**Financial Statements and Report of Independent Certified Public Accountants**

# AERO-COLOURS, INC.

**December 31, 2003 and 2002**

## CONTENTS

COPELAND BUHL & CO

Report of Independent Certified Public Accountants

Board of Directors and Stockholders
**Aero-Colours, Inc.**
Minneapolis, Minnesota

We have audited the accompanying balance sheets of Aero-Colours, Inc. as of December 31, 2003 and 2002, and the related statements of operations and accumulated deficit, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those statements require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Aero-Colours, Inc. as of December 31, 2003 and 2002, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Copeland Buhl & Company P.L.L.P.

COPELAND BUHL & COMPANY P.L.L.P.

April 30, 2004

COPELAND BUHL & COMPANY P.L.L.P.
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# AERO-COLOURS, INC.
## BALANCE SHEETS
## DECEMBER 31

| ASSETS | 2003 | 2002 |
|---|---|---|
| Current Assets: | | |
| Cash and equivalents | | $ 9,750 |
| Accounts receivable, net of allowance for doubtful accounts of $30,000 and $60,000, respectively | $ 208,241 | 124,910 |
| Inventories | 76,142 | 65,434 |
| Prepaid expenses | 5,473 | 3,210 |
| Notes receivable – current portion | 88,884 | 154,097 |
| Total Current Assets | 378,740 | 357,401 |
| Notes Receivable – Long-Term Portion | 106,347 | 194,579 |
| Equipment and Improvements, at Cost: | | |
| Office and other equipment | 190,867 | 149,985 |
| Vehicles | 140,428 | 102,142 |
| Furniture and fixtures | 34,515 | 30,616 |
| Leasehold improvements | | 48,051 |
| | 365,810 | 330,794 |
| Less accumulated depreciation | 223,940 | 192,308 |
| Net Equipment and Improvements | 141,870 | 138,486 |
| Other Assets: | | |
| Intangible assets | 338,649 | 338,649 |
| Deferred tax assets | 88,000 | 84,000 |
| Total Other Assets | 426,649 | 422,649 |
| TOTAL ASSETS | $ 1,053,606 | $ 1,113,115 |

See notes to financial statements.

| LIABILITIES AND STOCKHOLDERS' EQUITY | 2003 | 2002 |
|---|---|---|
| Current Liabilities: | | |
| Notes payable to bank | $ 223,276 | $ 144,136 |
| Accounts payable | 232,541 | 212,498 |
| Accrued compensation and related expenses | 24,847 | 14,285 |
| Other accrued expenses | 56,527 | 14,089 |
| Deferred income taxes | 22,000 | 53,000 |
| Due to stockholder, 6% | 71,398 | |
| Current maturities of long-term debt | 169,450 | 209,973 |
| Total Current Liabilities | 800,039 | 647,981 |
| Long-Term Debt | 472,230 | 531,589 |
| Total Liabilities | 1,272,269 | 1,179,570 |
| Commitments | | |
| Deficit in Stockholders' Equity: | | |
| Common stock - $.01 par value; 10,000,000 shares authorized; 1,390,839 issued and outstanding | 13,908 | 13,908 |
| Paid in capital | 840,913 | 840,913 |
| Accumulated deficit | (1,073,484) | (921,276) |
| Total Deficit in Stockholders' Equity | (218,663) | (66,455) |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | $ 1,053,606 | $ 1,113,115 |

# AERO-COLOURS, INC.
## STATEMENTS OF OPERATIONS AND ACCUMULATED DEFICIT
## YEARS ENDED DECEMBER 31

| | 2003 | | 2002 | |
|---|---|---|---|---|
| Net Revenues: | | | | |
| Paint repair services | $ 717,347 | 42.5% | $ 1,124,236 | 47.8% |
| Franchise royalties | 742,839 | 44.1 | 734,415 | 31.2 |
| Corporate franchise sales | | | 351,700 | 14.9 |
| Franchise fees | 226,000 | 13.4 | 142,700 | 6.1 |
| Total Net Revenues | 1,686,186 | 100.0 | 2,353,051 | 100.0 |
| Cost of Sales | 772,849 | 45.8 | 1,029,996 | 43.8 |
| Gross Profit | 913,337 | 54.2 | 1,323,055 | 56.2 |
| Operating Expenses | 1,011,923 | 60.0 | 1,250,122 | 53.1 |
| Income (Loss) from Operations | (98,586) | (5.8) | 72,933 | 3.1 |
| Other Income (Expense): | | | | |
| Interest expense | (72,612) | (4.3) | (101,450) | (4.3) |
| Gain (loss) on sale of equipment | (18,684) | (1.1) | 215,001 | 9.1 |
| Interest income | 3,774 | .2 | 4,210 | .2 |
| Total Other Income (Expense) | (87,522) | (5.2) | 117,761 | 5.0 |
| Income (Loss) before Income Taxes | (186,108) | (11.0) | 190,694 | 8.1 |
| Provision (Credit) for Income Taxes: | | | | |
| Currently payable | 1,100 | .1 | 13,900 | .6 |
| Deferred | (35,000) | (2.1) | 62,000 | 2.6 |
| | (33,900) | (2.0) | 75,900 | 3.2 |
| Net Income (Loss) | (152,208) | (9.0)% | 114,794 | 4.9% |
| Accumulated Deficit - Beginning of Year | (921,276) | | (1,036,070) | |
| Accumulated Deficit - End of Year | $ (1,073,484) | | $ (921,276) | |

See notes to financial statements.

