

## ***To Our Shareholders:***

As we reflect upon one of the most turbulent years in the history of the commercial aviation industry, we at Atlantic Coast Airlines—along with our peers at every other airline company—search for words that will somehow put the events of 2001 into perspective. Now that the storm brought on by the September tragedies has begun to recede, we have had time to open the shutters and survey the landscape. And although there has been some damage, our industry and our company continue to move forward.

Historically, we have worked to build a company that would serve the needs and interests of our shareholders, customers and employees over the long term. But during this past year, the beliefs we have come to trust over the last 12 years were tested by stresses beyond any imaginable measure. What have we learned? After a thorough review of our present and future direction, we have grown even more confident that future success will be achieved by remaining committed to the principles that have driven us since the very beginning:

- Service to our partners based on cooperative relationships that create increasing mutual value and the continued growth of our regional jet fleet.
- A philosophy of fiscal conservatism, cost-consciousness and a history of benefiting our shareholders by producing consistently satisfactory results.
- And, a solid belief in the abilities of our ACA team members, whose spirit of dedication and determination never waver, despite the many challenges they face.

Let us take a few moments to examine each of these key elements, and reflect on their importance to our future success in 2002 and beyond.

### **Service To Our Partners**

Never before have we worked so hard to produce excellent results for our two major airline partners. As each of them—along with the entire airline industry—experienced extraordinary challenges during 2001, we developed creative new ways to cut costs in an effort to assist in their financial recoveries. As they faced difficult decisions about whether to maintain their tradition of service to communities that were no longer producing strong profits, we were able to provide regional jet service that kept these destinations “on the map.” In many cases, we were asked to assist even further by operating the ground stations at those airports.

When United needed us to shift additional regional jet resources to Chicago O’Hare, we did so without hesitation. The situation there was made more challenging by a lack of gate space and ground facilities at the “F” concourse, hampering service to customers. But our partners needed our help, and we responded immediately, working from that point to find creative ways to improve the situation every day.

When Delta needed to redeploy some of its own regional jets to other hubs, we were asked to move into Cincinnati, expanding what was always envisioned as a two-hub operation to three hubs. Again, our immediate answer was yes.

Saying yes without hesitation is what we do at ACA. And while that makes for some very demanding situations for our management team, flight crews and line staff, we would never think of responding any other way. Our commitment to our partners is the basis of everything we do, and ultimately, the primary determinant of our own success.

## **Fleet Growth**

In 1997, we made a decision to pin the future of our company on our belief that public demand for regional jet service in the U.S. would grow for many years. We are proud to say that since that time, the decision has never been second-guessed. Now, with the retirement of the last of our 19-seat turboprops, we have improved our fleet product to an even greater degree. During 2002, we will reach another milestone by accepting our 100<sup>th</sup> regional jet aircraft.

## **Financial Philosophy**

We have always been extremely careful about developing budgets and cost structures that emphasize service to our partners and passengers, creating a safe and reliable product, while maintaining low unit costs. This year, more than at any other time, our ability to operate in this manner has proven to be a tremendous asset.

In the current atmosphere of cutbacks and downsizing, we have been able to operate as we always have, relying on prudent fiscal management, rather than being forced to resort to widespread staff reductions. In fact, although we were forced to cut our administrative staff in late September, we remain extremely proud that at no time did we ever lay off even one front line employee—crew members, airport personnel, maintenance staff or anyone directly involved in serving passengers.

## **Our People**

Our faith in the capabilities of our team has grown even stronger during this past year. In the face of circumstances that provided every opportunity to give up, our people became even more determined to move forward. While some other companies have experienced increased internal tension and workgroup fragmentation in recent months, our ACA team has pulled together. Our confidence in each other has made us all better at what we do.

Furthermore, our ability to ensure the safety of our passengers has expanded to an even greater extent in keeping with current security conditions. As a passenger, you are aware of the additional challenges inherent in air travel today. Imagine what it is like to face the new security environment on a day-after-day, hour-after-hour basis. We are extremely proud and thankful that our people have responded so well to these new conditions, even if their daily jobs have become that much more difficult.

In conclusion, it goes without saying that there will never be another year like this one. No matter what the future holds, we will never again experience the stresses of this past year. But in reflecting on these extraordinary times, we have learned things about ourselves we never could have known otherwise.

We remain focused on the things that truly matter to our success—service to our partners, the growth of our regional jet fleet, fiscal vigilance and belief in our team. To those of you who have endured the instability and uncertainties of this past year along with us, we offer our most sincere thanks for your support. Your faith in us has never been more valuable. We hope to reward you by continuing to produce solid results for many more years to come.



Kerry Skeen  
Chairman  
Chief Executive Officer



Tom Moore  
President  
Chief Operating Officer

## **Description of the Company**

Atlantic Coast Airlines Holdings, Inc. (“ACAI”), is a holding company with its primary subsidiary being Atlantic Coast Airlines (“ACA”), a regional airline serving 64 destinations in 28 states in the Eastern and Midwestern United States and Canada as of March 1, 2002 with 760 scheduled non-stop flights system-wide every weekday. On July 1, 2001, ACAI combined the operations of its Atlantic Coast Jet, Inc. (“ACJet”) subsidiary into the operations of ACA. As a result, ACA now operates under its marketing agreements as both a United Express carrier with United Air Lines, Inc. (“United”) and as a Delta Connection carrier with Delta Air Lines, Inc. (“Delta”). United Express operations are conducted throughout the Eastern and Central United States, while Delta Connection operations are conducted predominately in the Northeastern United States and Canada. Unless the context indicates otherwise, the terms “the Company”, “we”, “us”, or “our” refer herein to Atlantic Coast Airlines Holdings, Inc. As of March 1, 2002, the Company operated a fleet of 124 aircraft (93 regional jets and 31 turboprop aircraft) having an average age of approximately three years.

## **Selected Financial Data**

The following selected financial data under the captions “Consolidated Financial Data” and “Consolidated Balance Sheet Data” relating to the years ended December 31, 1997, 1998, 1999, 2000 and 2001 have been derived from the Company’s consolidated financial statements. The following selected operating data under the caption “Selected Operating Data” have been derived from Company records. The data should be read in conjunction with “Management’s Discussion and Analysis of Results of Operations and Financial Condition” and the Consolidated Financial Statements and Notes thereto contained in the 2001 Annual Report on Form 10-K.

**SELECTED CONSOLIDATED FINANCIAL AND OPERATING DATA**  
(Dollars in thousands, except per share amounts and operating data)

Consolidated Financial Data:	Years ended December 31,				
	1997	1998	1999	2000	2001
<b>Operating revenues:</b>					
Passenger revenues	\$202,540	\$285,243	\$342,079	\$442,695	\$577,604
Other revenues	2,904	4,697	5,286	9,831	5,812
<b>Total operating revenues</b>	<b>205,444</b>	<b>289,940</b>	<b>347,365</b>	<b>452,526</b>	<b>583,416</b>
<b>Operating expenses:</b>					
Salaries and related costs	49,661	68,135	84,554	107,831	164,446
Aircraft fuel	17,766	23,978	34,072	64,433	88,308
Aircraft maintenance and materials	16,860	22,730	24,357	36,750	48,478
Aircraft rentals	29,570	36,683	45,215	59,792	90,323
Traffic commissions and related fees	32,667	42,429	54,521	56,623	15,589
Facility rents and landing fees	10,376	13,475	17,875	20,284	32,025
Depreciation and amortization	3,566	6,472	9,021	11,193	15,353
Other	16,035	23,347	28,458	42,537	61,674
Aircraft early retirement charges (1)	-	-	-	28,996	23,026
<b>Total operating expenses</b>	<b>176,501</b>	<b>237,249</b>	<b>298,073</b>	<b>428,439</b>	<b>539,222</b>
<b>Operating income</b>	<b>28,943</b>	<b>52,691</b>	<b>49,292</b>	<b>24,087</b>	<b>44,194</b>
<b>Other income (expense):</b>					
Interest expense	(3,450)	(4,207)	(5,614)	(6,030)	(4,832)
Interest income	1,284	4,145	3,882	5,033	7,500
Debt conversion expense (2)	-	(1,410)	-	-	-
Government compensation (3)	-	-	-	-	9,710
Other income (expense), net	62	326	(85)	(278)	263
<b>Total other expense, net</b>	<b>(2,104)</b>	<b>(1,146)</b>	<b>(1,817)</b>	<b>(1,275)</b>	<b>12,641</b>
<b>Income before income tax expense and cumulative effect of accounting change</b>	<b>26,839</b>	<b>51,545</b>	<b>47,475</b>	<b>22,812</b>	<b>56,835</b>
<b>Income tax provision</b>	<b>12,339</b>	<b>21,133</b>	<b>18,319</b>	<b>7,657</b>	<b>22,513</b>
<b>Income before cumulative effect of accounting change</b>	<b>14,500</b>	<b>30,412</b>	<b>29,156</b>	<b>15,155</b>	<b>34,322</b>
<b>Cumulative effect of accounting change, net (4)</b>	<b>-</b>	<b>-</b>	<b>(888)</b>	<b>-</b>	<b>-</b>
<b>Net income</b>	<b>\$14,500</b>	<b>\$30,412</b>	<b>\$28,268</b>	<b>\$15,155</b>	<b>\$34,322</b>
<b>Income per share:</b>					
<b>Basic:</b>					
Income before cumulative effect of accounting change	\$0.47	\$0.84	\$0.77	\$0.38	\$0.79
Cumulative effect of accounting change	-	-	(0.02)	-	-
<b>Net income per share (5)</b>	<b>\$0.47</b>	<b>\$0.84</b>	<b>\$0.75</b>	<b>\$0.38</b>	<b>\$0.79</b>
<b>Diluted:</b>					
Income before cumulative effect of accounting change	\$0.40	\$0.71	\$0.68	\$0.36	\$0.76
Cumulative effect of accounting change	-	-	(0.02)	-	-
<b>Net income per share (5)</b>	<b>\$0.40</b>	<b>\$0.71</b>	<b>\$0.66</b>	<b>\$0.36</b>	<b>\$0.76</b>
<b>Weighted average number of shares used in computation (in thousands) (5)</b>					
Basic	31,294	36,256	37,928	40,150	43,434
Diluted	39,024	44,372	44,030	43,638	45,210

**SELECTED CONSOLIDATED FINANCIAL AND OPERATING DATA (continued)**  
**(Dollars in thousands, except per share amounts and operating data)**

Years ended December 31,

	1997	1998	1999	2000	2001
<b>Selected Operating Data:</b>					
Departures	146,069	170,116	186,571	199,050	235,794
Revenue passengers carried	1,666,975	2,534,077	3,234,713	3,778,811	4,937,208
Revenue passenger miles (000s) (6)	419,977	792,934	1,033,912	1,271,273	1,895,152
Available seat miles (000s) (7)	861,222	1,410,763	1,778,984	2,203,839	3,292,798
Passenger load factor (8)	48.8%	56.2%	58.1%	57.7%	57.6%
Revenue per available seat mile	\$0.239	\$0.206	\$0.195	\$0.205	\$0.177
Cost per available seat mile (9)	\$0.205	\$0.168	\$0.168	\$0.181	\$0.157
Average yield per revenue passenger mile (10)	\$0.482	\$0.360	\$0.331	\$0.348	\$0.305
Average passenger trip length (miles)	252	313	320	336	384
Aircraft in service (end of period)	65	74	84	105	117
Destinations served (end of period)	43	53	51	53	64
<b>Consolidated Balance Sheet Data:</b>					
Working capital	\$45,028	\$68,130	\$60,440	\$72,018	\$138,659
Total assets	148,992	227,626	293,753	382,700	452,425
Long-term debt and capital leases, less current portion	76,145	64,735	92,787	67,089	60,643
Total stockholders' equity	34,805	110,377	125,524	168,173	221,300

- In 2001, the Company recorded an operating charge of \$23,537,000 (\$14,005,000 net of income tax benefits) for the non-discounted value of future lease and other costs associated with the early retirement of nine J-41 turboprop aircraft. In 2000, the Company recorded an operating charge of \$28,996,000 (\$17,398,000 net of income tax benefits) for the present value of future lease and other costs associated with the early retirement of 28 J-32 turboprop aircraft. Upon completion of the J-32 retirement plan in 2001, the Company reversed \$500,000 of the original 2000 operating charge in 2001.
- In connection with the induced conversion of a portion of the 7% Convertible Subordinated Notes, the Company recorded a non-cash, non-operating charge of approximately \$1.4 million in 1998.
- In 2001, the Company recognized \$9.7 million as non-operating income under the Air Transportation Safety and System Stabilization Act, signed into law by President Bush on September 22, 2001.
- In 1999, the Company recorded a charge of \$888,000 for the cumulative effect, net of income taxes, of a change in accounting for preoperating costs in connection with the implementation of Statement of Position 98-5.
- All per share calculations have been restated to reflect 2-for-1 common stock splits effected as dividends distributed on May 15, 1998 and February 23, 2001.
- "Revenue passenger miles" or "RPMs" represent the number of miles flown by revenue passengers.
- "Available seat miles" or "ASMs" represent the number of seats available for passengers multiplied by the number of scheduled miles the seats are flown.
- "Passenger load factor" represents the percentage of seats filled by revenue passengers and is calculated by dividing revenue passenger miles by available seat miles.
- "Operating cost per available seat mile" or "CASM" represents total operating expenses, excluding aircraft early retirement charges, divided by available seat miles.

"Average yield per revenue passenger mile" represents the average passenger revenue received for each mile a revenue passenger

## Common Equity

The following table sets forth the reported high and low closing sale prices of the Common Stock on the NASDAQ/NM for the periods indicated:

<u>2000</u>	<u>High</u>	<u>Low</u>
First quarter	\$12.97	\$ 8.31
Second quarter	\$16.00	\$11.99
Third quarter	\$18.49	\$13.00
Fourth quarter	\$21.38	\$13.53
<u>2001</u>		
First quarter	\$23.50	\$18.25
Second quarter	\$29.99	\$20.75
Third quarter	\$29.16	\$10.03
Fourth quarter	\$24.94	\$13.61
<u>2002</u>		
First quarter	\$29.21	\$23.05

As of April 1, 2002, the closing sales price of the Common Stock on NASDAQ/NM was \$22.25 per share and there were approximately 166 holders of record of Common Stock.

The Company has not paid any cash dividends on its Common Stock and does not anticipate paying any Common Stock cash dividends in the foreseeable future. The Company intends to retain earnings to finance the growth of its operations.

# Management's Discussion and Analysis of Results of Operations and Financial Condition

## General

Atlantic Coast Airlines Holdings, Inc. ("ACAH") operates through its wholly owned subsidiary, Atlantic Coast Airlines ("ACA"). In 2001, the Company recorded net income of \$34.3 million compared to \$15.2 million for 2000, and \$28.3 million for 1999. The 2001 results include a restructuring charge of \$13.7 million, net of income taxes, related to the planned early retirement of nine leased 29-seat J-41 turboprop aircraft and \$5.8 million, net of income taxes, in government compensation received pursuant to the Air Transportation Safety and System Stabilization Act ("Stabilization Act") signed by the President of the United States in September 2001. The 2000 results include a restructuring charge of \$17.4 million, net of income taxes, related to the early retirement of 28 leased 19-seat J-32 turboprop aircraft and non-recurring tax credits of \$1.4 million. The 1999 net results include the cumulative effect of an accounting change, net of income taxes, of \$888,000 related to the adoption of Statement of Position 98-5, which resulted in the write-off of remaining unamortized regional jet implementation costs. Excluding these unusual items, net income for 2001, 2000 and 1999 would have been \$42.2 million, \$31.1 million, and \$29.2 million, respectively. For 2001, the Company's available seat miles ("ASM") increased 49% with the addition of 19 Canadair Regional Jet ("CRJ") aircraft and 15 Fairchild Dornier 328JET ("328JET") aircraft, net of the reduction of 21 J-32 turboprop aircraft during the year. The number of total passengers increased 31%, and revenue passenger miles ("RPM") increased 49%.

## Results of Operations

The Company's net income was \$34.3 million (including a \$23.0 million pre-tax operating charge related to the early retirement of nine J-41 turboprop aircraft and \$9.7 million in pre-tax income for government compensation) or \$.76 per diluted share in 2001 compared to \$15.2 million (including a \$29.0 million pre-tax operating charge related to the early retirement of 28 J-32 turboprop aircraft) or \$.36 per diluted share in 2000, and \$28.3 million or \$.66 per diluted share in 1999. During 2001, the Company generated operating income of \$44.2 million (including a \$23 million operating charge related to the early retirement of nine J-41 turboprop aircraft), compared to \$24.1 million for 2000 (including a \$29 million pre-tax operating charge related to the early retirement of 28 J-32 turboprop aircraft) and \$49.3 million for 1999. Excluding the aircraft early retirement charges in 2001 and 2000, operating margins for 2001, 2000 and 1999 were 11.5%, 11.7% and 14.2% respectively.

Results for 2001 include special pre-tax government compensation of \$9.7 million arising from the Stabilization Act. The Stabilization Act provides cash grants to commercial air carriers as compensation for direct and incremental losses resulting from the attacks of September 11, 2001 and incurred from that date through December 31, 2001.

The 83.5% increase in operating income from 2000 to 2001 is a reflection of the 49.4% increase in available seat miles coupled with a 13.7% decrease in revenue per available seat mile and a 13.3% decrease in the cost per available seat mile. Additionally, the 2001 aircraft early retirement charge of \$23 million was \$6 million less than the aircraft early retirement charge in 2000. Revenue and cost per available seat mile have decreased as the turboprop aircraft are retired and the Company utilizes more regional jets.

The 51.1% decrease in operating income from 1999 to 2000 is a reflection of the J-32 retirement charge of \$29 million. Excluding this charge, operating income increased 7.7%, which reflects a 5.1% increase in unit revenue (total revenue per ASM) from \$0.195 to \$0.205, an increase of 7.7% in unit costs (cost per ASM) from \$0.168 to \$.181 and a 23.9% increase in ASM's.

