payment is 24.5 of the contribution.

19. Contingency:

In September 2007, the Company, among others, were served with a counterclaim alleging that the Company induced a breach of contract and interfered with economic relationships. The Company maintains that the claims are without merit. Management intends to vigorously defend the matter and believes the outcome will be in its favour. On November 7, 2007, the Company filed a statement of defense and a counterclaim against three parties for interference with legally binding contracts, disrupted business, attacks on the Company's reputation, and costs. During 2010 there has been no substantial progress on a resolution to the action. Any amounts awarded as a result of these actions will be reflected in the year the amounts become reasonably estimable.

CORPORATE INFORMATION

Annual General Meeting

The Annual General Meeting of Shareholders will be held on Thursday, June 2, 2011 at 2 PM MDT time in the boardroom at AeroMechanical Services Ltd. offices Suite 200W, 1144-29th Ave NE, Calgary, Alberta, Canada.

Registrar and Transfer Agent

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Shares are traded on the TSX Venture Exchange
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Richard Hayden
Doug Marlin
Mike Brown
Paul Takalo, CA
Jacques Kavafian
Jack Olcott

CEO of the Company
President of the Company
President, Marlin Ventures Ltd.
Partner, Geselbracht Brown
Vice-President, Standen's Limited
President and CEO, 7546220 Canada Inc.
President, General Aviation Company

Officers

Bill Tempany
Richard Hayden
Thomas French, CGA
Matt Bradley

CEO
President
VP Finance & CFO
VP Business Development

Auditor

KPMG LLP

Calgary, Alberta

Legal Counsel

Chris Croteau

Tingle Merrett LLP

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Share Data

As of December 31st, 2010 the share data for AeroMechanical Services were as follows:

Shares issued and outstanding:	118.6 million
Warrants outstanding:	29.7 million
Options outstanding:	2.5 million
Shares fully diluted:	150.8 million
Share price:	\$0.26
Market cap:	\$30.8 million



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