# AERO-COLOURS, INC.
## STATEMENTS OF CASH FLOWS
## YEARS ENDED DECEMBER 31

| | | 2003 | | 2002 |
|---|---|---|---|---|
| Cash Flows from Operating Activities: | | | | |
| Net income (loss) | $ | (152,208) | $ | 114,794 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | | | |
| Depreciation and amortization | | 61,215 | | 100,505 |
| Provision for bad debts | | 121,998 | | 119,786 |
| (Gain) loss on sale of equipment | | 18,684 | | (215,001) |
| Deferred income taxes | | (35,000) | | 62,000 |
| (Increase) decrease in accounts receivable | | (87,972) | | 80,286 |
| (Increase) in inventories | | (10,708) | | (2,165) |
| (Increase) decrease in prepaid expenses | | (2,263) | | 32,665 |
| Decrease in notes receivable | | 36,088 | | 106,609 |
| Increase (decrease) in accounts payable | | 20,043 | | (82,358) |
| Increase (decrease) in accrued expenses | | 53,000 | | (26,527) |
| Net Cash Provided by Operating Activities | | 22,877 | | 290,594 |
| Cash Flows from Investing Activities: | | | | |
| Purchase of equipment | | (37,721) | | (38,132) |
| Proceeds from sale of equipment | | | | 280,800 |
| Net Cash Provided by (Used in) Investing Activities | | (37,721) | | 242,668 |
| Cash Flows from Financing Activities: | | | | |
| Net borrowings (repayments) from notes payable to bank | | 29,140 | | (46,839) |
| Principal payments on long-term debt | | (95,444) | | (546,518) |
| Proceeds from issuance of long-term debt | | | | 50,000 |
| Net borrowings from stockholders | | 71,398 | | 19,845 |
| Net Cash Provided by (Used in) Financing Activities | | 5,094 | | (523,512) |
| Net Increase (Decrease) in Cash and Equivalents | | (9,750) | | 9,750 |
| Cash and Equivalents – Beginning of Year | | 9,750 | | |
| Cash and Equivalents – End of Year | $ | | $ | 9,750 |

See notes to financial statements.

# AERO-COLOURS, INC.
## NOTES TO FINANCIAL STATEMENTS
## DECEMBER 31, 2003 AND 2002

Note A: **Significant Accounting Policies**

**Nature of Operations**

The Company provides automobile paint repair services to automobile dealerships, car rental companies, leasing companies, fleet operators, and private individual automobile owners. The Company offers its automobile paint repair services though the operation of its company-owned units and through its network of franchisee-owned units in the United States and Europe. Each unit equals one mobile vehicle (i.e., specially equipped van) which travels to customer locations. During 2002 the Company sold 15 company-owned units. Operations consisted of 5 company-owned and 218 franchisee-owned units as of December 31, 2002. During 2003, operations consisted of 8 company-owned and 210 franchisee owned units.

**Use of Estimates**

In preparing financial statements in conformity with generally accepted accounting principles, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Revenue Recognition**

All fees from franchised operations are included in revenue as earned. Initial franchise fees are earned when the franchise location opens for business. Franchise fees earned for the sale of territorial rights are recognized immediately. Royalty fees are based on the franchised locations' revenues and are recorded by the Company in the period the related franchised locations' revenues are earned. Product and equipment revenues are recognized upon shipment and service revenues are earned as they are performed.

**Cash Equivalents**

For purposes of the statement of cash flows, the Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

**Note A: Significant Accounting Policies (Continued)**

**Inventories**

Inventories consisting of supplies are stated at the lower of cost or market; cost is determined on the first-in, first-out basis.

**Equipment and Improvements**

Depreciation is provided in amounts sufficient to relate the cost of depreciable assets to operations over their estimated service lives. For financial reporting purposes, the straight-line method of depreciation is followed. For tax reporting purposes, accelerated methods of depreciation are followed for substantially all assets.

Expenditures for maintenance and repairs are charged to operations when the expense is incurred. Expenditures determined to represent additions and betterments are capitalized.

**Long-Lived Assets**

The Company reviews for impairment of long-lived assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

**Income Taxes**

The Company accounts for income taxes under SFAS No. 109, Accounting for Income Taxes. Under the asset and liability method of SFAS No. 109, deferred tax assets and liabilities are recognized for the expected future tax consequences of temporary differences between the financial statement carrying amount and tax basis of assets and liabilities. The Company provides for deferred taxes at the enacted tax rate that is expected to apply when the temporary differences reverse.