## **Fiscal Year 2000 vs. 2001**

### **Operating Revenues**

The Company's operating revenues increased 28.9% to \$583.4 million in 2001 compared to \$452.5 million in 2000. The increase resulted primarily from a 49.4% increase in ASMs to 3.3 billion as well as a 9.9% increase in revenue per departure to \$2,452. Revenue in 2001 was recognized primarily under fee-for-service agreements as compared to a combination of a proration-of-fare agreement and a fee-for-service agreement in 2000. Revenue for 2001 also included an additional \$3.8 million attributable to routine subsequent period sampling adjustments to prior billed tickets under the Company's former proration-of-fare arrangement. The Company believes that it will no longer experience revenue adjustments attributable to its former proration-of-fare arrangements. The increase in ASMs reflects the addition of 19 CRJ aircraft and 15 328JET aircraft in 2001, and the full year effect in 2001 of adding 14 CRJ aircraft and 14 328JET aircraft during 2000, offset by the removal of 21 J-32 aircraft during 2001. Revenue passengers increased 30.7% in 2001 compared to 2000, which combined with the increase in the average passenger stage length resulted in a 49.1% increase in RPMs.

The 40.8% decrease in other revenues year over year reflects a \$1.8 million decrease in revenue from package and mail delivery and a \$1.4 million decrease in United employee ticket revenue. The decrease reflects the fact that these revenues are no longer earned by the Company as a result of the restatement of the United Express agreement, which went into effect on December 1, 2000.

### **Operating Expenses**

Excluding the \$23 million and \$29 million aircraft early retirement charge in 2001 and 2000, respectively, the Company's operating expenses increased 29.2% to \$516.2 million in 2001 compared to \$399.4 million in 2000. This increase was due primarily to: a 52.5% increase in total salary costs, a 51.1% increase in aircraft rentals, a 57.9% increase in facility rents and landing fees and a 49.4% increase in ASMs. These increases reflect the addition of 34 regional jet aircraft in 2001, and the retirement of 21 J-32s during 2001.

A summary of operating expenses as a percentage of operating revenue and operating cost per ASM for the years ended December 31, 2000 and 2001 is as follows:

	Year Ended December 31,			
	2000		2001	
	Percent of Operating Revenues	Cost Per ASM (cents)	Percent of Operating Revenues	Cost Per ASM (cents)
Salaries and related costs	23.8%	4.9	<b>28.2%</b>	<b>5.0</b>
Aircraft fuel	14.2%	2.9	<b>15.1%</b>	<b>2.7</b>
Aircraft maintenance and materials	8.1%	1.7	<b>8.3%</b>	<b>1.5</b>
Aircraft rentals	13.2%	2.7	<b>15.5%</b>	<b>2.7</b>
Traffic commissions and related fees	12.5%	2.6	<b>2.7%</b>	<b>.5</b>
Facility rents and landing fees	4.5%	.9	<b>5.5%</b>	<b>1.0</b>
Depreciation and amortization	2.5%	.5	<b>2.6%</b>	<b>.4</b>
Other	9.5%	1.9	<b>10.6%</b>	<b>1.9</b>
Aircraft early retirement charge	6.4%	1.3	<b>3.9%</b>	<b>.7</b>
<b>Total</b>	<b>94.7%</b>	<b>19.4</b>	<b>92.4%</b>	<b>16.4</b>

Costs per ASM decreased 15.5% to 16.4 cents in 2001 compared to 19.4 cents for 2000. The main factors contributing to the decrease were a 49.4% increase in ASMs and a 72.5% decrease in the year-over-year traffic commissions and related fees. The decrease in traffic commissions and related fees reflects the fact that many of these fees are no longer borne by the Company as a result of the restatement of the United Express agreement, which went into effect on December 1, 2000. Excluding the aircraft early retirement charge in both 2001 and 2000, costs per ASM decreased 13.3% to 15.7 cents during 2001 compared to 18.1 cents for 2000.

Salaries and related costs per ASM increased 2.0% to 5.0 cents in 2001 compared to 4.9 cents in 2000. In absolute dollars, salaries and related expenses increased 52.5% from \$107.8 million in 2000 to \$164.4 million in 2001. The increase primarily resulted from the net addition of 557 full and part time employees during 2001 to support the 34 regional jet aircraft added during 2001, an accrual of \$2.9 million recorded in 2001 reflecting estimated costs for additional company contributions which may be made to the Company's 401(k) plan to address operational defects found in the plan, and \$1.8 million in executive compensation related to deferred compensation benefits being provided to senior executive officers.

The cost per ASM of aircraft fuel decreased to 2.7 cents in 2001 compared to 2.9 cents in 2000. The total average price per gallon of fuel decreased 11.7% to 98 cents in 2001 compared to \$1.11 in 2000. In absolute dollars, aircraft fuel expense increased 37.1% from \$64.4 million in 2000 to \$88.3 million in 2001, reflecting a 27.3% increase in block hours and the higher fuel consumption per hour of regional jet aircraft versus turboprop aircraft which resulted in a 21.6% increase in the system average burn rate (gallons used per block hour flown).

The cost per ASM of aircraft maintenance and materials decreased to 1.5 cents in 2001 compared to 1.7 cents in 2000. In absolute dollars, aircraft maintenance and materials expense increased 31.9% from \$36.8 million in 2000 to \$48.5 million in 2001. The increased expense resulted from the increase in the size of the total fleet, the continual increase in the average age of the J-41 turboprop fleet and the gradual expiration of manufacturer's warranties on the CRJs.

The cost per ASM of aircraft rentals remained the same at 2.7 cents in 2001 and 2000. During 2001, the Company took delivery of 34 additional regional jet aircraft, all of which were lease financed. In absolute dollars, aircraft rental expense increased 51.1% to \$90.3 million as compared to \$59.8 million in 2000 due to the additional regional jet aircraft added to the fleet.

The cost per ASM of traffic commissions and related fees decreased to .5 cents in 2001 as compared to 2.6 cents in 2000. In absolute dollars, traffic commissions and related fees decreased 72.5% to \$15.6 million in 2001 from \$56.6 million in 2000. The decrease reflects the fact that many of these fees are no longer borne by the Company as a result of the restatement of the United Express agreement, which went into effect on December 1, 2000. Under the restated agreement, the Company is now only responsible for fees associated with the major airline Computer Reservation Systems.

The cost per ASM of facility rent and landing fees increased to 1.0 cents for 2001 from .9 cents for 2000. In absolute dollars, facility rent and landing fees increased 57.9% to \$32 million for 2001 from \$20.3 million in 2000. The increase in absolute dollars for facility rent and landing fees is a result of an 18.5% increase in the number of departures, the heavier landing weight of the regional jets and the lease of the Company's new corporate headquarters building commencing on December 1, 2000.

The cost per ASM of depreciation and amortization decreased slightly to 0.4 cents for 2001 from 0.5 cents in 2000. In absolute dollars, depreciation and amortization expense for 2001 increased 37.2% to \$15.4 million from \$11.2 million in 2000. The absolute increase results in part from additional expenditures for rotatable spare parts, engines and aircraft improvements.

The cost per ASM of other operating expenses remained the same at 1.9 cents for 2001 and 2000. In absolute dollars, other operating expenses increased 45% to \$61.7 million for 2001 from \$42.5 million in 2000. The increased costs result primarily from a 200% increase in the cost of passenger insurance, a 96.4% increase in the cost of hull insurance, and the 30.7% increase in revenue passengers which resulted in higher passenger handling costs, training expenses and crew accommodation costs for new flight crews to support additional aircraft and stations. The Company expects pilot training and crew accommodation costs to continue to increase as the remaining firm ordered CRJ and 328JET aircraft are received. Under the Stabilization Act, the government subsequently authorized air carriers to apply for reimbursement for increased insurance costs incurred during the period October 1, 2001 to October 30, 2001, and the Company applied for, received, and recorded as a reduction to insurance expense \$652,000 in such reimbursements. This amount was based on costs incurred during the period, and no other insurance reimbursements are anticipated.

In 2001, the Company recorded an operating charge of 0.7 cents per ASM for costs associated with the early retirement of nine J-41 turboprop aircraft, as compared to 1.3 cents per ASM in 2000 for costs associated with the early retirement of 28 J-32 turboprop aircraft. In absolute dollars, the amount of the charge was \$23 million in 2001 compared to \$29 million in 2000. The retirement of the J-32 fleet was completed by December 31, 2001 and the Company reversed \$500,000 of the 2000 charge. Nine of the J-41 turboprop aircraft are expected to be retired in 2002, with the remaining 22 aircraft to be retired by December 31, 2003.

### **Other Income (Expense)**

Interest expense decreased from \$6 million in 2000 to \$4.8 million in 2001. The decrease is the result of the full year effect of the impact of the conversion of the Company's 7% notes into equity during the first half of 2000.

Interest income increased from \$5 million in 2000 to \$7.5 million in 2001. This is primarily the result of the Company's significantly higher cash balances during 2001 as compared to 2000 offset partially by lower rate of return on short-term investments in 2001.

On September 22, 2001, President Bush signed into law the Stabilization Act. The Stabilization Act provides cash grants to commercial air carriers as compensation for (1) direct losses incurred beginning with the terrorist attacks on September 11, 2001 as a result of any FAA mandated ground stop order issued by the Secretary of Transportation (and for any subsequent order which continues or renews such a stoppage), and (2) incremental losses incurred during the period beginning September 11, 2001 and ending December 31, 2001 as a direct result of such attacks. The Company is entitled to receive cash grants under these provisions. The exact amount of the Company's compensation will be based on the lesser of actual losses incurred or a statutory limit based on the total amount allocable to all airlines. This total amount is not yet determinable because the statutory limit is subject to information not yet released by the government. The Company has received \$9.7 million in government compensation, which is the government's estimate of approximately 85% of the Company's allocation based on preliminary data. The Company has received \$9.7 million in cash grants under these provisions recognized as non-operating income under "government compensation" for the third and fourth quarters 2001. This amount was the government's estimate of approximately 85% of amount due to the Company based on preliminary data. The exact amount of the Company's compensation will be based on the lesser of actual losses incurred or a statutory limit based on the total amount allocable to all airlines. This exact amount is not yet determinable because the statutory limit is subject to information not yet released by the federal government. As such, the Company is unsure if it will be entitled to any further government compensation under this program and will recognize any remaining payments as non-operating income during the period it is determined the Company is entitled to such amounts. All amounts received as government compensation are subject to audit and adjustment by the federal government.

The Company recorded a provision for income taxes of \$22.5 million for 2001, compared to a provision for income taxes of \$7.7 million in 2000. The 2001 effective tax rate was approximately 39.6% as compared to the 2000 effective tax rate of approximately 33.6%. This increase is primarily due to a favorable state income tax ruling in 2000 resulting in the

application of one time state tax credits, and the realization of certain tax benefits that were previously reserved, which together reduced income tax expense by approximately \$1.4 million for 2000. The effective tax rates reflect non-deductible permanent differences between taxable and book income.

## Fiscal Year 1999 vs. 2000

### Operating Revenues

The Company's operating revenues increased 30.3% to \$452.5 million in 2000 compared to \$347.4 million in 1999. The increase resulted from a 23.9% increase in ASMs, together with an increase in revenue per ASMs of 5.1%. The increase in ASMs reflects the addition of fourteen CRJ aircraft and fourteen 328JET aircraft in 2000, and the full year effect in 2000 of adding ten CRJ aircraft during 1999, offset by the removal of seven J-32 aircraft during 2000. Revenue passengers increased 16.8% in 2000 compared to 1999, which combined with the increase in the average passenger stage length resulted in a 23% increase in RPMs. The 86% increase in other revenues year over year includes amounts paid by Delta Air Lines related to certain pilot training for the Delta Connection operation.

### Operating Expenses

Excluding the \$29.0 million aircraft early retirement charge, the Company's operating expenses increased 34.0% to \$399.4 million in 2000 compared to \$298.1 million in 1999. This increase was due primarily to: an 89% increase in total fuel costs as a result of a 49% increase in the average price per gallon of jet fuel, coupled with a 20% increase in the average fuel burn rate to 222 gallons per hour; a 23.9% increase in ASMs; and expenses for the certification and start up of the ACJet operation. The increase in ASMs, passengers and burn rates reflects the addition of fourteen CRJs and fourteen 328JETs into scheduled service, net of the retirement of seven J-32s during 2000.

A summary of operating expenses as a percentage of operating revenue and operating cost per ASM for the years ended December 31, 1999 and 2000 is as follows:

	Year Ended December 31,			
	1999		2000	
	Percent of Operating Revenues	Cost per ASM (cents)	Percent of Operating Revenues	Cost per ASM (cents)
Salaries and related costs	24.3%	4.8	<b>23.8%</b>	<b>4.9</b>
Aircraft fuel	9.8%	1.9	<b>14.2%</b>	<b>2.9</b>
Aircraft maintenance and materials	7.0%	1.4	<b>8.1%</b>	<b>1.7</b>
Aircraft rentals	13.0%	2.5	<b>13.2%</b>	<b>2.7</b>
Traffic commissions and related fees	15.7%	3.1	<b>12.5%</b>	<b>2.6</b>
Facility rents and landing fees	5.2%	1.0	<b>4.5%</b>	<b>.9</b>
Depreciation and amortization	2.6%	.5	<b>2.5%</b>	<b>.5</b>
Other	8.2%	1.6	<b>9.5%</b>	<b>1.9</b>
Aircraft early retirement charge	-	-	<b>6.4%</b>	<b>1.3</b>
<b>Total</b>	<b>85.8%</b>	<b>16.8</b>	<b>94.7%</b>	<b>19.4</b>

Costs per ASM increased 15.5% to 19.4 cents in 2000 compared to 16.8 cents for 1999. The main factors contributing to the increase were a 49% increase in the year over year price per gallon of jet fuel, the expenses associated with the certification and start-up of ACJet, flight crew training costs, and the aircraft early retirement charge. Excluding the aircraft early retirement charge, costs per ASM increased 7.7% to 18.1 cents during 2000 compared to 16.8 cents for 1999.

Salaries and related costs per ASM increased 2.1% to 4.9 cents in 2000 compared to 4.8 cents in 1999. In absolute dollars, salaries and related expenses increased 27.5% from \$84.6 million in 1999 to \$107.8 million in 2000. The increase primarily resulted from the net addition of 780 full and part time employees during 2000 to support the 28 regional jet aircraft added during 2000.

The cost per ASM of aircraft fuel increased to 2.9 cents in 2000 compared to 1.9 cents in 1999. The total price per gallon of fuel increased 48.9% to \$1.11 in 2000 compared to 74.6 cents in 1999. In absolute dollars, aircraft fuel expense increased 89.1% from \$34.1 million in 1999 to \$64.4 million in 2000, reflecting the higher cost per gallon fuel price, a 5.8% increase in block hours and the higher fuel consumption per hour of regional jet aircraft versus a turboprop aircraft which resulted in a 20% increase in the system average burn rate (gallons used per block hour flown).

The cost per ASM of aircraft maintenance and materials increased to 1.7 cents in 2000 compared to 1.4 cents in 1999. In absolute dollars, aircraft maintenance and materials expense increased 50.9% from \$24.4 million in 1999 to \$36.8 million in 2000. The increased expense resulted from the increase in the size of the total fleet, the continual increase in the average age of the turboprop fleets, the gradual expiration of manufacturer's warranties on the CRJs, and the reversal in 1999 of approximately \$1.5 million in life limited parts repair expense accruals related to CRJ engines that were no longer required based on the introduction of a maintenance contract covering the GE engines operating on the CRJ fleet.

The cost per ASM of aircraft rentals increased slightly to 2.7 cents in 2000 compared to 2.5 cents in 1999. During 2000, the Company took delivery of 28 additional regional jet aircraft, all of which were lease financed. In absolute dollars, aircraft rental expense increased 32.2% to \$59.8 million as compared to \$45.2 million in 1999 due to the additional aircraft added to the fleet.

The cost per ASM of traffic commissions and related fees decreased to 2.6 cents in 2000 as compared to 3.1 cents in 1999. Delta is responsible for travel agent commissions and related fees and effective December 1, 2000, United is responsible for travel agent commissions and program fee expense as a result of the restated UA agreement. In absolute dollars, traffic commissions and related fees increased 3.9% to \$56.6 million in 2000 from \$54.5 million in 1999. The increase resulted from an increase in passenger revenues and passenger volumes, offset by a reduction in the commission rates payable to travel agents.

The cost per ASM of facility rents and landing fees decreased to .9 cents for 2000 from 1.0 cent for 1999. In absolute dollars, facility rent and landing fees increased 13.5% to \$20.3 million for 2000 from \$17.9 million in 1999. The increase in absolute dollars for facility rent and landing fees is a result of a 6.7% increase in the number of departures, and the heavier landing weight of the regional jets.

The cost per ASM of depreciation and amortization remained the same at 0.5 cents for 2000 and 1999. In absolute dollars, depreciation and amortization expense for 2000 increased 24.1% to \$11.2 million from \$9 million in 1999. The absolute increase results in part from the full year effect of purchasing two CRJ aircraft and rotatable spare parts in 1999 for approximately \$59 million.

The cost per ASM of other operating expenses increased to 1.9 cents for 2000 from 1.6 cents in 1999. In absolute dollars, other operating expenses increased 49.5% to \$42.5 million for 2000 from \$28.5 million in 1999. The increased costs result primarily from the 16.8% increase in revenue passengers which resulted in higher passenger handling costs, training expenses for new flight crews, and expenses for ACJet pre-operating activities.

In 2000, the Company recorded an operating charge of 1.3 cents per ASM for costs associated with the early retirement of 28 J-32 turboprop aircraft. In absolute dollars, the amount of the charge was \$29 million. The charge included the estimated cost of contractual obligations to meet aircraft return conditions as well as a lease termination fee. The retirement of the J-32 fleet was completed on December 31, 2001.

#### **Other Income (Expense)**

Interest expense increased from \$5.6 million in 1999 to \$6 million in 2000. The increase is the result of the full year effect of the debt outstanding for the purchase of two CRJs in 1999 partially offset by the impact of the conversion of the Company's 7% notes into equity during the first half of 2000.

Interest income increased from \$3.9 million in 1999 to \$5 million in 2000. This is primarily the result of the Company's significantly higher cash balances during 2000 as compared to 1999.