**Note B: Liquidity**

The Company has an accumulated deficit as of December 31, 2003. In addition, the Company has negative working capital as of December 31, 2003. The Company is dependent on achieving positive cash flows from operating activities and continuing bank and investor debt financing or other debt or equity financing to continue its operations. Management plans to improve operating cash flows through royalties and improved collections of notes receivable, cost containment of operating expenses, and the sale of franchises.

**Note C: Notes Receivable**

The Company has provided partial financing to franchisees for the purchase of franchises, territorial sales rights, and equipment from the Company. The notes mature through 2010 and bear interest at 5% to 13%. The notes are collateralized by the franchise agreements and the related equipment. Two notes in the amount of $60,000 are subordinated to the SBA.

Maturities of notes receivable are as follows for years ending December 31:

| | |
|---|---|
| 2004 | $ 88,884 |
| 2005 | 26,876 |
| 2006 | 8,802 |
| 2007 | 2,627 |
| 2008 | 2,379 |
| Thereafter | 65,663 |
| | $ 195,231 |

**Note D: Intangible Assets**

In 2002, the Company adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets (SFAS 142). Under SFAS 142, goodwill is not subject to amortization but is tested for impairment annually. In addition, upon initial application of SFAS 142, the Company reassessed goodwill and deemed it to have an indefinite life, therefore, the Company ceased amortization effective January 1, 2002.

### Note E: Notes Payable to Bank

The notes payable to bank consist of three bank lines of credit through two separate financial institutions and one short-term note maturing in August 2004. They are collateralized by all assets of the Company and marketable securities of a stockholder. Three of the notes bear interest at 6% and the other note bears interest at 17% at December 31, 2003. In 2003, the Company refinanced two lines of credit. Proceeds of $223,877 from the two lines of credit and one short-term note were used to pay off the two old lines of credit. The maximum credit available on the three credit lines with maturities through August 2004, is $130,000.

### Note F: Long-Term Debt

Long-term debt consists of the following as of December 31:

| | 2003 | 2002 |
|---|---|---|
| Installment note payable; 4.75%; maturing through June 2007; collateralized by all Company assets | $ 147,564 | $ 186,448 |
| Notes payable to stockholders; 8.75% -11.66%, maturing through September 2009; subordinated to the bank debt; unsecured | 384,108 | 417,954 |
| Installment note payable; 6.0%, maturing through 2004; unsecured | 52,714 | 110,791 |
| Installment notes payable; 6% -11.74%; maturing through 2008, collateralized by vehicles and equipment | 57,294 | 26,369 |
| | 641,680 | 741,562 |
| Less current maturities | 169,450 | 209,973 |
| | $ 472,230 | $ 531,589 |

**Note F: Long-Term Debt (Continued)**

In 2003, the Company refinanced the 11.66% note payable to stockholders. Proceeds of $366,690 from the note were used to pay the original stockholder note. The stockholder note bears interest at 11.66% and matures in December 2009.

Long-term debt incurred for the purchase of equipment was $45,562 and $7,450 in 2003 and 2002, respectively.

Cash paid for interest amounted to $72,612 in 2003 and $107,226 in 2002.

Maturities of long-term debt are as follows for years ending December 31:

| | | |
|---|---|---|
| 2004 | $ | 169,450 |
| 2005 | | 117,684 |
| 2006 | | 116,728 |
| 2007 | | 86,814 |
| 2008 | | 75,459 |
| Thereafter | | 75,545 |
| | $ | 641,680 |

**Note G: Commitments**

The Company conducts its operations in leased facilities and leases equipment under noncancellable operating leases expiring through 2009. Minimum rental commitments under the operating leases are as follows for the years ending December 31:

| | | |
|---|---|---|
| 2004 | $ | 34,587 |
| 2005 | | 32,032 |
| 2006 | | 32,032 |
| 2007 | | 26,738 |
| 2008 | | 26,619 |
| Thereafter | | 8,873 |
| | $ | 160,881 |

Rent expense in 2003 and 2002 was $63,672 and $72,952, respectively.

**Note H: Stock Transactions**

**Stock Options**

Stock options were granted to two employees of the Company in November 2001. Until November 2004, 7,500 shares of common stock can be purchased at $1.00 per share. The options vest in November of the years 2002 through 2004 at 2,500 shares per year. No options were exercised in 2003.

If the Company had used the fair value based method of accounting for its employee stock option plan, as prescribed by Statement of Financial Accounting Standards No. 123, compensation cost in net income for the year ended December 31, 2003 would have increased by $4,100, resulting in net loss of $156,308, net of tax.

**Stock Warrants**

Through June 1999, the Company has issued warrants to acquire a total of 84,000 shares of its common stock at $2.75 per share to individuals providing financing totaling $100,000 to the Company. Warrants issued in June 1999 contain an option to convert to net exercised or cash-less warrants. The warrants expire seven years from the date of issuance. No warrants have been exercised.

**Private Placement Offering**

During 1999, the Company completed a private placement offering. In total, 52,500 shares of common stock were sold at $2.80 per share. Net proceeds from the offering, after expense of $5,535, were $123,824.