The Company recorded a provision for income taxes of \$7.7 million for 2000, compared to a provision for income taxes of \$18.3 million in 1999. The 2000 effective tax rate is approximately 33.6% as compared to the 1999 effective tax rate of approximately 38.6%. This decrease is due to a favorable state income tax ruling resulting in the application of one time state tax credits, and the realization of certain tax benefits that were previously reserved, which together reduced income tax expense by approximately \$1.4 million for 2000. The effective tax rates reflect non-deductible permanent differences between taxable and book income.

The American Institute of Certified Public Accountants issued Statement of Position 98-5 on accounting for start-up costs, including preoperating costs related to the introduction of new fleet types by airlines. The new accounting guidelines were effective for 1999. The Company had previously deferred certain start-up costs related to the introduction of the CRJs and was amortizing such costs to expense ratably over four years. Effective January 1, 1999, the Company recorded a charge for the remaining unamortized balance of approximately \$888,000, net of \$598,000 of income taxes, associated with previously deferred preoperating costs.

## Outlook and Business Risks

This Outlook and Business Risks section and the Liquidity and Capital Resources section below contain forward-looking statements. The Company's actual results may differ materially. Factors that could cause the Company's future results to differ materially from the expectations described here include the costs and other effects of enhanced security measures and other possible government orders; changes in and satisfaction of regulatory requirements including requirements relating to fleet expansion; changes in levels of service agreed to by the Company with its code share partners due to market conditions; the ability of these partners to manage their operations and cash flow; the ability and willingness of these partners to continue to deploy the Company's aircraft and to utilize and pay for scheduled service at agreed rates; the ability of these partners to force changes in rates; increased cost and reduced availability of insurance; changes in existing service; final calculation and auditing of government compensation; unexpected costs or delays in the implementation of new service; adverse weather conditions; satisfactory resolution of union contracts becoming amendable during 2002 with the Company's aviation maintenance technicians and ground service equipment mechanics, and the Company's flight attendants; ability to hire and retain employees; availability and cost of funds for financing new aircraft; the ability of Fairchild Dornier to fulfill its contractual obligations to the Company, and of Bombardier and Fairchild Dornier to deliver aircraft on schedule; airport and airspace congestion; ability to successfully retire turboprop aircraft; flight reallocations and potential service disruptions due to labor actions by employees of Delta Air Lines or United Airlines; general economic and industry conditions; and additional acts of war. The statements in this Annual Report are made as of March 29, 2002 and the Company undertakes no obligation to update any of the forward-looking information included in this release, whether as a result of new information, future events, changes in expectations or otherwise.

The events of September 11, together with the slowing economy throughout 2001, have significantly affected the U.S. airline industry. These events have resulted in changed government regulation, declines and shifts in passenger demand, increased insurance costs and tightened credit markets which continue to affect the operations and financial condition of participants in the industry including the Company, its code share partners, and aircraft manufacturers. These circumstances have raised substantial risks and uncertainties, including those discussed below, which may impact the Company, its code share partners, and aircraft manufacturers, in ways that the Company is not currently able to predict.

The Company provides service for its Delta Connection operations exclusively with regional jets and is continuing its transformation of its existing United Express operation to an all regional jet fleet. In addition to the 60 CRJs and 33 328JETs in service as of March 1, 2002, the Company has firm orders for an additional 36 CRJs from Bombardier Inc. and 32 328JETs from Fairchild Dornier, with option orders for 80 CRJs and 81 328JETs, and long-term marketing agreements with United and Delta to fly the firm ordered jet aircraft in United Express and Delta Connection service. Under these agreements, the Company is dependent on United and Delta for substantially all of its revenue and for providing support services necessary to operate its aircraft, and is dependent on Bombardier and Fairchild for providing aircraft expected to support the Company's future growth and for other support described in this report on Form 10-K. Business or operational difficulties, liquidity problems or bankruptcy of any of these entities could materially impact the Company's operations and financial condition.

The slowing economy in 2001 and the terrorist attacks of September 11 have resulted in both United and Delta changing how the Company's regional jet aircraft are utilized. In the past, regional jets were primarily deployed to open new long, thin routes and to replace some turboprop service in higher traffic markets. With the fleet reductions of older, higher cost narrow body aircraft by United and Delta, the Company has been replacing mainline service to select United markets from Chicago and added mainline complementary service on numerous other routes. For Delta, the Company is currently operating hubs at New York's LaGuardia airport, Boston's Logan airport, and Cincinnati and Northern Kentucky International Airport.

UAL Corporation, the parent of United, has disclosed that during the fourth quarter 2001 it began implementing a financial recovery plan that includes four planks: reducing the size of the airline and cutting capital and operating spending in line with that reduction, generating as much revenue as possible from each flight, working with its unions and other employee groups to find further labor savings and implementing a financing plan to support it through the execution of its financial recovery plan. UAL Corporation further disclosed that the impact of the events of September 11, 2001 on United and the sufficiency of its financial resources to absorb that impact are dependent on a number of factors, including United's success in implementing its financial recovery plan.

Following September 11, United requested that the Company propose measures that it could take to assist in improving United's financial situation. The Company believes that United made a similar request to other suppliers and vendors. On December 31, 2001, the Company and United agreed on fee-per-departure rates to be utilized during 2002. In addition, in the context of reaching this agreement, the Company agreed to certain concessions that would benefit United by (1) settling various existing contract issues, (2) agreeing that United would not have to pay increased rates to reflect utilization changes in the fourth quarter of 2001, (3) agreeing to 2002 rates that require aggressive cost containment, and (4) reaffirming its commitment to retire the Company's J-41 turboprop aircraft. The Company determined that these concessions, which were favorable to United as compared to prior contractual arrangements and were designed to assist United in its financial recovery plan, were appropriate in light of the circumstances at the time.

In late March 2002, United informed the Company that an essential component of its financial recovery plan includes obtaining cost reductions from its employees, suppliers and partners, and that United is seeking the Company's assistance in decreasing the cost of the Company's product and achieving cash flow improvements for United over the next 24 months. The Company has commenced discussions with United regarding opportunities for reducing its costs or creating value to address United's financial situation. The basis for, nature, timing and extent of any such actions has not been agreed. While the Company has expressed its willingness to work with United to find mutually acceptable opportunities, the Company believes that it is not contractually obligated to make any such changes under the United Express Agreements or the December 31, 2001 rate setting agreement.

The Company's Delta Connection service commenced revenue service with 328JETs during the third quarter of 2000 and added CRJs during the fourth quarter of 2000. Approximately \$7.8 million in start-up expenses from inception through commencement of revenue service were incurred, which were expensed as incurred. Delta is reimbursing the

Company for \$5.2 million of these costs, and the amounts are being recorded as revenue ratably through July 2003. As of December 31, 2001 the Company has recorded \$2.0 million of this revenue.

The chairman of Fairchild Dornier, the manufacturer of the 328JET, recently stated that it has an immediate and critical need for additional funding, and that it is in discussions with several potential strategic partners regarding proposed investments. The Company is unable to predict whether Fairchild Dornier will be successful in finding additional capital or in otherwise restructuring its finances, but believes that Fairchild Dornier may be forced to seek bankruptcy protection if it is unsuccessful in its efforts. In the event of a Fairchild Dornier bankruptcy, Fairchild Dornier could either sell, liquidate or reorganize some or all of its businesses, and in the event of a reorganization or sale of its businesses would have the right to assume or reject future contractual obligations. Should Fairchild Dornier be unable to deliver ordered 328JETS, the Company would reassess available alternatives in pursuing its growth strategy and possibly delay the Company's turboprop retirement plans, and adjust other plans discussed elsewhere in this Form 10-K relating to its 328JET aircraft.

Fairchild Dornier has significant future obligations to the Company in connection with the order of 328JET aircraft. These include obligations: to deliver 32 firm ordered 328JETs and 81 additional option 328JETs with certain financing support; to pay the Company any difference between the lease payments, if any, received from the remarketing the of 26 J-41 aircraft leased by the Company and the lease payment obligations of the Company on those aircraft; to purchase five J-41 aircraft owned by the Company at their net book value at the time of retirement; to assume certain crew training costs; and, to provide spares, warranty, engineering, and related support. Fairchild Dornier has delayed the delivery of one 328JET that was scheduled to be delivered to the Company during the week of March 25, 2002 for reasons connected with its financing. The Company believes it has secured rights to Fairchild Dornier's equity interest in the delivered 328JETs that it may proceed against in the event that Fairchild Dornier fails to fulfill certain of these obligations.

During the fourth quarter of 2001, the Company recorded a pre-tax aircraft early retirement charge of \$23.5 million for the early retirement of nine leased Jetstream-41 turboprop aircraft, which the Company plans to remove from service prior to year-end 2002. The Company anticipates taking additional charges during 2002 of approximately \$48.0 million pre-tax for the retirement of its remaining 29-seat Jetstream-41 turboprop aircraft. The undiscounted remaining lease obligations (net of the Company's estimate of the future sublease rentals) on the J-41 fleet after planned retirement dates in 2002 and 2003 are approximately \$55 million and continue through 2010 and the book value of the five owned J-41 aircraft as of March 1, 2002 is \$18.1 million. To the extent that Fairchild Dornier fulfills its contractual obligations, the majority of the aircraft early retirement charge will not adversely affect the Company's cash position, with the payments by Fairchild Dornier being recorded as an aircraft purchase inducement on the 328JET aircraft. The Company would remain liable for the lease payments on its J-41 aircraft and thus be required to pay the remaining lease payments if, and to the extent that, Fairchild Dornier were to default on its obligation.

As of December 31, 2001, the Company has received \$9.7 million in cash grants under the loss compensation provisions of the Stabilization Act, which amount was recognized as non-operating income under “government compensation” in its financial results for 2001. This amount was the government’s estimate of approximately 85% of amount due to the Company based on preliminary data. The exact amount of the Company’s compensation will be based on the lesser of actual losses incurred or a statutory limit based on the total amount allocable to all airlines. This exact amount is not yet determinable because the statutory limit is subject to information not yet released by the federal government. As such, the Company is unsure if it will be entitled to any further government compensation under this program and will recognize any remaining payments as non-operating income during the period it is determined the Company is entitled to such amounts. All amounts received as government compensation are subject to audit and adjustment by the federal government.

In addition to the compensation described above, the Stabilization Act, among other things, provides U.S. air carriers with the option to purchase certain war risk liability insurance from the U.S. government on an interim basis at rates that are more favorable than those available from the private market; authorizes the federal government to reimburse air carriers for the increased cost of war risk insurance premiums for a limited but undetermined period of time as a result of the terrorist attacks of September 11, 2001; and, authorizes the federal government, pursuant to new regulations, to provide loan guarantees to air carriers in the aggregate amount of \$10 billion. Since September 11, the Company has purchased hull war risk coverage through the private insurance market through September 24, 2002, and has purchased liability war risk coverage from the U.S. government through May 19, 2002 and anticipates renewing the government insurance for as long as the coverage is available. The government subsequently authorized air carriers to apply for reimbursement under the Stabilization Act for increased insurance costs incurred during the period October 1, 2001 to October 30, 2001, and the Company applied for, received, and recorded as a reduction in insurance expense, \$652,000 in such reimbursements. The airlines and insurance industry, together with the United States and other governments, are continuing to evaluate both the cost and options for providing coverage of aviation insurance. Recently, an industry-led group announced a proposal to create a mutual insurance company, to be called Equitime, to cover war risk and terrorism risk, which would initially seek support through government guarantees. Equitime would provide a competitive alternative to insurance being offered by the traditional insurance market, which opposes this initiative. Equitime’s organizers project that it may be available to provide insurance as early as May 2002 to up to 70 U.S. carriers. The Company has not been actively involved in the formation of Equitime and is unable to anticipate whether this source of insurance will be made available and, if so, whether it will offer competitive rates. The Company anticipates that it will follow industry practices with respect to sources of insurance.

The Company continues to evaluate the terms and conditions being imposed by the government with respect to federal loan guarantees, and has not yet determined whether to make application for any such facility.

Collective bargaining agreements are negotiated under the Railway Labor Act, which governs labor relations in the transportation industry, and typically do not contain an expiration date. Instead, they specify a date called the amendable date, by which either party may notify the other of its desire to amend the agreement. Upon reaching the amendable date, the contract is

considered "open for amendment." Prior to the amendable date, neither party is required to agree to modifications to the bargaining agreement. Nevertheless, nothing prevents the parties from agreeing to start negotiations or to modify the agreement in advance of the amendable date. Contracts remain in effect while new agreements are negotiated. During the negotiating period, both the Company and the negotiating union are required to maintain the status quo.

ACA's collective bargaining agreement with AFA was ratified in October 1998. The agreement is for a four-year duration and becomes amendable in October 2002. This agreement covers all flight attendants working for the Company. The collective bargaining agreement with AMFA was ratified in June 1998. The agreement is for a four-year duration and becomes amendable in June 2002. This agreement covers all aviation maintenance technicians and ground service equipment mechanics working for the Company. Although there can be no assurances as to the outcome of these negotiations, the Company anticipates being able to reach agreement with both unions on mutually satisfactory contracts with no material effect on its results of operations or financial position.

## **Liquidity and Capital Resources**

As of December 31, 2001, the Company had cash, cash equivalents, and short-term investments of \$181 million and working capital of \$138.7 million compared to \$121.2 million and \$72 million, respectively, as of December 31, 2000. During the year ended December 31, 2001, cash and cash equivalents increased \$87.6 million, reflecting net cash provided by operating activities of \$88 million, net cash used in investing activities of \$5.7 million (primarily the results of increased purchases of property and equipment of \$34.9 million offset by the net reduction in short term investments of \$27.8 million) and net cash provided by financing activities of \$5.2 million. Net cash provided by financing activities was mainly related to proceeds from exercise of stock options.

As of December 31, 2000, the Company had cash, cash equivalents, and short-term investments of \$121.2 million and working capital of \$72 million compared to \$57.4 million and \$60.4 million, respectively, as of December 31, 1999. During the year ended December 31, 2000, cash and cash equivalents increased \$46.2 million, reflecting net cash provided by operating activities of \$93.9 million, net cash used in investing activities of \$43.8 million (related to aircraft purchase deposits, purchases of aircraft and equipment and increases in short term investments) and net cash used in financing activities of \$3.9 million. The increase in cash provided by operating activities is primarily due to the restated UA Agreements, effective December 1, 2000, in which the Company is now paid weekly in advance for monthly revenue as compared to receiving monthly revenue 30 to 60 days after the end of a month. Net cash used in financing activities was mainly related to payments of long-term debt and capital lease obligations and purchases of treasury stock.

## **Capital Commitments**

The Company's business is very capital intensive, requiring significant amounts of capital to fund the acquisition of assets, particularly aircraft. The Company has historically funded the acquisition of its aircraft by entering into off-balance sheet financing arrangements known as leveraged leases, in which third parties provide equity and debt financing to purchase the aircraft and simultaneously enter into long-term agreements to lease the aircraft to the

Company. Similarly, the Company often enters into long-term lease commitments with airports to ensure access to terminal, cargo, maintenance and other similar facilities. As can be seen in the table below setting forth information as of December 31, 2001, these operating lease commitments are significant.

(In thousands)	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>Thereafter</u>	<u>Total</u>
Long term debt	\$ 4,639	\$ 4,900	\$ 5,153	\$ 6,019	\$ 42,369	\$ 63,080
Capital lease obligations	1,584	1,565	772	-	-	3,921
Guaranteed simulator usage commitments	3,631	1,371	1,391	1,178	4,929	12,500
Operating lease commitments	128,150	120,138	124,243	122,653	1,106,225	1,601,409
Aircraft purchase commitments	524,000	664,000	-	-	-	1,188,000
Total contractual cash obligations	662,004	791,974	131,559	129,850	1,153,523	2,868,910

See Note 4 "Debt", Note 5 "Obligations Under Capital Leases", Note 6 "Operating Leases", and Note 10 "Commitments and Contingencies" in the Notes to Consolidated Financial Statements for additional discussion of these items. The Company also has a variety of other long-term contractual commitments that are of a nature that, under accounting principles generally accepted in the United States, are not required to be reflected on the Company's balance sheet, and that are not generally viewed as "off-balance sheet financing arrangements," such as commitments for major overhaul maintenance on the Company's aircraft. See "Liquidity and Capital Resources – Other Commitments" below and "Business – Pilot Training" above, and Note 1 "Summary of Accounting Policies – (I) Maintenance" and Note 10 "Commitments and Contingencies – Training" in the Notes to Consolidated Financial Statements for additional discussion of these items.

The Company believes that, in the absence of unusual circumstances, its cash flow from operations, the expected availability of operating lease financing, and other available equipment financing will be sufficient to meet its working capital needs, expected operating lease financing commitments, aircraft acquisitions and other capital expenditures, and debt service requirements for the next twelve months.

### **Other Financing**

On September 28, 2001, the Company entered into an asset-based lending agreement with a financial institution that provided the Company with a line of credit for up to \$25 million. The new line of credit, which will expire on October 15, 2003, replaced a previous \$35 million line of credit. The interest rate on this line is LIBOR plus .875% to 1.375% depending on the Company's fixed charges coverage ratio. As of December 31, 2001, the Company's interest rate on its line of credit was 3.0%. The Company has pledged \$15.3 million of this line of credit as collateral for letters of credit issued on behalf of the Company by a financial institution. The available borrowing under the line of credit is limited to the value of the bond letter of credit on the Company's Dulles, Virginia hangar facility plus the value of 60% of the book value of certain rotatable spare parts. As of December 31, 2001 the amount of available credit under the line was \$9.7 million. As of December 31, 2001 there were no outstanding borrowings on the \$25 million line of credit.

In September 1997, approximately \$112 million of pass through certificates were issued in a private placement by separate pass through trusts, which purchased with the proceeds, equipment notes (the "Equipment Notes") issued in connection with (i) leveraged lease transactions relating to four J-41s and six CRJs, all of which were leased to the Company (the "Leased Aircraft"), and (ii) the financing of four J-41s owned by the Company (the "Owned Aircraft"). The Equipment Notes issued with respect to the Owned Aircraft are direct obligations of ACA, guaranteed by ACAI and are included as debt obligations in the accompanying consolidated financial statements and in the table above. The Equipment Notes issued with respect to the Leased Aircraft are not obligations of ACA or guaranteed by ACAI.

## **Aircraft**

The Company has significant lease obligations for aircraft that are classified as operating leases and therefore are not reflected as liabilities on the Company's balance sheet. The remaining terms of such leases range from one to sixteen and three quarters years. The Company's total rent expense in 2001 under all non-cancelable aircraft operating leases was approximately \$90.3 million. As of December 31, 2001, the Company's minimum annual rental payments for 2002 under all non-cancelable aircraft operating leases with remaining terms of more than one year were approximately \$120.9 million. In order to minimize the total aircraft rental expense over the entire life of the related aircraft leveraged lease transactions, the Company has uneven semiannual lease payment dates of January 1 and July 1 for its CRJ and 328JET aircraft. Currently, approximately 56.7% of the Company's annual lease payments for its CRJ and 328JET aircraft are due in January and 28.4% are due in July. The Company made lease payments for its CRJ and 328JET aircraft totaling \$59.9 million on January 2, 2002.

As of March 1, 2002, the Company had a total of 36 CRJs on order from Bombardier, Inc., and held options for 80 additional CRJs. The Company also has a firm order with Fairchild Dornier for 32 328JET aircraft, and options for 81 additional 328JETs. Of the 68 firm ordered aircraft deliveries, 26 are scheduled for the remainder of 2002 and 42 are scheduled for 2003. The addition of the firm ordered regional jets, net of the removal from service of all of the turboprop aircraft, will allow the Company to grow capacity as measured in ASM's, based on planned aircraft delivery dates, by approximately 34% in 2002 and 25% in 2003. As of March 2002, the Company's ASM capacity was split 82% in United Express service and 18% in Delta Connection service. The Company is obligated to purchase and finance (including leveraged leases) the 68 firm ordered aircraft at an approximate capital cost of \$1.1 billion. The Company anticipates leasing all of its year 2002 aircraft deliveries on terms similar to previously delivered regional jet aircraft, except that three 328JETs to be utilized for charter operations will be purchased by the Company. One of these, which has already been acquired, was purchased through the application of certain deposits previously placed with Fairchild Dornier, and the others will be financed through debt, with repayment over approximately ten years. Aircraft orders are subject to price escalation formulas based on certain indices designed to reflect increased costs in the production of the aircraft. During 2001 the rate of escalation increased, and such increases will be reflected in future aircraft cost or lease rates. During the first quarter of 2002, the rate of escalation has remained constant.

The Company has financed its aircraft through leveraged lease transactions, which include requiring equity and debt investors for each aircraft. For the CRJs, the Company has firm commitments for equity financing for 19 future aircraft and for debt financing for one aircraft, and anticipates finalizing arrangements with Canada's export development agency during the second quarter 2002 for debt financing for at least nine additional aircraft. For the 328JETs, the manufacturer has committed to find debt financing for all undelivered aircraft, to provide equity financing for the next 8 aircraft and to find equity financing for the remaining undelivered aircraft (for recent developments regarding Fairchild Dornier, see Outlook). From time to time the Company seeks investors to participate in its leveraged leases, with equity sources normally consisting of domestic banks and industrial credit investors, and debt sources including export credit agencies and European banks. Commitments are normally sought during the first and second quarter of each year for funding for aircraft to be delivered throughout the year. Following the terrorist attacks, it has been the Company's experience that sources of funding have decreased and the cost of available funding has increased. The Company believes that it will be able to find funding for its future lease requirements, but the outcome, and the cost of funds, is subject to market conditions in a volatile lease financing market.

### **Capital Equipment and Debt Service**

In 2002 the Company anticipates capital spending of approximately \$56 million consisting of approximately \$30 million for aircraft, \$15.5 million for rotatable spare parts, \$4.8 million for equipment, and \$5.7 million for other capital assets, and expects to finance these capital expenditures out of working capital.

Principal payments on long term debt for 2002 are estimated to be approximately \$4.6 million reflecting borrowings related to the purchase of four CRJs acquired in 1998 and 1999 and five J-41s acquired in 1997 and 1998. The foregoing amount does not include additional debt that may be required for the financing of new CRJs, 328JETs, spare parts and spare engines.

### **Other Commitments**

The Company's regional jet fleet is comprised of new aircraft with an average age of less than two years. Since maintenance expense on new aircraft is lower in the early years of operation due to manufacturers' warranties and the generally lower failure rates of major components, the Company's maintenance expense for regional jet aircraft will increase in future periods.

In 2000, the Company executed a seven-year engine services agreement with GE Engine Services, Inc. ("GE") covering the scheduled and unscheduled repair of ACA's CRJ jet engines, operated on the 43 CRJs already delivered or on order for the United Express operation. This agreement was amended in July 2000 to cover 23 additional CRJ aircraft, bringing the total number of CRJ aircraft covered under the agreement to 66. Under the terms of the agreement, the Company pays a set dollar amount per engine hour flown on a monthly basis to GE and GE assumes the responsibility to repair the engines when required at no additional expense to the Company, subject to certain exclusions. The Company expenses the amount paid to GE based on the monthly rates stipulated in the agreement, as engine hours are flown. The Company's future maintenance expense on CRJ engines covered under the new agreement will escalate based on contractual rate increases, intended to match the timing of actual maintenance events that are due

pursuant to the terms. The Company is presently negotiating with GE for an adjustment in rates. The Company believes that it has the right to remove any or all engines from this agreement at any time, and that it may remove engines if a favorable adjustment cannot be agreed. GE has expressed the view that it does not agree that the Company has the right to remove all engines, but nevertheless is participating in rate discussions. The Company has signed an hourly maintenance agreement covering engines for up to 80 328JETs with Pratt & Whitney, and also anticipates signing a similar agreement for the remaining regional jets on order.

Effective September 2001, the Company entered a sixteen year maintenance agreement with Air Canada covering maintenance, repair and overhaul services for airframe components on its CRJ aircraft. Under the terms of this agreement, the Company pays a varying amount per flight hour each month, based on the age of the aircraft. The Company expenses the amount paid to Air Canada based on the rates stipulated in the agreement and the hours flown each month. In February 2002, the Company entered into a five-year agreement with Air Canada covering the scheduled airframe C-check overhaul of its CRJ aircraft. The Company expenses this cost as the overhaul is completed.

Effective January 2001, the Company entered into an agreement with BAE Systems Holdings, Inc. covering repair and overhaul of airframe rotatable parts on the Company's J-41 aircraft through the remaining service life of the J-41 fleet. Under the terms of this agreement, the Company pays a fixed amount per flight hour each month. The Company expenses the amount paid to BAE Systems Holdings, Inc. based on the rates stipulated in the agreement and the hours flown each month.

The Company has entered into agreements with Pan Am International Flight Academy ("PAIFA"), which allow the Company to train CRJ, J-41 and 328JET pilots at PAIFA's facility near Washington-Dulles. In 2001, PAIFA relocated its Washington-Dulles operations to a new training facility housing two CRJ simulators, a 328JET simulator, and a J-41 simulator near the Company's Washington-Dulles headquarters. The Company has agreements to purchase an annual minimum number of CRJ and J-41 simulator training hours at agreed rates, through 2010 for the CRJ, and 2002 for the J-41. The Company's payment obligations for CRJ and J-41 simulator usage over the remaining years of the agreements total approximately \$12.5 million.

In 2001, a simulator provision and service agreement between PAIFA, CAE Schreiner and the Company was executed and 328JET training commenced at the PAIFA facility. Under this agreement, the Company has committed to purchase all of its 328JET simulator time from PAIFA at agreed upon rates, with no minimum number of simulator hours guaranteed. A second 328JET simulator is scheduled for installation at the Washington-Dulles PAIFA simulator facility in July 2002.

The Company has committed to provide its senior executive officers a deferred compensation plan which utilizes split dollar life insurance policies, and for a certain officer, a make-whole provision for income taxes, post retirement salary based on ending salary, and post retirement benefits based on benefits similar to those currently provided to the executive while actively employed. The Company has estimated the cost of the deferred compensation and tax gross up feature, future salary and future benefits and is accruing this cost over the remaining required service time of the executive officers. In 2001, the Company expensed approximately \$1.8 million as the current year's cost of these benefits. The company expects to recognize similar costs annually over the remaining required service life of the senior executives.

In 1999, the Company commenced a replacement project of its computer software systems. The Company anticipates spending approximately \$11 million on this project, the majority of which will be capitalized and amortized over seven years. In 1999, the Company expensed approximately \$400,000 related to replacement software selection and capitalized \$2.3 million in acquisition and implementation costs. In 2000 and 2001, the Company capitalized an additional \$5.2 million and \$2.8 million of costs incurred, respectively, bringing the total capitalized costs to date to \$10.3 million. In October 2001, the Company implemented a new Payroll/Human Resource system as part of this project. The Company anticipates completing the remainder of this project in 2002.

The Company's Board of Directors has approved the purchase of up to \$40 million of the Company's outstanding common stock in open market or private transactions. As of March 1, 2002, the Company has purchased 2,128,000 shares of its common stock at an average price of \$8.64 per share. The Company has approximately \$21.6 million remaining of the \$40 million authorization. The Company has not repurchased shares of its common stock since February 2, 2000.

### **Inflation**

Inflation has not had a material effect on the Company's operations.

### **Critical Accounting Policies and Estimates**

The preparation of the Company's financial statements in conformity with generally accepted accounting principles requires Company management to make estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The U.S. Securities and Exchange Commission has defined a company's most critical accounting policies as the ones that are most important to the portrayal of the Company's financial condition and results, and which require the company to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Based on this definition, the Company has identified its critical accounting policies as including those addressed below. The Company also has other key accounting policies, which involve the use of estimates, judgments and assumptions. See Note 1 "Summary of Accounting Policies " in the Notes to Consolidated Financial Statements for additional discussion of these items. Management believes that its estimates and assumptions are reasonable, based upon information presently available; however, actual results may differ from these estimates under different assumptions or conditions.

*Revenue Recognition:* Under the proration-of-fare arrangement in effect with United until November of 2000, the Company recognized passenger revenue when a flight was completed. This required various estimates about passenger fares and other factors that were subject to subsequent adjustment and settlement with United and other carriers. Following certain changes in estimates, which resulted in adjustments in 2001, as, described in "Results of Operations", the Company does not expect any further adjustments attributable to the former proration-of-fare arrangement. Under the fee-per-departure and fee-per-block hour contracts currently in place with United and Delta, respectively, revenue is the product of the agreed upon

rate and the number of departures or the number of block hours flown. Rates are generally agreed to on an annual basis and are subject to adjustments upon certain specified events. In certain circumstances, the Company may be required to estimate these rates until final rates are agreed to by either United or Delta.

*Major maintenance costs:* The Company has executed long-term agreements with the engine manufacturers and other service providers covering the repair and overhaul of its engines, airframe and avionics components, and landing gear. These agreements generally include escalating rates per flight hour over the term of the agreement. The escalating rates are intended to reflect the approximate actual maintenance cost increases as the aircraft age. The Company expenses costs based upon the current rate per hour and the number of aircraft and engines hours for the period. As a result, maintenance costs for the Company's existing aircraft fleet are expected to increase in future years.

*Aircraft leases:* The majority of the Company's aircraft are leased from third parties. In order to determine the proper classification of a lease as either an operating lease or a capital lease, the Company must make certain estimates at the inception of the lease relating to the economic useful life and the fair value of an asset as well as select an appropriate discount rate to be used in discounting future lease payments. These estimates are utilized by management in making computations as required by existing accounting standards that determine whether the lease is classified as an operating lease or a capital lease. Substantially all of the Company's aircraft leases have been classified as operating leases, which results in rental payments being charged to expense over the terms of the related leases. Additionally, operating leases are not reflected in the balance sheet and accordingly, neither a lease asset nor an obligation for future lease payments are reflected in the Company's consolidated balance sheet.

*Aircraft Early Retirement Costs:* In determining the cost of the early retirement of leased aircraft (and thus in determining the amount of the aircraft early retirement charge), the Company must estimate, among other things, market lease rates, future sub-lease income, the cost of maintenance return provisions and the duration and cost of aircraft storage. The Company generally does not accrue for the costs of retiring leased aircraft more than one year before the planned date of removal from service, considering the potential for changes in plans and associated costs. As the associated leases may extend over several years, these costs estimates are subject to change.

### **Recent Accounting Pronouncements**

On July 5, 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 141, "Business Combinations", and Statement of Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets". Statement No. 141 addresses the accounting for acquisitions of businesses and is effective for acquisitions occurring on or after July 1, 2001. Statement No. 142 includes requirements to test goodwill and indefinite life intangible assets for impairment rather than amortize them. Statement No. 142 will be effective for fiscal years beginning after December 15, 2001. The Company will adopt Statement No. 142 beginning in the first quarter of 2002. The Company anticipates that implementation of SFAS 141 and SFAS 142 will have minimal impact on the Company's financial position or results of operations.

On October 3, 2001, the Financial Accounting Standards Board issued FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which addresses financial accounting and reporting for the impairment or disposal of long-lived assets. Statement No. 144 supersedes FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of and APB Opinion No. 30, Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions. Statement No. 144 includes requirements related to the classification of assets as held for sale, including the establishment of six criteria that must be satisfied prior to this classification. Statement No. 144 also includes guidance related to the recognition and calculation of impairment losses for long-lived assets. Statement No. 144 will be effective for fiscal years beginning after December 15, 2001. The Company will adopt Statement No. 144 beginning in the first quarter of 2002. The Company anticipates that implementation of Statement No. 144 will have minimal impact on the Company's financial position or results of operations.

### **Quantitative and Qualitative Disclosures About Market Risk**

The Company's principal market risk results in changes in interest rates.

The Company's exposure to market risk associated with changes in interest rates relates to the Company's commitment to acquire regional jets. From time to time the Company has entered into put and call contracts designed to limit the Company's exposure to interest rate changes until permanent financing is secured upon delivery of the Bombardier regional jet aircraft. During 1999 and 2000, the Company settled seven and eight hedge transactions, respectively, receiving \$119,000 in 1999 and paying the counterparty \$379,000 in 2000. In 1999, the Company recognized a gain of \$211,000 on the settlement of one contract, representing the ineffective portion of a hedge. At December 31, 2000 the Company had one interest rate hedge transaction open with a notional value of \$8.5 million. The Company settled this contract on January 3, 2001 by paying the counterparty \$722,000. The Company had no open hedge transactions at December 31, 2001.

As of March 1, 2002, the Company had firm commitments to purchase 68 additional jet aircraft. The Company expects to finance these commitments using a combination of debt and leveraged leases. Changes in interest rates will impact the actual cost to the Company for these transactions. Aircraft orders are also subject to price escalation formulas based on certain indices designed to reflect increased costs in the production of the aircraft. During 2001 the rate of escalation increased, and such increases will be reflected in future aircraft cost or lease rates. During the first quarter of 2002, the rate of escalation has remained constant.

The Company does not have significant exposure to changing interest rates on its long-term debt as the interest rates on such debt are fixed. The Company's interest rate on its \$25 million line of credit is dependent on LIBOR plus a percentage ranging from .875% to 1.375% depending on the Company's fixed charges coverage ratio. The Company does not hold long-term interest sensitive assets and therefore is not exposed to interest rate fluctuations for its assets. The Company does not purchase or hold any derivative financial instruments for trading purposes.

## **Independent Auditors' Report**

The Board of Directors and Stockholders  
Atlantic Coast Airlines Holdings, Inc.:

We have audited the accompanying consolidated balance sheets of Atlantic Coast Airlines Holdings, Inc. and subsidiaries as of December 31, 2000 and 2001, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2001. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Atlantic Coast Airlines Holdings, Inc. and subsidiaries as of December 31, 2000 and 2001, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, effective January 1, 1999, the Company changed its method of accounting for preoperating costs.