The agents for the offerings were issued warrants to purchase a total of 110,500 shares of common stock at $2.80 per share. The warrants vested at issuance and expire in 2005. No warrants have been exercised.

**Note I: Profit Sharing**

The Company sponsors a 401(k) retirement plan covering all full-time employees who are at least 21 years of age. Company contributions are voluntary and at the discretion of the Board of Directors. Contributions to the plan by the Company, charged to operations amounted to $1,594 in 2003 and $1,882 in 2002.

## Note J: Income Taxes

The income tax effects of temporary differences that gave rise to net deferred taxes are as follows as of December 31:

| | 2003 | 2002 |
|---|---|---|
| Deferred Tax Assets: | | |
| Working capital items | $ 84,200 | $ 71,800 |
| Acquisition costs and amortization | 96,300 | 97,500 |
| Net operating loss carryforward | 17,500 | 16,400 |
| Total Deferred Tax Assets | 198,000 | 185,700 |
| Deferred Tax Liabilities: | | |
| Working capital items | 78,600 | 66,300 |
| Depreciation | 8,400 | 13,300 |
| Installment contracts | 45,000 | 75,100 |
| Total Deferred Tax Liabilities | 132,000 | 154,700 |
| Net Deferred Tax Asset | $ 66,000 | $ 31,000 |

At December 31, 2003, the Company has a net operating loss carryforward of approximately $70,000, which expires at various dates through 2024.

Financial Statements and Report of Independent Certified Public Accountants

# AERO-COLOURS, INC.

December 31, 2002 and 2001

# CONTENTS

COPELAND BUHL & CO

Report of Independent Certified Public Accountants

Board of Directors and Stockholders
**Aero-Colours, Inc.**
Minneapolis, Minnesota

We have audited the accompanying balance sheets of Aero-Colours, Inc. as of December 31, 2002 and 2001, and the related statements of operations, stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those statements require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Aero-Colours, Inc. as of December 31, 2002 and 2001, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Copeland Buhl & Company PLLP

COPELAND BUHL & COMPANY P.L.L.P.

April 2, 2003

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# AERO-COLOURS, INC.
## BALANCE SHEETS
## DECEMBER 31

| ASSETS | 2002 | 2001 |
|---|---|---|
| Current Assets: | | |
| Cash and equivalents | $ 9,750 | |
| Accounts receivable, net of allowance for doubtful accounts of $60,000 and $10,000, respectively | 124,910 | $ 261,906 |
| Inventories | 65,434 | 63,269 |
| Prepaid expenses | 3,210 | 35,875 |
| Notes receivable – current portion | 154,097 | 160,775 |
| Due from stockholder | | 19,845 |
| Total Current Assets | 357,401 | 541,670 |
| Notes Receivable – Long-Term Portion | 194,579 | 357,586 |
| Equipment and Improvements, at Cost: | | |
| Office and other equipment | 149,985 | 211,027 |
| Vehicles | 102,142 | 196,045 |
| Furniture and fixtures | 30,616 | 31,550 |
| Leasehold improvements | 48,051 | 48,051 |
| | 330,794 | 486,673 |
| Less accumulated depreciation | 192,308 | 262,165 |
| Net Equipment and Improvements | 138,486 | 224,508 |
| Other Assets: | | |
| Intangible assets | 338,649 | 373,349 |
| Deferred tax assets | 84,000 | 95,000 |
| Total Other Assets | 422,649 | 468,349 |
| TOTAL ASSETS | $ 1,113,115 | $ 1,592,113 |

See notes to financial statements.

| LIABILITIES AND STOCKHOLDERS' EQUITY | 2002 | 2001 |
|---|---|---|
| Current Liabilities: | | |
| Notes payable to bank | $ 144,136 | $ 190,975 |
| Accounts payable | 212,498 | 294,856 |
| Accrued compensation and related expenses | 14,285 | 46,418 |
| Other accrued expenses | 14,089 | 8,483 |
| Deferred income taxes | 53,000 | 2,000 |
| Current maturities of long-term debt | 209,973 | 788,052 |
| Total Current Liabilities | 647,981 | 1,330,784 |
| Long-Term Debt | 531,589 | 442,578 |
| Total Liabilities | 1,179,570 | 1,773,362 |
| Commitments | | |
| Deficit in Stockholders' Equity: | | |
| Common stock - $.01 par value; 10,000,000 shares authorized; 1,390,839 issued and outstanding | 13,908 | 13,908 |
| Paid in capital | 840,913 | 840,913 |
| Accumulated deficit | (921,276) | (1,036,070) |
| Total Deficit in Stockholders' Equity | (66,455) | (181,249) |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | $ 1,113,115 | $ 1,592,113 |