KPMG LLP

McLean, VA  
January 30, 2002, except as to Notes 1(f) and 13,  
which are as of March 29, 2002

# Atlantic Coast Airlines Holdings, Inc.

## Consolidated Balance Sheet

(In thousands, except for share data and par values)

December 31,	2000	2001
<b>Assets</b>		
<b>Current:</b>		
Cash and cash equivalents	\$ 86,117	\$ 173,669
Short term investments	35,100	7,300
Accounts receivable, net	29,052	8,933
Expendable parts and fuel inventory, net	6,188	10,565
Prepaid expenses and other current assets	8,055	19,365
Deferred tax asset	13,973	6,806
<b>Total current assets</b>	<b>178,485</b>	<b>226,638</b>
<b>Property and equipment at cost, net of accumulated depreciation and amortization</b>	<b>142,840</b>	<b>171,528</b>
<b>Intangible assets, net of accumulated amortization</b>	<b>2,045</b>	<b>1,941</b>
<b>Debt issuance costs, net of accumulated amortization</b>	<b>2,912</b>	<b>3,415</b>
<b>Aircraft deposits</b>	<b>46,420</b>	<b>44,810</b>
<b>Other assets</b>	<b>9,998</b>	<b>4,093</b>
<b>Total assets</b>	<b>\$ 382,700</b>	<b>\$ 452,425</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Current:</b>		
Current portion of long-term debt	\$ 4,344	\$ 4,639
Current portion of capital lease obligations	1,512	1,359
Accounts payable	19,724	21,750
Accrued liabilities	53,044	55,570
Accrued aircraft early retirement charge	27,843	4,661
<b>Total current liabilities</b>	<b>106,467</b>	<b>87,979</b>
<b>Long-term debt, less current portion</b>	<b>63,080</b>	<b>58,441</b>
<b>Capital lease obligations, less current portion</b>	<b>4,009</b>	<b>2,202</b>
<b>Deferred tax liability</b>	<b>18,934</b>	<b>17,448</b>
<b>Deferred credits, net</b>	<b>22,037</b>	<b>45,063</b>
<b>Accrued aircraft early retirement charge, less current portion</b>	<b>-</b>	<b>19,226</b>
<b>Other long-term liabilities</b>	<b>-</b>	<b>766</b>
<b>Total liabilities</b>	<b>214,527</b>	<b>231,125</b>
<b>Stockholders' equity:</b>		
Preferred Stock: \$.02 par value per share; shares authorized 5,000,000; no shares issued or outstanding in 2000 or 2001	-	-
Common stock: \$.02 par value per share; shares authorized 130,000,000; shares issued 47,704,720 in 2000 and 49,229,202 in 2001; shares outstanding 42,658,388 in 2000 and 44,182,870 in 2001	954	985
Class A common stock: nonvoting; no par value; \$.02 stated value per share; shares authorized 6,000,000; no shares issued or outstanding	-	-
Additional paid-in capital	117,284	136,058
Less: Common stock in treasury, at cost, 5,046,332 shares in 2000 and 2001	(35,303)	(35,303)
Retained earnings	85,238	119,560
<b>Total stockholders' equity</b>	<b>168,173</b>	<b>221,300</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$382,700</b>	<b>\$452,425</b>
<b>Commitments and Contingencies</b>		

See accompanying notes to consolidated financial statements

# Atlantic Coast Airlines Holdings, Inc.

## Consolidated Statements of Operations

(In thousands, except for per share data)

Years ended December 31,	1999	2000	2001
<b>Operating revenues:</b>			
Passenger	\$ 342,079	\$ 442,695	\$ 577,604
Other	5,286	9,831	5,812
<b>Total operating revenues</b>	<b>347,365</b>	<b>452,526</b>	<b>583,416</b>
<b>Operating expenses:</b>			
Salaries and related costs	84,554	107,831	164,446
Aircraft fuel	34,072	64,433	88,308
Aircraft maintenance and materials	24,357	36,750	48,478
Aircraft rentals	45,215	59,792	90,323
Traffic commissions and related fees	54,521	56,623	15,589
Facility rents and landing fees	17,875	20,284	32,025
Depreciation and amortization	9,021	11,193	15,353
Other	28,458	42,537	61,674
Aircraft early retirement charge	-	28,996	23,026
<b>Total operating expenses</b>	<b>298,073</b>	<b>428,439</b>	<b>539,222</b>
<b>Operating income</b>	<b>49,292</b>	<b>24,087</b>	<b>44,194</b>
<b>Other income (expense):</b>			
Interest expense	(5,614)	(6,030)	(4,832)
Interest income	3,882	5,033	7,500
Government compensation	-	-	9,710
Other income (expense), net	(85)	(278)	263
<b>Total other (expense) income, net</b>	<b>(1,817)</b>	<b>(1,275)</b>	<b>12,641</b>
<b>Income before income tax provision and cumulative effect of accounting change</b>	<b>47,475</b>	<b>22,812</b>	<b>56,835</b>
Income tax provision	18,319	7,657	22,513
Income before cumulative effect of accounting change	29,156	15,155	34,322
Cumulative effect of accounting change, net of income tax benefit of \$598	(888)	-	-
<b>Net income</b>	<b>\$ 28,268</b>	<b>\$ 15,155</b>	<b>\$ 34,322</b>
<b>Income per share:</b>			
Basic:			
Income before cumulative effect of accounting change	\$.77	\$.38	<b>\$.79</b>
Cumulative effect of accounting change	(.02)	-	-
Net income	<u>\$.75</u>	<u>\$.38</u>	<u><b>\$.79</b></u>
Diluted:			
Income before cumulative effect of accounting change	\$.68	\$.36	<b>\$.76</b>
Cumulative effect of accounting change	(.02)	-	-
Net income	<u>\$.66</u>	<u>\$.36</u>	<u><b>\$.76</b></u>
Weighted average shares used in computation:			
Basic	37,928	40,150	43,434
Diluted	44,030	43,638	45,210

See accompanying notes to consolidated financial statements.

# Atlantic Coast Airlines Holdings, Inc.

## Consolidated Statements of Stockholders' Equity

(In thousands, except for share data)

	Common Stock		Additional Paid-In Capital	Treasury Stock		Retained Earnings
	Shares	Amount		Shares	Amount	
<b>Balance December 31, 1998</b>	<b>41,642,002</b>	<b>\$ 833</b>	<b>\$ 84,798</b>	<b>2,945,000</b>	<b>\$ (17,069)</b>	<b>\$ 41,815</b>
Exercise of common stock options	525,852	10	1,574	-	-	-
Tax benefit of stock option exercise	-	-	1,835	-	-	-
Purchase of treasury stock	-	-	-	1,993,000	(17,192)	-
ESOP share contributions	-	-	60	(26,668)	155	-
Amortization of deferred compensation	-	-	437	-	-	-
Net income	-	-	-	-	-	28,268
<b>Balance December 31, 1999</b>	<b>42,167,854</b>	<b>\$ 843</b>	<b>\$ 88,704</b>	<b>4,911,332</b>	<b>\$ (34,106)</b>	<b>\$ 70,083</b>
Exercise of common stock options	1,132,432	23	3,919	-	-	-
Tax benefit of stock option exercise	-	-	4,952	-	-	-
Purchase of treasury stock	-	-	-	135,000	(1,197)	-
Conversion of debt	4,404,434	88	19,261	-	-	-
Amortization of deferred compensation	-	-	448	-	-	-
Net income	-	-	-	-	-	15,155
<b>Balance December 31, 2000</b>	<b>47,704,720</b>	<b>\$ 954</b>	<b>\$ 117,284</b>	<b>5,046,332</b>	<b>\$ (35,303)</b>	<b>\$ 85,238</b>
Exercise of common stock options	1,524,482	31	8,145	-	-	-
Tax benefit of stock option exercise	-	-	9,010	-	-	-
Amortization of deferred compensation	-	-	1,619	-	-	-
Net income	-	-	-	-	-	34,322
<b>Balance December 31, 2001</b>	<b>49,229,202</b>	<b>\$ 985</b>	<b>\$136,058</b>	<b>5,046,332</b>	<b>\$ (35,303)</b>	<b>\$119,560</b>

See accompanying notes to consolidated financial statements.

# Atlantic Coast Airlines Holdings, Inc.

## Consolidated Statements of Cash Flows

(In thousands)

Years ended December 31,

	1999	2000	2001
<b>Cash flows from operating activities:</b>			
Net income	\$ 28,268	\$ 15,155	\$ 34,322
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	9,109	11,544	16,179
Write-off of preoperating costs	1,486	-	-
Amortization of intangibles and preoperating costs	176	183	193
Provision for uncollectible accounts receivable	564	503	227
Provision for inventory obsolescence	110	237	578
Amortization of deferred credits	(1,114)	(1,599)	(3,662)
Amortization of debt issuance costs	354	297	293
Capitalized interest, net	(1,683)	(2,554)	(1,835)
Deferred tax provision (benefit)	5,905	(4,648)	5,681
Net loss on disposal of fixed assets	380	-	198
Amortization of debt discount and finance costs	73	56	61
Contribution of stock to the ESOP	214	-	-
Gain on ineffective hedge position	(211)	-	-
Gain on early termination of capital lease	(291)	(3)	-
Amortization of deferred compensation	437	469	1,619
Changes in operating assets and liabilities:			
Accounts receivable	(3,572)	6,564	25,148
Expendable parts and fuel inventory	(847)	(2,310)	(4,956)
Prepaid expenses and other current assets	(2,660)	(1,866)	(5,376)
Accounts payable	2,139	22,300	9,275
Accrued liabilities	11,013	49,601	10,100
<b>Net cash provided by operating activities</b>	<b>49,850</b>	<b>93,929</b>	<b>88,045</b>
<b>Cash flows from investing activities:</b>			
Purchases of property and equipment	(59,669)	(19,146)	(34,903)
Proceeds from sales of fixed assets	6,608	585	-
Purchases of short term investments	(17,550)	(74,705)	(76,715)
Sales of short term investments	66	57,155	104,515
Refund of deposits	3	4,600	11,100
Payments for aircraft and other deposits	(19,270)	(12,330)	(9,701)
<b>Net cash used in investing activities</b>	<b>(89,812)</b>	<b>(43,841)</b>	<b>(5,704)</b>
<b>Cash flows from financing activities:</b>			
Proceeds from issuance of long-term debt	37,203	-	-
Payments of long-term debt	(4,189)	(4,758)	(4,344)
Payments of capital lease obligations	(1,839)	(1,647)	(1,959)
Proceeds from receipt of deferred credits and other	37	173	4,286
Deferred financing costs	(157)	(381)	(948)
Proceeds from exercise of stock options	1,584	3,942	8,176
Purchase of treasury stock	(17,192)	(1,197)	-
<b>Net cash provided by (used in) financing activities</b>	<b>15,447</b>	<b>(3,868)</b>	<b>5,211</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>(24,515)</b>	<b>46,220</b>	<b>87,552</b>
<b>Cash and cash equivalents, beginning of year</b>	<b>64,412</b>	<b>39,897</b>	<b>86,117</b>
<b>Cash and cash equivalents, end of year</b>	<b>\$ 39,897</b>	<b>\$ 86,117</b>	<b>\$ 173,669</b>

See accompanying notes to consolidated financial statements.

# Notes to Consolidated Financial Statements

## 1. Summary of Accounting Policies

### (a) *Basis of Presentation*

The accompanying consolidated financial statements include the accounts of Atlantic Coast Airlines Holdings, Inc. (“ACAH”) and its wholly owned subsidiaries, Atlantic Coast Airlines (“ACA”) and Atlantic Coast Jet, Inc. (“ACJet”), (together, the “Company”). On July 1, 2001, ACAI combined the operations of its ACJet subsidiary into the operations of ACA. All significant intercompany accounts and transactions have been eliminated in consolidation. The Company’s flights are operated under code sharing agreements with United Airlines, Inc. (“United”) and Delta Airlines (“Delta”) and are identified as United Express and Delta Connection flights in computer reservation systems. As of December 31, 2001, the Company provided scheduled air transportation service as United Express for passengers to destinations in states in the Eastern and Midwestern United States. The Company provides scheduled air transportation service as Delta Connection to various destinations in the Eastern United States and Canada.

### (b) *Cash, Cash Equivalents and Short-Term Investments*

The Company considers investments with an original maturity of three months or less when purchased to be cash equivalents. Investments with an original maturity greater than three months and less than one year are considered short-term investments. In addition, the Company holds investments in tax-free Industrial Revenue Bonds (“IRB”) having initial maturities up to 30 years. The IRB’s are secured by letters of credit or insured and come up for auction on a weekly or monthly basis. As such, the Company considers securities of this type to be short-term investments. All short-term investments are considered to be available for sale. Due to the short maturities associated with the Company’s investments, the amortized cost approximates fair market value. Accordingly, no adjustment has been made to record unrealized holding gains and losses.

### (c) *Airline Revenues*

Passenger revenues are recorded as operating revenues at the time transportation is provided. Under the Company’s fee-per-departure and fee-per-block hour agreements, transportation is considered provided when the flight has been completed. Under the proration of fare agreement in effect with United for periods prior to and through November 2000, transportation was considered provided when the passenger flew. All of the passenger tickets used by the Company’s revenue passengers are sold by other air carriers.

ACA participates in United’s Mileage Plus frequent flyer program and in the Delta SkyMiles frequent flyer program. The Company does not accrue for incremental costs for mileage accumulation or redemption relating to these programs because the Company operates under agreements with United and Delta, which are not affected by the number of miles earned by its passengers or number of passengers on its flights redeeming miles.

### (d) *Accounts and Notes Receivable*

Accounts receivable are stated net of allowances for uncollectible accounts of approximately \$755,000 and \$595,000 at December 31, 2000 and 2001, respectively. Amounts charged to expenses for uncollectible accounts in 1999, 2000 and 2001 were \$564,000, \$503,000 and \$227,000, respectively. Write-off of accounts receivable were \$156,000, \$521,000 and \$386,000 in 1999, 2000 and 2001, respectively. Accounts receivable as of December 31, 2000 and 2001 included ticket receivables of \$18.6 million and \$1.3 million respectively, and approximately \$5.6 million and \$4.4 million, respectively, related to manufacturers credits to be applied towards future spare parts purchases and training expenses. The large decrease in ticket receivables is due to the change in the United Express agreement from a proration-of-fare arrangement to a fee-per-departure arrangement as described herein.

(e) *Concentrations of Credit Risk*

Substantially all of the Company's passenger tickets are sold by other air carriers. Prior to the change from a proration of fare agreement to a fee-per-departure agreement, the Company had a significant concentration of its accounts receivable with other air carriers with no collateral. At December 31, 2000 and 2001, accounts receivable from air carriers totaled approximately \$18.6 million and \$929,000, respectively. Of the total amount, approximately \$13.3 million and \$240,000 at December 31, 2000 and 2001, respectively, were due from United. Under the fee-per-departure agreements, the Company receives payment in advance from both United and Delta. Historically, accounts receivable losses have not been significant.

(f) *Risks and Uncertainties*

The events of September 11, together with the slowing economy throughout 2001, have significantly affected the U.S. airline industry. These events have resulted in changed government regulation, declines and shifts in passenger demand, increased insurance costs and tightened credit markets which continue to affect the operations and financial condition of participants in the industry including the Company, its code share partners, and aircraft manufacturers. These circumstances have raised substantial risks and uncertainties, including those discussed below, which may impact the Company, its code share partners, and aircraft manufacturers, in ways that the is not currently able to predict.

United Express:

The Company's United Express Agreements ("UA Agreements") define the Company's relationship with United. The UA Agreements authorize the Company to use United's "UA" flight designator code to identify the Company's flights and fares in the major airline Computer Reservation Systems, including United's "Apollo" reservation system, to use the United Express logo, to use United's exterior aircraft paint schemes, and to use uniforms similar to those of United.

In November 2000, the Company and United restated the UA Agreements, effectively changing from a prorated fare arrangement to a fee-per-departure arrangement. Under the fee-per-departure structure, the Company is contractually obligated to operate the flight schedule, for which United pays the Company an agreed amount per departure regardless of the number of passengers carried, with incentive payments based on operational performance. The Company thereby assumes the risks associated with operating the flight schedule and United assumes the risk of scheduling, marketing, and selling seats to the traveling public. The restated UA Agreements are for a term of ten years. The restated UA Agreements give ACA the authority to operate 128 regional jets in the United Express operation. Pursuant to the restated UA Agreements, United provides a number of additional services to ACA at no cost. These include customer reservations, customer service, pricing, scheduling, revenue accounting, revenue management, frequent flyer administration, advertising, provision of ground support services at most of the airports served by both United and ACA, provision of ticket handling services at United's ticketing locations, and provision of airport signage at airports where both ACA and United operate.

The UA Agreements do not prohibit United from serving, or from entering into agreements with other airlines who would serve, routes served by the Company, but state that United may terminate the UA Agreements if ACAI or ACA enter into a similar arrangement with any other carrier other than Delta or a replacement for Delta without United's prior written approval. The UA Agreements limit the ability of ACAI and ACA to merge with another company or dispose of certain assets or aircraft without offering United a right of first refusal to acquire the Company or such assets or aircraft, and provide United a right to terminate the UA Agreements if ACAI or ACA merge with or are controlled or acquired by another carrier. The UA agreements provide United with the right to assume ACA's ownership or leasehold interest in certain aircraft in the event ACA breaches specified provisions of the UA agreements, or fails to meet specified performance standards. The UA Agreements call for the resetting of fee-for-departure rates annually based on the Company's planned level of operations for the upcoming year.

UAL Corporation, the parent of United, has disclosed that during the fourth quarter 2001 it began implementing a financial recovery plan that includes four planks: reducing the size of the airline and cutting capital and operating spending in line with that reduction, generating as much revenue as possible from each flight, working with its unions and other employee groups to find further labor savings and implementing a financing plan to support it through the execution of its financial recovery plan. UAL Corporation further disclosed that the impact of the events of September 11, 2001 on United and the sufficiency of its financial resources to absorb that impact are dependent on a number of factors, including United's success in implementing its financial recovery plan.

Following September 11, United requested that the Company propose measures that it could take to assist in improving United's financial situation. The Company believes that United made a similar request to other suppliers and vendors. On December 31, 2001, the Company and United agreed on fee-per-departure rates to be utilized during 2002. In addition, in the context of reaching this agreement, the Company agreed to certain concessions that would benefit United by (1) settling various existing contract issues, (2) agreeing that United would not have to pay increased rates to reflect utilization changes in the fourth quarter of 2001, (3) agreeing to 2002 rates that require aggressive cost containment, and (4) reaffirming its commitment to retire the Company's J-41 turboprop aircraft. The Company determined that these concessions, which were favorable to United as compared to prior contractual arrangements and were designed to assist United in its financial recovery plan, were appropriate in light of the circumstances at the time.

In late March 2002, United informed the Company that an essential component of its financial recovery plan includes obtaining cost reductions from its employees, suppliers and partners, and that United is seeking the Company's assistance in decreasing the cost of the Company's product and achieving cash flow improvements for United over the next 24 months. The Company has commenced discussions with United regarding opportunities for reducing its costs or creating value to address United's financial situation. The basis for, nature, timing and extent of any such actions has not been agreed. While the Company has expressed its willingness to work with United to find mutually acceptable opportunities, the Company believes that it is not contractually obligated to make any such changes under the United Express Agreements or the December 31, 2001 rate setting agreement.

Delta Connection:

In September 1999, the Company reached a ten-year agreement with Delta to operate regional jet aircraft as part of the Delta Connection program on a fee-per-block hour basis. The Company began Delta Connection revenue service on August 1, 2000. The Company's Delta Connection Agreement ("DL Agreement") defines the Company's relationship with Delta. The Company is compensated by Delta on a fee-per-block hour basis. Under the fee-per-block hour structure, the Company is contractually obligated to operate the flight schedule, for which Delta pays the Company an agreed amount per block hour flown regardless of passenger revenue with additional incentive payments based on operational performance. The Company thereby assumes the risks associated with operating the flight schedule and Delta assumes the risks of scheduling, marketing, and selling seats to the traveling public. By operating as part of the Delta Connection program, the Company is able to use Delta's "DL" flight designator to identify ACA's flights and fares in the major Computer Reservation Systems, including Delta's "Deltamatic" reservation system, and to use the Delta Connection logo and exterior aircraft paint schemes and uniforms similar to those of Delta.

Due to the rapid increase in fleet size during 2001, the Company and Delta agreed to compensation based on a cost plus formula based on reimbursement of fixed amounts for initial pilot training expenses and for all other costs, based on actual costs incurred, plus a contracted margin, and incentive compensation tied to operating performance. The Company and Delta have agreed to return to a fee-per-block hour rate arrangement for 2002. The Company and Delta are currently setting these rates based on the Company's planned level of operations for the upcoming year. The Company does not anticipate material differences on a per-block-hour basis for its 2002 revenues as compared to 2001 revenues due to the reversion to a fee-per-block-hour rate.

Pursuant to the DL Agreement, Delta, at its expense, provides a number of support services to ACA. These include customer reservations, customer service, ground handling, station operations, pricing, scheduling, revenue accounting, revenue management, frequent flyer administration, advertising and other passenger, aircraft and traffic servicing functions in connection with the ACA operation. Delta may terminate the DL Agreement at any time if the Company fails to maintain certain performance standards and, subject to certain rights of the Company and by providing 180 days notice to the Company, may terminate without cause, effective no earlier than August 1, 2002. If Delta terminates the Delta agreement without cause prior to March 2010, the Company has the right to put all or some of the Delta Connection aircraft to Delta. In January 2001, the Company reached an agreement with United and Delta to place 20 Bombardier Canadair Regional Jets ("CRJ's") originally ordered for the Delta Connection program in the United Express program. The DL Agreement requires the Company to obtain Delta's approval if it chooses to enter into a code-sharing arrangement with another carrier other than a replacement for United, to list its flights under any other code, or to operate flights for any other carrier, except with respect to such arrangements with United or non-U.S. code-share partners of United or in certain other circumstances. The DL Agreement does not prohibit Delta from serving, or from entering into agreements with other airlines who would serve, routes flown by the Company. The DL Agreement also restricts the ability of the Company to dispose of aircraft subject to the agreement without offering Delta a right of first refusal to acquire such aircraft, and provides that Delta may extend or terminate the agreement if, among other things, the Company merges with or sells its assets to another entity, is acquired by another entity or if any person acquires more than a specified percentage of its stock.

At December 31, 2001 54 CRJs, and 31 British Aerospace J-41's ("J-41's") were operated under the United Express program and 29 Fairchild-Dornier 328 Jets ("328JET's") and three CRJs were operated under the Delta Connection program. For the year ended December 31, 2001, 82% of consolidated revenues were derived from the United Express program and 18% of consolidated revenues were derived from the Delta Connection program. Following the terrorist attacks on September 11, 2001, the major U.S. airlines have suffered substantial losses and continued losses are expected until passenger traffic levels substantially recover. Notwithstanding that the terms of the Company's agreements with its major U.S. airline partners, as described above, extend several years into the future, the near term loss of either of the Company's code share agreements would, unless replaced by a similar agreement with another carrier, likely have a material adverse impact on the Company financial position and operating results.

Fairchild Dornier Purchase Agreement:

Fairchild Dornier, the manufacturer of the 328JET, recently stated that it has an immediate and critical need for additional funding, and that it is in discussions with several potential strategic partners regarding proposed investments. The Company is unable to predict whether Fairchild Dornier will be successful in finding additional capital or in otherwise restructuring its finances, but believes that Fairchild Dornier may be forced to seek bankruptcy protection if it is unsuccessful in its efforts. In the event of a Fairchild Dornier bankruptcy, Fairchild Dornier could either sell, liquidate or reorganize some or all of its businesses, and in the event of a reorganization or sale of its businesses would have the right to assume or reject future contractual obligations. Should Fairchild Dornier be unable to deliver ordered 328JETS, the Company would reassess available alternatives in pursuing its growth strategy and possibly delay the Company's turboprop retirement plans, and adjust other plans discussed elsewhere in this Form 10-K relating to its 328JET aircraft.

Fairchild Dornier has significant future obligations to the Company in connection with the order of 328JET aircraft. These include obligations: to deliver 32 firm ordered 328JETs and 81 additional option 328JETs with certain financing support; to pay the Company any difference between the lease payments, if any, received from remarketing the 26 J-41 aircraft leased by the Company and the lease payment obligations of the Company on those aircraft; to purchase five J-41 aircraft owned by the Company at their net book value at the time of retirement; to assume certain crew training costs; and, to provide spares, warranty, engineering, and related support. Fairchild Dornier has delayed the delivery of one 328JET that was scheduled to be delivered to the Company during the week of March 25, 2002 for reasons connected with its financing. The Company believes it has secured rights to Fairchild Dornier's equity interest in the delivered 328JETs that it may proceed against in the event that Fairchild Dornier fails to fulfill certain of these obligations.

During the fourth quarter of 2001, the Company recorded a pre-tax aircraft early retirement charge of \$23.5 million for the early retirement of nine leased Jetstream-41 turboprop aircraft, which the Company plans to remove from service prior to year-end 2002. The Company anticipates taking additional charges during 2002 of approximately \$48.0 million pre-tax for the retirement of its remaining 29-seat Jetstream-41 turboprop aircraft. The undiscounted remaining lease obligations (net of the Company's estimate of the future sublease rentals) on the J-41 fleet after planned retirement dates in 2002 and 2003 are approximately \$55 million and continue through 2010 and the book value of the five owned J-41 aircraft as of March 1, 2002 is \$18.1 million. To the extent that Fairchild Dornier fulfills its contractual obligations, the majority of the aircraft early retirement charge will not adversely affect the Company's cash position, with the payments by Fairchild Dornier being recorded as an aircraft purchase inducement on the 328JET aircraft. The Company would remain liable for the lease payments on its J-41 aircraft and thus be required to pay the remaining lease payments if, and to the extent that, Fairchild Dornier were to default on its obligation.

#### Collective Bargaining Agreements:

The Company's pilots are represented by the Airline Pilots Association ("ALPA"), flight attendants are represented by the Association of Flight Attendants ("AFA"), and aviation maintenance technicians and ground service equipment mechanics are represented by the Aircraft Mechanics Fraternal Association ("AMFA").

The ALPA collective bargaining agreement became amendable in February 2000 and in early 2001, the Company's pilots ratified a new four-and-a-half year agreement in effect until August 2005. This agreement provides for improvements in pay rates, benefits, training and other areas. The collective bargaining agreement covers pilots flying for both the Atlantic Coast Airlines/United Express operation, as well as the Atlantic Coast Airlines/Delta Connection operation. The new agreement provides for substantial increases in pilot compensation, which the Company believes are consistent with regional airline industry trends.

ACA's collective bargaining agreement with AFA was ratified in October 1998. The agreement is for a four-year duration and becomes amendable in October 2002.

The collective bargaining agreement with AMFA was ratified in June 1998. The agreement is for a four-year duration and becomes amendable in June 2002. This agreement covers all aviation maintenance technicians and ground service equipment mechanics working for the Company.

#### Aviation Insurance

Following the September 11 terrorist attacks, the aviation insurance industry imposed a worldwide surcharge on aviation insurance rates as well as a reduction in coverage for certain war risks. In response to the reduction in coverage, the Air Transportation Safety and System Stabilization Act provided U.S. air carriers with the option to purchase certain war risk liability insurance from the United States government on an interim basis at rates that are more favorable than those available from the private market. Prior to September 11, it was not customary for independent regional airlines to carry general war risk insurance. Since September 11, the Company has purchased hull war risk coverage through the private insurance market through September 24, 2002, and has purchased liability war risk coverage from the U.S. government through May 19, 2002 and anticipates renewing the government insurance for as long as the coverage is available.

The airlines and insurance industry, together with the United States and other governments, are continuing to evaluate both the cost and options for providing coverage of aviation insurance. Recently, an industry-led group announced a proposal to create a mutual insurance company, to be called Equitime, to cover war risk and terrorism risk, which would initially seek support through government guarantees. Equitime would provide a competitive alternative to insurance being offered by the traditional insurance market, which opposes this initiative. Equitime's organizers project that it may be available to provide insurance as early as May 2002 to up to 70 U.S. carriers. The Company has not been actively involved in the formation of Equitime and is unable to anticipate whether this source of insurance will be made available and, if so, whether it will offer competitive rates. The Company anticipates that it will follow industry practices with respect to sources of insurance.

#### *(g) Use of Estimates*

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make certain estimates and assumptions regarding valuation of assets, recognition of liabilities for costs such as aircraft maintenance, differences in timing of air traffic billings from United and other airlines, operating revenues and expenses during the period and disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Actual results could differ from those estimated.

(h) *Expendable Parts*

Expendable parts and supplies are stated at the lower of cost or market, less an allowance for obsolescence of \$665,000 and \$1.2 million as of December 31, 2000 and 2001, respectively. Expendable parts and supplies are charged to expense as they are used. Amounts charged to costs and expenses for obsolescence in 1999, 2000 and 2001 were \$110,000, \$237,000 and \$578,000, respectively.

(i) *Property and Equipment*

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets that range from five to sixteen and one half years. Capital leases and leasehold improvements are amortized over the shorter of the estimated life or the remaining term of the lease.

Amortization of capital leases and leasehold improvements is included in depreciation expense.

The Company periodically evaluates whether events and circumstances have occurred which may impact the remaining estimated useful life or the recoverability of the remaining carrying value of its long-lived assets. If such events or circumstances were to indicate that the carrying amount of these assets would not be recoverable, the Company would estimate the future cash flows expected to result from the use of the assets and their eventual disposition. If the sum of the expected future cash flows (undiscounted and without interest charges) is less than the carrying amount of the asset, an impairment loss would be recognized by the Company.

(j) *Preoperating Costs*

Preoperating costs represent the cost of integrating new types of aircraft. Prior to 1999, such costs, which consist primarily of flight crew training and aircraft ownership related costs, were deferred and amortized over a period of four years on a straight-line basis. The American Institute of Certified Public Accountants issued Statement of Position 98-5 ("SOP 98-5") on accounting for start-up costs, including preoperating costs related to the introduction of new fleet types by airlines.

During 1997 the Company capitalized approximately \$2.1 million of these costs related to the introduction of the regional jet ("CRJ") into the Company's fleet. Accumulated amortization of preoperating costs at December 31, 1998 was \$571,000. On January 1, 1999, the Company wrote-off the remaining unamortized preoperating costs balance of approximately \$1.5 million, before income tax benefit of \$598,000, in accordance with the implementation of SOP 98-5. Also, in accordance with SOP 98-5, approximately \$2.2 million of preoperating costs incurred during 1999 and approximately \$5.6 million of preoperating costs incurred during 2000 for the start up of ACJet were expensed as incurred.

(k) *Intangible Assets*

Goodwill of approximately \$3.2 million, representing the excess of cost over the fair value of net assets acquired in the acquisition of ACA, is being amortized by the straight-line method over twenty years. Costs incurred to acquire slots are being amortized by the straight-line method over twenty years. The primary financial indicator used by the Company to assess the recoverability of its intangible assets is undiscounted future cash flows from operations. The amount of impairment, if any, is measured based on projected future cash flows using a discount rate reflecting the Company's average cost of funds. Accumulated amortization of intangible assets at December 31, 2000 and 2001 was \$1.6 million and \$1.8 million, respectively.

In accordance with Statement of Financial Accounting Standards No. 142, (see Footnote 16), which the Company will adopt as of January 1, 2002, the Company will no longer recognize amortization of its goodwill and slots for 2002 and future years.

(l) *Maintenance*

The Company has executed long term agreements with the engine manufacturers and other service providers covering repair and overhaul of its engines, airframe and avionics components, and landing gear. These agreements call for an escalating rate per hour flown over the life of the agreement. The Company's maintenance accounting policy is to expense amounts based on the current rate as the aircraft are flown. Prior to the execution of these long-term maintenance agreements, the Company's maintenance policy was a combination of expensing certain events as incurred and accruing for certain maintenance events at rates it estimated would be sufficient to cover maintenance cost for the aircraft.

In 2000, the Company executed a seven-year engine services agreement with GE Engine Services, Inc. ("GE") covering the scheduled and unscheduled repair of ACA's CRJ jet engines, operated on the 43 CRJs already delivered or on order for the United Express operation. This agreement was amended in July 2000 to cover 23 additional CRJ aircraft, bringing the total number of CRJ aircraft covered under the agreement to 66. Under the terms of the agreement, the Company pays a set dollar amount per engine hour flown on a monthly basis to GE and GE assumes the responsibility to repair the engines when required at no additional expense to the Company, subject to certain exclusions. The Company expenses the amount paid to GE based on the monthly rates stipulated in the agreement, as engine hours are flown. The Company's future maintenance expense on CRJ engines covered under the new agreement will escalate based on contractual rate increases, intended to match the timing of actual maintenance events that are due pursuant to the terms. The Company has signed a similar agreement covering engines for up to 80 328JETs with Pratt & Whitney.

Effective September 2001, the Company entered a sixteen year maintenance agreement with Air Canada covering maintenance, repair and overhaul services for airframe components on its CRJ aircraft. Under the terms of this agreement, the Company pays a varying amount per flight hour each month, based on the age of the aircraft. The Company expenses the amount paid to Air Canada based on the rates stipulated in the agreement and the hours flown each month.

Effective January 2001, the Company entered into an agreement with BAE Systems Holdings, Inc. covering repair and overhaul of airframe rotatable parts on the Company's J-41 aircraft through the remaining service life of the J-41 fleet. Under the terms of this agreement, the Company pays a fixed amount per flight hour each month. The Company expenses the amount paid to BAE Systems Holdings, Inc. based on the rates stipulated in the agreement and the hours flown each month.

During the third quarter of 1999, the Company reversed approximately \$1.5 million in life limited parts repair expense accruals related to CRJ engines that are no longer required based on the maintenance services and terms contained in the GE engine maintenance agreement.

(m) *Deferred Credits*

The Company accounts for incentives provided by the aircraft manufacturers as deferred credits for leased aircraft. These credits are amortized on a straight-line basis as a reduction to lease expense over the respective lease term. The incentives are credits that may be used to purchase spare parts, pay for training expenses, or be applied against future rental payments.

(n) *Income Taxes*

The Company accounts for income taxes using the asset and liability method. Under the asset and liability method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts for existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in future years in which those temporary differences are expected to be recovered or settled.

(o) *Stock-Based Compensation*

The Company accounts for its stock-based compensation plans using the intrinsic value method prescribed under Accounting Principles Board (APB) No. 25. As such, the Company records compensation expense for stock options and awards only if the exercise price is less than the fair market value of the stock on the measurement date.

(p) *Income Per Share*

Basic income per share is computed by dividing net income by the weighted average number of common shares outstanding. Diluted income per share is computed by dividing net income by the weighted average number of common shares outstanding and common stock equivalents, which consist of shares subject to stock options computed using the treasury stock method. In addition, dilutive convertible securities are included in the denominator while interest on convertible debt, net of tax, is added back to the numerator. On January 25, 2001, the Company announced a 2-for-1 common stock split payable as a stock dividend on February 23, 2001 to shareholders of record on February 9, 2001. All share and income per share information has been adjusted for all years presented to reflect the stock split.

A reconciliation of the numerator and denominator used in computing income per share is as follows (in thousands, except per share amounts):

	<u>1999</u>		<u>2000</u>		<u>2001</u>	
	Basic	Diluted	Basic	Diluted	Basic	Diluted
Share calculation:						
Average number of common shares						
Outstanding	37,928	37,928	40,150	40,150	43,434	43,434
Incremental shares due to assumed						
exercise of options	-	1,698	-	1,616	-	1,776
Incremental shares due to assumed						
conversion of convertible debt	-	4,404	-	1,872	-	-
Weighted average common shares						
Outstanding	<u>37,928</u>	<u>44,030</u>	<u>40,150</u>	<u>43,638</u>	<u>43,434</u>	<u>45,210</u>
Adjustments to net income:						
Income before cumulative effect						
of accounting change	\$ 29,156	\$ 29,156	\$ 15,155	\$ 15,155	\$ 34,322	\$ 34,322
Cumulative effect of accounting						
change, net of income tax	(888)	-	-	-	-	-
Interest expense on convertible debt,						
net of tax	-	831	-	416	-	-
Net Income	<u>\$ 28,268</u>	<u>\$ 29,987</u>	<u>\$ 15,155</u>	<u>\$ 15,571</u>	<u>\$ 34,322</u>	<u>\$ 34,322</u>
Net Income per share	\$ .75	\$ .66	\$ .38	\$ .36	\$ .79	\$ .76

- (q) *Reclassifications*  
 Certain prior year amounts as previously reported have been reclassified to conform to the current year presentation.
- (r) *Interest Rate Hedges*  
 The Company has periodically used swaps to hedge the effects of fluctuations in interest rates associated with aircraft financings. These transactions meet the requirements for current hedge accounting. The effective portions of hedging gains and losses resulting from the interest rate swap contracts are deferred until the contracts are settled and then amortized over the aircraft lease term or capitalized as part of acquisition cost, if purchased, and depreciated over the life of the aircraft. The ineffective portions of hedging gains and losses are recorded as incurred.
- (s) *Segment Information*  
 The Company has adopted SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information." The statement requires disclosures related to components of a company for which separate financial information is available that is evaluated regularly by a company's chief operating decision maker in deciding the allocation of resources and assessing performance. The Company is engaged in one line of business, the scheduled and chartered transportation of passengers, which constitutes nearly all of its operating revenues.

## 2. Property and Equipment

Property and equipment consist of the following:

<i>(in thousands)</i>		
<i>December 31,</i>	2000	2001
Owned aircraft and improvements	\$ 92,931	\$ <b>92,562</b>
Improvements to leased aircraft	5,771	<b>6,782</b>
Flight equipment, primarily rotatable spare parts	51,199	<b>82,372</b>
Maintenance and ground equipment	9,310	<b>10,971</b>
Computer hardware and software	11,345	<b>14,314</b>
Furniture and fixtures	1,329	<b>2,120</b>
Leasehold improvements	4,282	<b>7,887</b>
	176,167	<b>217,008</b>
Less: Accumulated depreciation and amortization	33,327	<b>45,480</b>
	\$ 142,840	\$ <b>171,528</b>

In 1999, the Company commenced a replacement project of its computer software systems. The Company anticipates spending approximately \$11 million on this project, the majority of which will be capitalized and amortized over seven years. In 1999, the Company expensed approximately \$400,000 related to replacement software selection and capitalized \$2.3 million in acquisition and implementation costs. In 2000 and 2001, the Company capitalized an additional \$5.2 million and \$2.8 million of costs incurred, respectively, bringing the total capitalized costs to date to \$10.3 million.