# AERO-COLOURS, INC.
## STATEMENTS OF OPERATIONS
## YEARS ENDED DECEMBER 31

| | 2002 | | 2001 | |
|---|---|---|---|---|
| Net Revenues: | | | | |
| Paint repair services | $ 1,124,236 | 47.8% | $ 2,139,253 | 65.5% |
| Franchise royalties | 734,415 | 31.2 | 658,237 | 20.2 |
| Corporate franchise sales | 351,700 | 14.9 | 349,840 | 10.7 |
| Franchise fees | 142,700 | 6.1 | 117,823 | 3.6 |
| Total Net Revenues | 2,353,051 | 100.0 | 3,265,153 | 100.0 |
| Cost of Sales | 1,029,996 | 43.8 | 1,955,137 | 59.9 |
| Gross Profit | 1,323,055 | 56.2 | 1,310,016 | 40.1 |
| Operating Expenses | 1,250,122 | 53.1 | 1,507,045 | 46.1 |
| Income (Loss) from Operations | 72,933 | 3.1 | (197,029) | (6.0) |
| Other Income (Expense): | | | | |
| Gain on sale of equipment | 215,001 | 9.1 | 225,640 | 6.9 |
| Interest expense | (101,450) | (4.3) | (158,704) | (4.9) |
| Interest income | 4,210 | .2 | 39,712 | 1.2 |
| Miscellaneous | | | 67,216 | 2.1 |
| Total Other Income | 117,761 | 5.0 | 173,864 | 5.3 |
| Income (Loss) before Income Taxes | 190,694 | 8.1 | (23,165) | (.7) |
| Provision (Credit) for Income Taxes: | | | | |
| Currently payable | 13,900 | .6 | 1,100 | |
| Deferred | 62,000 | 2.6 | (5,000) | (.1) |
| | 75,900 | 3.2 | (3,900) | (.1) |
| Net Income (Loss) | $ 114,794 | 4.9% | $ (19,265) | (.6)% |

See notes to financial statements.

# AERO-COLOURS, INC.
## STATEMENT OF STOCKHOLDERS' EQUITY
## TWO YEARS ENDED DECEMBER 31, 2002

| | Common Stock | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | # Shares | | Amount | | Paid In Capital | | Accumulated Deficit | | Total Stockholders' Deficit |
| Balance at January 1, 2001 | 1,390,839 | $ | 13,908 | $ | 840,913 | $ | (1,016,805) | $ | (161,984) |
| Net loss for the year ended December 31, 2001 | | | | | | | (19,265) | | (19,265) |
| Balance at December 31, 2001 | 1,390,839 | | 13,908 | | 840,913 | | (1,036,070) | | (181,249) |
| Net income for the year ended December 31, 2002 | | | | | | | 114,794 | | 114,794 |
| Balance at December 31, 2002 | 1,390,839 | $ | 13,908 | $ | 840,913 | $ | (921,276) | $ | (66,455) |

See notes to financial statements.

# AERO-COLOURS, INC.
## STATEMENTS OF CASH FLOWS
## YEARS ENDED DECEMBER 31

| | | 2002 | | 2001 |
|---|---|---|---|---|
| Cash Flows from Operating Activities: | | | | |
| Net income (loss) | $ | 114,794 | $ | (19,265) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | | | |
| Depreciation and amortization | | 100,505 | | 152,345 |
| Provision for bad debts | | 119,786 | | 268,998 |
| Gain on sale of equipment | | (215,001) | | (225,640) |
| Deferred income taxes | | 62,000 | | (5,000) |
| Decrease in accounts receivable | | 80,286 | | 50,713 |
| (Increase) decrease in inventories | | (2,165) | | 29,438 |
| Decrease in prepaid expenses | | 32,665 | | 1,752 |
| (Increase) decrease in notes receivable | | 106,609 | | (50,976) |
| (Decrease) in accounts payable | | (82,358) | | (112,762) |
| Increase (decrease) in accrued expenses | | (26,527) | | (114,962) |
| Net Cash Provided by (Used in) Operating Activities | | 290,594 | | (25,359) |
| Cash Flows from Investing Activities: | | | | |
| Purchase of equipment | | (38,132) | | (106,657) |
| Proceeds from sale of equipment | | 280,800 | | 419,829 |
| Net repayments from stockholders | | 19,845 | | 4,841 |
| Net Cash Provided by Investing Activities | | 262,513 | | 318,013 |
| Cash Flows from Financing Activities: | | | | |
| Net borrowings (repayments) from notes payable to bank | | (46,839) | | 186,940 |
| Principal payments on long-term debt | | (546,518) | | (957,643) |
| Proceeds from issuance of long-term debt | | 50,000 | | 478,049 |
| Net Cash Used in Financing Activities | | (543,357) | | (292,654) |
| Net Increase in Cash and Equivalents | | 9,750 | | |
| Cash and Equivalents – Beginning of Year | | | | |
| Cash and Equivalents – End of Year | $ | 9,750 | $ | |

See notes to financial statements.