### 3. Accrued Liabilities

Accrued liabilities consist of the following:

<i>(in thousands)</i>		
<i>December 31,</i>	<b>2000</b>	<b>2001</b>
Payroll and employee benefits	\$ 13,038	\$ <b>20,385</b>
Air traffic liability	3,075	<b>2,534</b>
Interest	1,021	<b>949</b>
Aircraft rents	8,109	<b>6,765</b>
Passenger related expenses	9,692	<b>6,075</b>
Maintenance costs	2,880	<b>1,266</b>
Fuel	7,049	<b>4,595</b>
Other	8,180	<b>13,001</b>
	<b>\$ 53,044</b>	<b>\$ 55,570</b>

### 4. Debt

On September 28, 2001, the Company entered into an asset-based lending agreement with a financial institution that provided the Company with a line of credit for up to \$25 million. The new line of credit, which will expire on October 15, 2003, replaced a previous \$35 million line of credit. The interest rate on this line is LIBOR plus .875% to 1.375% depending on the Company's fixed charges coverage ratio. As of December 31, 2001, the Company's interest rate on its line of credit was 3.0%. The Company has pledged \$15.3 million of this line of credit as collateral for letters of credit issued on behalf of the Company by a financial institution. The available borrowing under the line of credit is limited to the value of the bond letter of credit on the Company's Dulles, Virginia hangar facility plus the value of 60% of the book value of certain rotatable spare parts. As of December 31, 2001 the amount of available credit under the line was \$9.7 million. As of December 31, 2001 there were no outstanding borrowings on the \$25 million line of credit.

In July 1997, the Company issued \$57.5 million aggregate principal amount of 7% Convertible Subordinated Notes due July 1, 2004 ("the Notes"). The Notes were convertible into shares of Common Stock unless previously redeemed or repurchased, at a conversion price of \$4.50 per share, subject to certain adjustments. During 1998, approximately \$37.7 million of the notes were converted into approximately 8.5 million shares of common stock. Interest on the Notes was payable on April 1 and October 1 of each year. On May 15, 2000, the Company called the remaining \$19.8 million principal amount of Notes outstanding, for redemption at 104% of face value effective July 3, 2000. The Noteholders elected to convert all of the Notes into common stock and approximately 4.4 million shares were issued in exchange for the Notes during the period May 25, 2000 to June 6, 2000, resulting in an addition to paid in capital of approximately \$19.8 million partially offset by a reduction of approximately \$471,000 for the unamortized debt issuance costs relating to the Notes in connection with their conversion.

In September 1997, approximately \$112 million of pass through certificates were issued in a private placement by separate pass through trusts, which purchased with the proceeds, equipment notes (the "Equipment Notes") issued in connection with (i) leveraged lease transactions relating to four J-41s and six CRJs, all of which were leased to the Company (the "Leased Aircraft"), and (ii) the financing of four J-41s owned by the Company (the "Owned Aircraft"). The Equipment Notes issued with respect to the Owned Aircraft are direct obligations of ACA, guaranteed by ACAI and are included as debt obligations in the accompanying consolidated financial statements. The Equipment Notes issued with respect to the Leased Aircraft are not obligations of ACA or guaranteed by ACAI.

Long-term debt consists of the following: *(in thousands)*

<i>December 31,</i>	2000	2001
Equipment Notes associated with Pass Through Trust Certificates, due January 1, 2008 and January 1, 2010, principal payable annually through January 1, 2006 and semi-annually thereafter through maturity, interest payable semi-annually at 7.49% throughout term of notes, collateralized by four J-41 aircraft.	13,304	12,262
Notes payable to institutional lenders, due between October 23, 2010 and May 15, 2015, principal payable semiannually with interest ranging from 5.65% to 7.63% through maturity, collateralized by four CRJ aircraft.	50,952	48,096
Note payable to institutional lender, due October 2, 2006, principal payable semiannually with interest at 6.56%, collateralized by one J-41 aircraft.	3,168	2,722
<b>Total</b>	<b>67,424</b>	<b>63,080</b>
Less: Current Portion	4,344	4,639
	<b>\$63,080</b>	<b>\$58,441</b>

As of December 31, 2001, maturities of long-term debt are as follows:  
*(in thousands)*

2002	\$ 4,639
2003	4,900
2004	5,153
2005	6,019
2006	5,936
Thereafter	36,433
	<b>\$63,080</b>

The Company has various financial covenant requirements associated with its debt and United marketing agreements. These covenants require the Company to meet certain financial ratio tests, including tangible net worth, net earnings, current ratio and debt service levels.

## 5. Obligations Under Capital Leases

The Company leases certain equipment for noncancellable terms of more than one year. The net book value of the equipment under capital leases at December 31, 2000 and 2001 is \$5.5 million and \$3.6 million, respectively. The leases were capitalized at the present value of the lease payments. The weighted average interest rate for these leases is approximately 7.6 %.

At December 31, 2001, the future minimum payments, by year and in the aggregate, together with the present value of the net minimum lease payments, are as follows:

*(in thousands)*

*Year Ending December 31,*

2002	\$ 1,584
2003	1,565
2004	772
Total future minimum lease payments	3,921
Amount representing interest	360
Present value of minimum lease payments	3,561
Less: Current maturities	1,359
	<b>\$ 2,202</b>

## 6. Operating Leases

Future minimum lease payments under noncancellable operating leases at December 31, 2001 are as follows:

*(in thousands)*

<i>Year ending December 31,</i>	<i>Aircraft</i>	<i>Other</i>	<i>Total</i>
2002	\$ 120,914	\$ 7,236	\$ 128,150
2003	112,841	7,297	120,138
2004	116,945	7,297	124,242
2005	115,559	7,094	122,653
2006	113,565	7,042	120,607
Thereafter	940,188	45,431	985,619
Total minimum lease payments	\$ 1,520,012	\$ 81,397	\$ 1,601,409

Certain of the Company's leases require aircraft to be in a specified maintenance condition at lease termination or upon return of the aircraft.

The Company's lease agreements generally provide that the Company pays taxes, maintenance, insurance and other operating expenses applicable to leased assets. Operating lease expense was \$56.2 million, \$70.8 million, and \$107.4 million for the years ended December 31, 1999, 2000, and 2001, respectively.

## 7. Stockholders' Equity

### *Stock Splits*

On January 25, 2001, the Company announced a 2-for-1 common stock split payable as a stock dividend on February 23, 2001 to shareholders of record on February 9, 2001. The effect of this stock split is reflected in the accompanying financial statements, calculation of income per share, and stock option table presented below as of and for the years ended December 31, 1999, 2000 and 2001.

### *Stock Option Plans*

The Company's 1992 Stock Option Plan has 3.0 million shares of which a majority had been granted by 1995. The Company's 1995 Stock Incentive Plan has 5.0 million shares of which the majority had been granted by year-end 1999. In 2000, the Company's shareholders approved a new 2000 Stock Incentive Plan for 4.0 million shares. These three shareholder approved plans provide for the issuance of incentive stock and non qualified stock options to purchase common stock of the Company and restricted stock awards to certain employees and directors of the Company. In addition, during 2000 the Company's Board of Directors approved stock option programs for an additional 2.4 million shares. The Board approved programs provide for the issuance of non-qualified stock options to purchase common stock of the Company and restricted stock awards to certain employees. Executive officers and directors of the Company are not eligible to participate in the Board authorized stock option programs. Under the plans and programs, options are granted by the Chief Executive Officer of the Company with approval from the Compensation Committee of the Board of Directors and vest over a period ranging from three to five years.

A summary of the status of the Company's stock option plan awards, including restricted stock awards as of December 31, 1999, 2000, and 2001 and changes during the periods ending on those dates is presented below:

	<u>1999</u>		<u>2000</u>		<u>2001</u>	
	Shares	Weighted-average exercise price	Shares	Weighted-average exercise price	Shares	Weighted-average exercise price
Options outstanding at beginning of year	3,719,798	\$ 3.76	4,445,642	\$ 6.14	<b>4,576,994</b>	<b>\$ 8.57</b>
Granted	1,470,000	\$11.44	1,341,000	\$ 12.51	<b>2,202,826</b>	<b>\$ 14.74</b>
Exercised	525,852	\$ 3.07	1,132,432	\$ 3.46	<b>1,524,482</b>	<b>\$ 5.35</b>
Canceled	218,304	\$ 8.85	77,216	\$ 10.84	<b>60,700</b>	<b>\$ 14.90</b>
Options outstanding at end of year	4,445,642	\$ 6.14	4,576,994	\$ 8.58	<b>5,194,638</b>	<b>\$ 12.07</b>
Options exercisable at year-end	2,320,412	\$ 3.03	2,132,823	\$ 5.02	<b>1,408,608</b>	<b>\$ 7.88</b>
Options available for granting at year end	54,668		5,190,884		<b>3,048,758</b>	
Weighted-average fair value of options granted during the year		\$6.57		\$7.45		<b>\$8.77</b>

The Company awarded a total of 55,900 shares of restricted stock to certain employees during 2001. These shares vest over four years and have a provision for accelerated vesting tied to a 25% increase in any 2002 quarter's operating results over the prior years quarter. The Company recognized \$218,000 in compensation expense in 2001 due to these restricted stock awards. The Company awarded a total of 67,000 shares of restricted stock to certain employees during 2000. These shares vest over three years and had a provision for accelerated vesting if the Company's stock price appreciated by 25% during the first year of vesting. In February 2001, the Company's stock price met the threshold for accelerated vesting and as a result, these restricted shares vested 100% in April 2001. The Company recognized \$1.1 million and \$78,000 in compensation expense in 2001 and 2000, respectively, due to these restricted stock awards and as a result of the accelerated vesting schedule. In 1998, the Company awarded a total of 200,000 shares of restricted stock to certain employees. These shares vest over three to five years. The Company recognized \$343,000, \$301,000 and \$241,000 in compensation expense for 1999, 2000 and 2001 respectively, associated with the 1998 restricted stock awards and \$94,000, \$90,000 and \$57,000 for 1999, 2000 and 2001 respectively, associated with stock option awards.

The following table summarizes information about stock options outstanding at December 31, 2001:

Range of exercise price	<u>Options Outstanding</u>			<u>Options Exercisable</u>	
	Number outstanding at 12/31/01	Weighted-average remaining contractual life (years)	Weighted-average exercise price	Number exercisable 12/31/01	Weighted-average exercise price
\$0.00 - \$2.79	421,588	2.7	\$ .42	310,302	\$ .58
\$2.80 - \$5.59	198,776	5.0	\$ 3.72	198,776	\$ 3.72
\$5.60 - \$8.39	134,992	6.0	\$ 6.12	134,992	\$ 6.12
\$8.40 - \$11.19	593,866	7.5	\$9.85	221,516	\$9.67
\$11.20 - \$13.99	3,195,730	8.9	\$13.43	404,386	\$12.55
\$14.00 - \$16.79	351,786	7.8	\$15.67	135,136	\$15.35
\$16.80 - \$19.59	13,000	9.0	\$17.70	2,000	\$17.13
\$19.60 - \$22.39	188,000	9.2	\$20.56	1,500	\$20.95
\$22.40 - \$25.19	16,500	9.3	\$23.49	-	-
\$25.20 - \$27.99	80,400	9.6	\$26.90	-	-
	5,194,638	8.0	\$12.07	1,408,608	\$ 7.88

The Company uses the Black-Scholes option model to estimate the fair value of options. A risk-free interest rate of 6.6%, 6.0% and 4.5% for 1999, 2000 and 2001, respectively, a volatility rate of 65%, 65% and 73.4% for 1999, 2000 and 2001, respectively, with an expected life of 6.7 years for 1999, 4.0 years for 2000 and 4.0 years for 2001 were assumed in estimating the fair value. No dividend rate was assumed for any of the years.

The following summarizes the pro forma effects assuming compensation for such awards had been recorded based upon the estimated fair value. The proforma information disclosed below does not include the impact of awards made prior to January 1, 1995 (in thousands, except per share data):

	1999		2000		2001	
	As Reported	Pro Forma	As Reported	Pro Forma	As Reported	Pro Forma
Net income	\$ 28,268	\$ 23,931	\$ 15,155	\$ 12,009	\$ 34,322	\$ 29,038
Basic earnings per share	\$ .75	\$ .63	\$ .38	\$ .30	\$ .79	\$ .67
Diluted earnings per share	\$ .66	\$ .56	\$ .36	\$ .28	\$ .76	\$ .64

#### *Preferred Stock*

The Board of Directors of the Company is authorized to provide for the issuance by the Company of preferred stock in one or more series and to fix the rights, preferences, privileges, qualifications, limitations and restrictions thereof, including, without limitation, dividend rights, dividend rates, conversion rights, voting rights, terms of redemption or repurchase, redemption or repurchase prices, limitations or restrictions thereon, liquidation preferences and the number of shares constituting any series or the designation of such series, without any further vote or action by the stockholders.

## 8. Employee Benefit Plans

### *Employee Stock Ownership Plan*

The Company established an Employee Stock Ownership Plan (the "ESOP") covering substantially all employees. For each of the years 1992 through 1995, the Company made contributions to the ESOP that were used in part to make loan and interest payments. Shares of common stock acquired by the ESOP were allocated to each employee based on the employee's annual compensation.

Effective June 1, 1998, the Board of Directors of the Company voted to terminate the Plan. On March 15, 1999, the Internal Revenue Service issued a determination letter notifying the Company that the termination of the Plan does not adversely affect the Plan's qualification for federal tax purposes. Upon termination of the Plan, a participant becomes 100% vested in his or her account. In preparing for the final distribution of ESOP shares to participants, it was determined that a misallocation of shares had occurred in years 1993 through 1997 resulting in certain eligible participants not receiving some of their entitled shares. The Company contributed the required number of additional shares to the ESOP during the second and third quarters of 1999 when the final calculation was determined and recognized approximately \$250,000 in expense. The Company filed a request for a compliance statement under the IRS's Voluntary Compliance Resolution Program to obtain Service approval of the Company's response to the share misallocation issue. In September 1999, the ESOP trustee began distribution of the ESOP assets per participant's direction. In 2000 and 2001, additional ESOP shares were distributed, as participants were located. The ESOP will continue until all participants are located and any remaining assets are properly distributed. The number of shares remaining in the Plan as of December 31, 2000 and 2001 were 29,074 and 14,537, respectively.

### *401K Plan*

Effective January 1, 1992, the Company adopted a 401(k) Plan (the "Plan"). The Plan covers substantially all full-time employees who meet the Plan's eligibility requirements. Employees may elect a salary reduction contribution of up to 15% of their annual compensation not to exceed the maximum amount allowed by the Internal Revenue Service.

Effective October 1, 1994, the Plan was amended to require the Company to make contributions to the Plan for eligible pilots in exchange for certain concessions. These contributions are in excess of any discretionary contributions made for the pilots under the original terms of the Plan. These contributions are 100% vested and equal to 3% of the first \$15,000 of each eligible pilot's compensation plus 2% of compensation in excess of \$15,000. The Plan limits the Company's contributions for the pilots to 15% of the Company's adjusted net income before extraordinary items for such plan year. The Company's obligations to make contributions with respect to all plan years in the aggregate are limited to \$2.5 million. The employer's aggregate contribution as of December 31, 1999 was \$2,500,000.

The Plan allows the Company to make discretionary matching contributions for non-union employees, mechanics, and certain flight attendants, equal to 25% of salary contributions up to 4% of total compensation. Effective with the ratification of the pilot's new union agreement on February 9, 2001, the Company's match for pilots is variable depending upon the pilot's length of service and the Company's operational performance. The Company's matching percentage for a pilot can range from one to seven percent of eligible contributions. The Company's matching contribution for all qualified employees, if any, vests ratably over five years. Contribution expense was approximately \$303,000, \$374,000 and \$3.9 million for 1999, 2000 and 2001, respectively. The Company's contribution expense in 2001 includes estimated costs of \$2.9 million for additional contributions to correct operational defects found in the Company's 401(k) plan in addition to \$1 million in discretionary matching contributions.

*Profit Sharing Programs*

The Company has profit sharing programs that result in periodic payments to all eligible employees. Profit sharing compensation, which is based on attainment of certain performance and financial goals, was approximately \$4.5 million, \$4.5 million, and \$6.3 million in 1999, 2000 and 2001, respectively.

**9. Income Taxes**

The provision (benefit) for income taxes includes the following components:

*(in thousands)*

<i>Year Ended December 31,</i>	1999	2000	2001
Federal:			
Current	\$ 10,420	\$ 11,295	\$ 15,392
Deferred	5,602	(4,267)	4,437
Total federal provision	16,022	7,028	19,829
State:			
Current	1,993	1,010	2,207
Deferred	304	(381)	477
Total state provision	2,297	629	2,684
Total provision on income before accounting change	18,319	7,657	22,513
Income tax benefit due to change in accounting method	(598)	-	-
Total provision	\$ 17,721	\$ 7,657	\$ 22,513

A reconciliation of income tax expense at the applicable federal statutory income tax rate of 35% to the tax provision recorded is as follows:

*(in thousands)*

<i>Year ended December 31,</i>	1999	2000	2001
Income tax expense at statutory rate	\$16,616	\$7,984	\$19,892
Increase (decrease) in tax expense due to:			
Permanent differences and other	89	(487)	877
State income taxes, net of federal benefit	1,614	160	1,744
Income tax expense	\$18,319	\$7,657	\$22,513

Deferred income taxes result from temporary differences which are the result of provisions of the tax laws that either require or permit certain items of income or expense to be reported for tax purposes in different periods than for financial reporting purposes. The Company's 2000 effective tax rate was positively affected by the receipt of a favorable ruling request which allowed the Company to obtain additional tax credits to offset income tax as well as the realization of certain tax benefits that were previously reserved which together reduced income tax expense by approximately \$1.4 million.

The following is a summary of the Company's deferred income taxes as of December 31, 2000 and 2001:

*(in thousands)*

<i>December 31,</i>	2000	2001
Deferred tax assets:		
Engine maintenance accrual	\$ 679	\$ 411
Intangible assets	735	569
Air traffic liability	672	942
Allowance for bad debts	302	238
Deferred aircraft rent	1,737	2,363
Deferred credits	2,830	2,241
Accrued compensation	944	1,557
Accrued aircraft early retirement charge	11,599	9,555
Start up and organizational costs	2,204	1,702
Other	867	3,735
Total deferred tax assets	22,569	23,313
Deferred tax liabilities:		
Depreciation and amortization	(26,534)	(32,717)
Accrued expenses and other	(996)	(1,238)
Total deferred tax liabilities	(27,530)	(33,955)
Net deferred income tax (liabilities)	\$ (4,961)	\$ (10,642)

No valuation allowance was established in either 2000 or 2001, as the Company believes it is more likely than not that the deferred tax assets will be realized.