## Note A: Significant Accounting Policies

### Nature of Operations

The Company provides automobile paint repair services to automobile dealerships, car rental companies, leasing companies, fleet operators, and private individual automobile owners. The Company offers its automobile paint repair services though the operation of its company-owned units and through its network of franchisee-owned units in the United States and Europe. Each unit equals one mobile vehicle (i.e., specially equipped van) which travels to customer locations. During 2001 the Company sold 31 company-owned units and shut down 4 company-owned units. Operations consisted of 14 company-owned and 207 franchisee-owned units as of December 31, 2001. During 2002 the Company sold 15 company-owned units. Operations consisted of 5 company-owned and 218 franchisee owned units as of December 31, 2002.

### Use of Estimates

In preparing financial statements in conformity with generally accepted accounting principles, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

### Revenue Recognition

All fees from franchised operations are included in revenue as earned. Initial franchise fees are earned when the franchise location opens for business. Franchise fees earned for the sale of territorial rights are recognized immediately. Royalty fees are based on the franchised locations' revenues and are recorded by the Company in the period the related franchised locations' revenues are earned. Product and equipment revenues are recognized upon shipment and service revenues are earned as they are performed.

### Cash Equivalents

For purposes of the statement of cash flows, the Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

Note A: **Significant Accounting Policies (Continued)**

**Inventories**

Inventories consisting of supplies is stated at the lower of cost or market; cost is determined on the first-in, first-out basis.

**Equipment and Improvements**

Depreciation is provided in amounts sufficient to relate the cost of depreciable assets to operations over their estimated service lives. For financial reporting purposes, the straight-line method of depreciation is followed. For tax reporting purposes, accelerated methods of depreciation are followed for substantially all assets.

Expenditures for maintenance and repairs are charged to operations when the expense is incurred. Expenditures determined to represent additions and betterments are capitalized.

**Long-Lived Assets**

The Company reviews for impairment of long-lived assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets.

**Income Taxes**

The Company accounts for income taxes under SFAS No. 109, Accounting for Income Taxes. Under the asset and liability method of SFAS No. 109, deferred tax assets and liabilities are recognized for the expected future tax consequences of temporary differences between the financial statement carrying amount and tax basis of assets and liabilities. The Company provides for deferred taxes at the enacted tax rate that is expected to apply when the temporary differences reverse.

**Reclassifications**

Certain reclassifications have been made in the 2001 financial statements to conform to the classifications used in 2002. These reclassifications have no effect on net income or retained earnings.

**Note B: Liquidity**

The Company's business is highly seasonal as a significant portion of its operating revenues are generated May through October. As such, the Company periodically requires additional working capital in November through April.

The Company incurred a loss in each of the three years ended December 31, 2001 and has negative working capital as of December 31, 2002. The Company is dependent on achieving positive cash flows from operating activities or continuing bank and investor debt financing or other debt or equity financing to continue the implementation of its strategic initiatives. Management also plans to improve operating cash flows through improved collections of notes receivable, cost containment of operating expenses, the sale of franchises, and improved economies of scale from its company-owned operations.

**Note C: Notes Receivable**

The Company has provided partial financing to franchisees for the purchase of franchises, territorial sales rights, and equipment from the Company. The notes mature through 2010 and bear interest at 5% to 13%. The notes are collateralized by the franchise agreements and the related equipment. Two notes in the amount of $60,000 are subordinated to the SBA.

Maturities of notes receivable are as follows for years ending December 31:

| | |
|---|---|
| 2003 | $ 154,097 |
| 2004 | 50,464 |
| 2005 | 27,677 |
| 2006 | 46,331 |
| 2007 | 2,163 |
| Thereafter | 67,944 |
| | $ 348,676 |

**Note D: Intangible Assets**

In 2002, the Company adopted Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets (SFAS 142). Under SFAS 142, goodwill is not subject to amortization but is tested for impairment annually. In addition, upon initial application of SFAS 142, the Company reassessed goodwill and deemed it to have an indefinite life, therefore, the Company ceased amortization effective January 1, 2002.

**Note D: Intangible Assets (Continued)**

During 2002, other intangible assets, consisting of a noncompete agreement, acquisition costs and territorial licenses, were fully amortized resulting in a net book value of zero at December 31, 2002.

**Note E: Notes Payable to Bank**

The notes payable bank consists of two bank lines of credit through two separate financial institutions. They are collateralized by all assets of the Company and marketable securities of a stockholder. The notes bear interest at 17% and 6.75% at December 31, 2002. The maximum credit available on the two notes through June 2003 is $205,000.

**Note F: Long-Term Debt**

Long-term debt consists of the following as of December 31:

| | 2002 | 2001 |
|---|---|---|
| Installment note payable; 4.75%; maturing through June 2007; collateralized by all Company assets | $ 186,448 | $ 655,591 |
| Note payable to stockholders; 8.75% -11.66%, maturing through September 2006; subordinated to the bank debt; unsecured | 417,954 | 461,397 |
| Installment notes payable; 6% to 9.0%; maturing through 2003; unsecured | 110,791 | 80,522 |
| Installment notes payable; 6% to 10%; maturing through 2005, collateralized by vehicles and equipment | 26,369 | 33,120 |
| | 741,562 | 1,230,630 |
| Less current maturities | 209,973 | 788,052 |
| | $ 531,589 | $ 442,578 |

## Note F: Long-Term Debt (Continued)

In 2001, the Company refinanced the 4.75% term note. Proceeds of $635,908 from the note were used to pay the original term note. The term note is collateralized by substantially all assets of the Company and marketable securities of a stockholder. The term note bears interest at a variable rate and matures in June 2007.