## 10. Commitments and Contingencies

### *Aircraft*

As of December 31, 2001, the Company had a total of 39 Canadair Regional Jets (“CRJs”) on order from Bombardier, Inc., and held options for 80 additional CRJs. The Company also had a firm order with Fairchild Dornier for 36 Fairchild Dornier 32 seat regional jets (“328JET”) aircraft, and options for 81 additional 328JETs. Of the 75 firm aircraft deliveries, 33 are scheduled for 2002 and 42 are scheduled for 2003. The Company is obligated to purchase and finance (including leveraged leases) the 75 firm ordered aircraft at an approximate capital cost of \$1.2 billion. The Company anticipates leasing the majority of its year 2002 aircraft deliveries on terms similar to previously delivered regional jet aircraft.

### *Post Retirement Benefits*

The Company has committed to provide its senior executive officers a deferred compensation plan which utilizes split dollar life insurance policies, and for a certain officer, a make-whole provision for taxes, post retirement salary based on ending salary, and post retirement benefits based on benefits similar to those currently provided to the executive while actively employed. The Company has estimated the cost of the deferred compensation and tax gross up feature, future salary and future benefits and is accruing this cost over the remaining required service time of the executive officer. In 2001, the Company expensed approximately \$1.8 million as the current year’s cost of these benefits. The company expects to recognize similar costs annually over the remaining service life of the senior executives.

### *Training*

The Company has entered into agreements with Pan Am International Flight Academy (“PAIFA”), which allow the Company to train CRJ, J-41 and 328JET pilots at PAIFA’s facility near Washington-Dulles. In 2001, PAIFA relocated its Washington-Dulles operations to a new training facility housing two CRJ simulators, a 328JET simulator, and a J-41 simulator near the Company’s Washington-Dulles headquarters. The Company has agreements to purchase an annual minimum number of CRJ and J-41 simulator training hours at agreed rates, through 2010 for the CRJ, and 2002 for the J-41. The Company’s payment obligations for CRJ and J-41 simulator usage over the remaining years of the agreements total approximately \$12.5 million.

In 2001, a simulator provision and service agreement between PAIFA, CAE Schreiner and the Company was executed and 328JET training commenced at the PAIFA facility. Under this agreement, the Company has committed to purchase all of its 328JET simulator time from PAIFA at agreed upon rates, with no minimum number of simulator hours guaranteed. A second 328JET simulator is scheduled for installation at the Washington-Dulles PAIFA simulator facility in July 2002.

At December 31, 2001, the Company’s minimum payment obligations under the PAIFA agreements for the CRJ and J-41 simulators are as follows:

(in thousands)

Year ended December 31,

2002	\$3,631
2003	1,371
2004	1,391
2005	1,178
2006	1,195
Thereafter	3,692
	<hr/>
	\$ 12,458

#### *Derivative Financial Instruments*

The Company has periodically entered into a series of put and call contracts as an interest rate hedge designed to limit its exposure to interest rate changes on the anticipated issuance of permanent financing relating to the delivery of the CRJ aircraft. During 1999, 2000 and 2001, the Company settled seven, eight and one hedge transactions, respectively, receiving \$119,000 from the counterparty in 1999, paying the counterparty \$379,000 in 2000 and paying the counterparty \$722,000 in 2001. In 1999, the Company recognized a gain of \$211,000 on the settlement of one contract, representing the ineffective portion of a hedge. At December 31, 2000 the Company had one interest rate hedge transaction open with a notional value of \$8.5 million. It settled on January 3, 2001 resulting in the payment to the counterparty referenced above.

In October 1999, the Company entered into commodity swap transactions to hedge price changes on approximately 13,300 barrels of crude oil per month for the period April to June 2000, and on approximately 23,300 barrels of crude oil per month for the period July through September 2000. The contracts provided for an average fixed price equal to approximately 52.6 cents per gallon for the second quarter of 2000 and 51 cents per gallon for the third quarter of 2000. Effective December 1, 2000, under the United Air Lines agreements and since inception of the Delta Air Lines agreements, the Company no longer bears the risk associated with fuel price volatility for its operations. Accordingly, no fuel hedging transactions were entered for 2001, and there were no fuel hedging transactions open as of December 31, 2001 and 2000.

### **11. Aircraft Early Retirement Charge**

During the fourth quarter of 2001, the Company recorded an aircraft early retirement charge of \$23.5 million (\$14.0 million after tax) for the early retirement of nine leased Jetstream-41 turboprop aircraft that will be removed from service prior to year-end 2002. The Company anticipates taking additional charges during 2002 of approximately \$48 million pre-tax (\$28.4 million after-tax) for the retirement of its remaining 29-seat Jetstream-41 turboprop aircraft in 2003. Fairchild Dornier, the manufacturer of the 328JETs, is contractually obligated to make the Company whole for any difference between lease payments, if any, received from remarketing the 26 J-41 aircraft leased by the Company and the lease payment obligations of the Company on those aircraft. To the extent that Fairchild Dornier fulfills its contractual obligations, the majority of the aircraft early retirement charge will not adversely affect the Company's cash position, with the payments by Fairchild Dornier being recorded as an aircraft purchase inducement on the 328JET aircraft. The undiscounted remaining lease obligations (net of the Company's estimate of future sublease rentals) on the J-41 fleet after planned retirement dates in 2002 and 2003 are approximately \$55 million and continue through 2010. The Company would remain liable for these lease payments in the event that Fairchild Dornier defaults on its obligation. No asset impairment charges were included in the aircraft early retirement charge.

During 2000, the Company recorded aircraft early retirement operating charges totaling \$29 million (\$17.4 million net of income tax) for the early lease termination of its 28 19-seat Jetstream 32 turboprop aircraft, which were removed from service prior to December 31, 2001. The charge included the estimated cost of contractual obligations to meet aircraft return conditions, as well as a lease termination fee, which fee was calculated including such factors as the discounted present value cost of future lease obligations from the planned out of service date to the lease termination date, and miscellaneous costs and benefits of early return to the lessor. As a result of completing the J-32 early retirement during the fourth quarter of 2001, the Company reversed approximately \$500,000 of the original \$29 million charge which will not be required, and recorded this amount as a reduction to the aircraft early retirement charge taken in 2001.

## **12. Air Transportation Safety and System Stabilization Act/ Aviation and Transportation Security Act**

On September 22, 2001, President Bush signed into law the Air Transportation Safety and System Stabilization Act (the "Act"). The Act provided cash grants to commercial air carriers as compensation for direct losses incurred beginning with the terrorist attacks on September 11, 2001 as a result of the FAA mandated ground stop order issued by the Secretary of Transportation, and for incremental losses incurred during the period beginning September 11, 2001 and ending December 31, 2001 as a direct result of such attacks. The Company has received \$9.7 million in cash grants under these provisions recognized as non-operating income under "government compensation" for the third and fourth quarters 2001. This amount was the government's estimate of approximately 85% of amount due to the Company based on preliminary data. The exact amount of the Company's compensation will be based on the lesser of actual losses incurred or a statutory limit based on the total amount allocable to all airlines. This exact amount is not yet determinable because the statutory limit is subject to information not yet released by the federal government. As such, the Company is unsure if it will be entitled to any further government compensation under this program and will recognize any remaining payments as non-operating income during the period it is determined the Company is entitled to such amounts. All amounts received as government compensation are subject to audit and adjustment by the federal government.

In addition to the Compensation described above, the Act: provides U.S. air carriers with the option to purchase certain war risk liability insurance from the United States government on an interim basis at rates that are more favorable than those available from the private market; authorizes the federal government to reimburse air carriers for the increased cost of war risk insurance premiums for a limited but undetermined period of time as a result of the terrorist attacks of September 11, 2001; and, authorizes the federal government, pursuant to new regulations, to provide loan guarantees to air carriers in the aggregate amount of \$10 billion. Subsequently the government authorized air carriers to apply for reimbursement under the Act for increased insurance costs incurred during the period October 1, 2001 to October 30, 2001, and the Company applied for received, and booked as a reduction to insurance expense \$652,000 in such reimbursements. This amount was based on costs incurred during the period, and no other insurance reimbursements are anticipated. Finally, with respect to federal loan guarantees, the Company continues to evaluate the terms and conditions being imposed by the government, and has not yet determined whether to make application for any such facility.

Following the September 11 terrorist attacks, the aviation insurance industry imposed a worldwide surcharge on aviation insurance rates as well as a reduction in coverage for certain war risks. In response to the reduction in coverage, the Air Transportation Safety and System Stabilization Act provided U.S. air carriers with the option to purchase certain war risk liability insurance from the United States government on an interim basis at rates that are more favorable than those available from the private market. The Company has purchased this coverage through May 19, 2002 and anticipates renewing it for as long as the coverage is available from the U.S. government. The airlines and insurance industry, together with the United States and other governments, are continuing to evaluate both the cost and options for providing coverage of aviation insurance. Recently, an industry-led group announced a proposal to create a mutual insurance company, to be called Equitime, to cover war risk and terrorism risk, which would initially seek support through government guarantees. Equitime would provide a competitive alternative to insurance being offered by the traditional insurance market, which opposes this initiative. Equitime's organizers project that it may be available to provide insurance as early as May 2002 to up to 70 U.S. carriers. The Company has not been actively involved in the formation of Equitime and is unable to anticipate whether this source of insurance will be made available and, if so, whether it will offer competitive rates. The Company anticipates that it will follow industry practices with respect to sources of insurance.

On November 19, 2001 the President signed into law the Aviation and Transportation Security Act (the "Security Act"). The Security Act requires heightened passenger, baggage and cargo security measures be adopted as well as enhanced airport security procedures. The Security Act created the Transportation Security Administration ("TSA") that has taken over from the air carriers the responsibility for conducting the screening of passengers and their baggage. The TSA assumed both of the Company's passenger screening contracts on February 17, 2002. Air carriers continue to have responsibility for aircraft security, employee background checks, the security of air carrier airport facilities and other security related functions.

The activities of the TSA are to be funded in part by the application of a \$2.50 per passenger enplanement security fee (subject to a maximum of \$5.00 per one way trip) and payment by all passenger carriers of a sum not exceeding each carrier's passenger and baggage screening cost incurred in calendar year 2000. The TSA is charged to have equipment in operation by the end of 2002 to be able to electronically screen all checked passenger baggage with explosive detection systems. The TSA is also required to deploy federal air marshals on an increased number of passenger flights. The Security Act imposes new and increased requirements for air carrier employee background checks and additional security training of flight and cabin crew personnel. These additional and new requirements may increase the security related costs of the Company. The Security Act also mandated and the FAA has adopted new rules requiring the strengthening of cockpit doors, some of the costs of which may be reimbursed by the FAA. The Company has completed level one fortification of its cockpit doors on all of its aircraft as of November 15, 2001. The FAA has mandated additional cockpit door modifications that will result in additional costs. The Company intends to apply for reimbursement of these costs and other security costs for which the FAA has established a cost reimbursement program. There is no guarantee that the Company will be reimbursed in full for the cost of these modifications. New passenger and baggage screening requirements have caused disruptions in the flow of passengers through airports and in some cases delayed airline operations. The Company may experience security-related disruptions in the future, including reduced passenger demand for air travel, but believes that its exposure to such disruptions is not greater than that faced by other providers of regional air carrier services.

### **13. Subsequent Events**

In the first quarter of 2002, the Company expanded its charter operations by ordering three additional 328JET aircraft from Fairchild Dornier. One of these, which has already been acquired, was purchased through the application of certain deposits previously placed with Fairchild Dornier, and the others will be financed through debt, with repayment over approximately ten years.

### **14. Litigation**

The Company is a party to routine litigation and to FAA civil action proceedings, all of which are incidental to its business, and none of which the Company believes are likely to have a material effect on the Company's financial position or the results of its operations.

## 15. Financial Instruments

Statement of Financial Accounting Standards No. 107, "Disclosure of Fair Value of Financial Instruments" requires the disclosure of the fair value of financial instruments. Some of the information used to determine fair value is subjective and judgmental in nature; therefore, fair value estimates, especially for less marketable securities, may vary. The amounts actually realized or paid upon settlement or maturity could be significantly different.

Unless quoted market price indicates otherwise, the fair values of cash and cash equivalents, short-term investments, accounts receivable and accounts payable generally approximate market because of the short maturity of these instruments. The Company has estimated the fair value of long term debt based on quoted market prices, when available, or by discounted expected future cash flows using current rates offered to the Company for debt with similar maturities.

The estimated fair values of the Company's financial instruments, none of which are held for trading purposes, are summarized as follows (brackets denote liability):

<i>(in thousands)</i>	<i>December 31, 2000</i>		<i>December 31, 2001</i>	
	<i>Carrying Amount</i>	<i>Estimated Fair Value</i>	<i>Carrying Amount</i>	<i>Estimated Fair Value</i>
Cash and cash				
Equivalents	\$86,117	\$ 86,117	<b>\$173,669</b>	<b>\$ 173,669</b>
Short-term investments	35,100	35,100	<b>7,300</b>	<b>7,300</b>
Accounts receivable	29,052	29,052	<b>8,933</b>	<b>8,933</b>
Accounts payable	(19,724)	(19,724)	<b>(21,750)</b>	<b>(21,750)</b>
Long-term debt	(67,424)	(68,061)	<b>(63,080)</b>	<b>(63,856)</b>

See note 10 for information regarding the fair value of derivative financial instruments.

## 16. Supplemental Cash Flow Information

Supplemental disclosures of cash flow information:

	Year ended December 31, (in thousands)		
	<u>1999</u>	<u>2000</u>	<u>2001</u>
Cash paid during the period for:			
- Interest	\$ 4,532	\$ 6,410	<b>\$ 5,352</b>
- Income taxes	8,193	8,944	<b>7,837</b>

The following non cash investing and financial activities took place in 1999, 2000 and 2001:

During 1999, the Company received \$755,000 of manufacturers credits that were applied against the purchase price of the two CRJs purchased in 1999 from the manufacturer. The credits will be utilized primarily through the purchase of rotatable parts and other fixed assets, expendable parts, and pilot training.

In 1999, the Company capitalized \$1.8 million in interest related to \$38.7 million on deposit with aircraft manufacturers.

In 2000, the Company capitalized \$2.7 million in interest related to \$46.4 million on deposit with aircraft manufacturers.

In 2000, the remaining \$19.8 million principal amount of Notes outstanding were converted into common stock of the Company resulting in a \$19.3 million increase to paid in capital.

In 2001, the Company capitalized \$2.6 million in interest related to \$44.8 million on deposit with aircraft manufacturers.

## **17. Recent Accounting Pronouncements**

On July 5, 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 141, "Business Combinations", and Statement of Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets". Statement No. 141 addresses the accounting for acquisitions of businesses and is effective for acquisitions occurring on or after July 1, 2001. Statement No. 142 includes requirements to test goodwill and indefinite life intangible assets for impairment rather than amortize them. Statement No. 142 will be effective for fiscal years beginning after December 15, 2001. The Company will adopt Statement No. 142 beginning in the first quarter of 2002. The Company anticipates that implementation of SFAS 141 and SFAS 142 will have minimal impact on the Company's financial position or results of operations.

On October 3, 2001, the Financial Accounting Standards Board issued FASB Statement No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which addresses financial accounting and reporting for the impairment or disposal of long-lived assets. Statement No. 144 supersedes FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of and APB Opinion No. 30, Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions. Statement No. 144 includes requirements related to the classification of assets as held for sale, including the establishment of six criteria that must be satisfied prior to this classification. Statement No. 144 also includes guidance related to the recognition and calculation of impairment losses for long-lived assets. Statement No. 144 will be effective for fiscal years beginning after December 15, 2001. The Company will adopt Statement No. 144 beginning in the first quarter of 2002. Statement No. 144 is projected to have minimal impact on the Company's financial position or results of operations.

## 18. Selected Quarterly Financial Data (Unaudited)

(in thousands, except per share amounts)

	<b>Quarter Ended</b>			
	March 31, <u>2001</u>	June 30, <u>2001</u>	September 30, <u>2001</u>	December 31, <u>2001</u>
Operating revenues	\$133,454	\$146,221	\$147,651	\$156,090
Operating income	15,479	20,868	15,895	(8,049) <sup>1</sup>
Net income (loss)	9,625	12,948	12,751	(1,003) <sup>1,3</sup>
Net income (loss) per share				
Basic	\$ 0.23	\$ 0.30	\$ 0.29	\$ (0.02)
Diluted	\$ 0.22	\$ 0.29	\$ 0.28	\$ (0.02)
Weighted average shares outstanding				
Basic	42,750	43,168	43,775	43,999
Diluted	44,638	45,029	45,426	43,999

  

	<b>Quarter Ended</b>			
	March 31, <u>2000</u>	June 30, <u>2000</u>	September 30, <u>2000</u>	December 31, <u>2000</u>
Operating revenues	\$92,499	\$116,332	\$115,356	\$128,339
Operating income	4,540	20,629	2,226 <sup>2</sup>	(3,308) <sup>2</sup>
Net income	2,280	12,029	2,666 <sup>2</sup>	(1,821) <sup>2</sup>
Net income per share				
Basic	\$ 0.06	\$ 0.31	\$ 0.06	\$ (0.04)
Diluted	\$ 0.06	\$ 0.28	\$ 0.06	\$ (0.04)
Weighted average shares outstanding				
Basic	37,256	38,746	42,144	42,404
Diluted	43,048	43,542	43,864	42,404

<sup>1</sup> In the fourth quarter of 2001, the Company recorded an aircraft early retirement charge. The amount of the charge was 23.0 million (pre-tax).

<sup>2</sup> In the third and fourth quarters of 2000, the Company recorded aircraft early retirement charges. The amount of the charges were \$8.7 million (pre-tax) in the third quarter, and \$20.3 million (pre-tax) in the fourth quarter.

<sup>3</sup> Includes government compensation of \$4.6 million in the third quarter of 2001 and \$5.1 million in the fourth quarter of 2001.

Note: The sum of the four quarters may not equal the totals for the year due to rounding of quarterly results