During 2001, $95,595 of accrued interest on a note payable stockholder was added to the note. The remainder of the accrued interest, $64,888, was forgiven by the stockholder.

Long-term debt incurred for the purchase of equipment was $7,450 and $44,912 in 2002 and 2001, respectively.

Cash paid for interest amounted to $107,226 in 2002 and $167,830 in 2001.

Maturities of long-term debt are as follows for years ending December 31:

| | |
|---|---|
| 2003 | $ 209,973 |
| 2004 | 405,938 |
| 2005 | 53,342 |
| 2006 | 50,082 |
| 2007 | 22,227 |
| | $ 741,562 |

## Note G: Commitments

The Company conducts its operations in leased facilities and leases equipment under noncancellable operating leases expiring through 2003. Minimum rental commitments under the operating leases are $33,578 for the year ending December 31, 2003.

Rent expense in 2002 and 2001 was approximately $73,000 and $141,000, respectively.

## Note H: Stock Transactions

### Stock Options

Stock options were granted to two employees of the Company in November 2001. Until November 2004, 7,500 shares of common stock can be purchased at $1.00 per share. The options vest in November of the years 2002 through 2004 at 2,500 shares per year. No options were exercised in 2002.

If the Company had used the fair value based method of accounting for its employee stock option plan, as prescribed by Statement of Financial Accounting Standards No. 123, compensation cost in net income for the year ended December 31, 2002 would have increased by $5,000, resulting in net income of $110,294, net of tax.

### Stock Warrants

Through June 1999, the Company has issued warrants to acquire a total of 84,000 shares of its common stock at $2.75 per share to individuals providing financing totaling $100,000 to the Company. Warrants issued in June 1999 contain an option to convert to net exercised or cash-less warrants. The warrants expire seven years from the date of issuance. No warrants have been exercised.

### Private Placement Offering

During 1999, the Company completed a private placement offering. In total, 52,500 shares of common stock were sold at $2.80 per share. Net proceeds from the offering, after expense of $5,535, were $123,824.

The agents for the offerings were issued warrants to purchase a total of 110,500 shares of common stock at $2.80 per share. The warrants vested at issuance and expire in 2005. No warrants have been exercised.

## Note I: Profit Sharing

The Company sponsors a 401(k) retirement plan covering all full-time employees who are at least 21 years of age. Company contributions are voluntary and at the discretion of the Board of Directors. Contributions to the plan by the Company, charged to operations amounted to $1,882 in 2002 and $2,416 in 2001.

**Note J: Income Taxes**

The income tax effects of temporary differences that gave rise to net deferred taxes are as follows as of December 31:

| | 2002 | 2001 |
|---|---|---|
| Deferred Tax Assets: | | |
| Working capital items | $ 71,800 | $ 83,700 |
| Acquisition costs and amortization | 97,500 | 97,900 |
| Net operating loss carryforward | 16,400 | 106,800 |
| Total Deferred Tax Assets | 185,700 | 288,400 |
| Deferred Tax Liabilities: | | |
| Working capital items | 66,300 | 84,300 |
| Depreciation | 13,300 | 7,700 |
| Installment contracts | 75,100 | 103,400 |
| Total Deferred Tax Liabilities | 154,700 | 195,400 |
| Net Deferred Tax Asset | $ 31,000 | $ 93,000 |

At December 31, 2002, the Company has a net operating loss carryforward of approximately $72,000, which expires at various dates through 2017.

## ITEM 22

## CONTRACTS

Attached are copies of the following agreements proposed for use regarding the offering of the AC franchise:

1. Franchise Agreement.
2. Non-competition Agreement and Non-disclosure agreement (Attachment G to Franchise Agreement).
3. Personal Guarantee of Performance (Attachment H to Franchise Agreement).

NOTE: See Exhibit C to this offering circular for form financing agreements.

AERO-COLOURS, INC.

FRANCHISE AGREEMENT

BETWEEN

AERO-COLOURS, INC.

and

______________________________________

Dated: ______________________

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**ATTACHMENTS**

**FRANCHISE AGREEMENT**

## 1. PARTIES

This Agreement is signed on _________, 20__, by and between AERO-COLOURS, INC., a Minnesota corporation ("Franchisor"), with its principal office in Minneapolis, Minnesota, and ________________________________________("Franchisee").

## 2. RECITALS

### 2.1. Ownership of System

Franchisor is the owner of certain intellectual and industrial property rights, including, without limitation, the name "Aero-Colours®" and the Marks (as defined in Section 3 below). Franchisor has spent a substantial amount of time, effort, and money to devise, and continues to develop, business methods, technical knowledge and marketing concepts including, but not limited to, products, product formulas and processes that are or may become protected by patent, trademark and copyright law, and has and continues to develop trade secrets, that, taken together, comprise a proprietary System (as defined in Section 3 below) for the operation of certain painting and related services performed from either a mobile unit or a fixed site. As a result of the time, effort and money invested by Franchisor, Franchisor has established a high reputation with the public as to the quality of service provided by Franchisor and has acquired extensive goodwill connected therewith.

### 2.2. Objectives of Parties

Franchisor desires to grant to Franchisee and Franchisee desires to accept from Franchisor a franchise to engage in the Franchised Business (as defined in Section 3 below) specified in this Agreement, using the Trade Name, Marks, and System (as such terms are defined in Section 3 below), on the terms and conditions described in this Agreement.

## 3. DEFINITIONS

For purposes of this Franchise Agreement, the following words and phrases are defined as follows:

### 3.1. Affiliate

"Affiliate" or "Affiliates" means people and companies associated with Franchisor or Franchisee, as the context indicates, including, but not limited to, owners, general partners, limited partners owning a Substantial Interest in Franchisor or Franchisee, shareholders owning a Substantial Interest in Franchisor or Franchisee, corporations in which any person or entity owning a Substantial Interest in Franchisor or Franchisee also has a Substantial Interest, or officers, directors, employees or agents of Franchisor or Franchisee. As used in this paragraph, the phrase "Substantial Interest" means the right to _______________ percent (___%) or more of the capital or earnings of a partnership or, alternatively, ownership of ____________________ percent (___%) or more of the voting stock of a corporation.

**3.2. Agreement**

"The Agreement" or "this Agreement" means this Franchise Agreement, as the same may be amended, restated or otherwise modified from time to time.

**3.3. Approved Location**

"Approved Location" means a location that Franchisor has approved in writing as a site from which Franchisee may conduct a Franchised Business. The personal residence or a Fixed Site (as defined below) of Franchisee may qualify.

**3.4. Commencement Date**

"Commencement Date" means the earlier of_______________, 20__, or the date when Franchisee's first Franchised Business opens. The Commencement Date may be extended only with the written consent of Franchisor.

**3.5. Company-Owned Unit**

"Company-Owned Unit" means a business operating under the Trade Name, Marks, and System that is owned by Franchisor or by any of its Affiliates.

**3.6. Designated Manager**

"Designated Manager" means Franchisee in his or her role as general manager of a Franchised Business or a person whom Franchisee has appointed to act as general manager of a Franchised Business.

**3.7. Fixed Site**

"Fixed Site" means a permanent location for the operation of the Franchised Business, other than the Franchisee's home, that the Franchisee holds out as his/her place of business for customers to come to so that the Franchisee can perform the Aero-Colours process there on the customer's vehicle.

**3.8. Franchised Business**

"Franchised Business" means an enterprise that Franchisor has authorized Franchisee to conduct under the Trade Name, Marks, and System at one or more Approved Locations.

**3.9. Franchisee**

"Franchisee" means the person or entity that is named as Franchisee in Article 1 of this Agreement. "Franchisee" means, in addition, all persons or entities that succeed to the interest of the original Franchisee by Transfer or operation of law.

### 3.10. Franchisor

"Franchisor" means Aero-Colours, Inc. or any person or entity to which Franchisor transfers all or part of its rights and obligations under this Agreement.

### 3.11. Good Standing

"Good Standing" means timely compliance by Franchisee and its Affiliates with all provisions of this Agreement, specifically including, but not limited to, provisions for timely payment of amounts owed by Franchisee to Franchisor or its Affiliate.

### 3.12. Gross Revenue

"Gross Revenue" means the total amount of money, property, and other income earned by Franchisee and its Affiliates for all goods sold and services rendered from the Approved Location or in connection with the Trade Name or Marks, excluding sales tax, refunds, and price adjustments made in the normal course of business, within an accounting period.

### 3.13. Index

"Index" means the Consumer Price Index: All Items/U.S. City Average - All Urban Consumers (1967 = 100), published by the Bureau of Labor Statistics, U.S. Department of Labor, or a comparable index selected by Franchisor should the above-referenced index cease to be published.

### 3.14. Initial Franchise Fee

"Initial Franchise Fee" means the fee payable by the Franchisee to the Franchisor upon the signing of this Agreement, which fee shall be in the amount set forth in Section 6.1 of this Agreement.

### 3.15. Marks

"Marks" means those selected trademarks, service marks, trade dress, logotypes, slogans and other commercial symbols that appear in Attachment "A" attached hereto and incorporated herein by this reference which are licensed by Franchisor to Franchisee under this Agreement, and which are the only "marks" that Franchisee may and must use in operating the Franchised Business.

### 3.16. Mobile Unit

"Mobile Unit" means a Chevrolet Astro van, other comparable van, or other vehicle approved by Franchisor for use in the System by Franchisee to travel to customers to perform the painting and related services granted to Franchisee in this Agreement. Franchisee must purchase or lease the Mobile Unit and, at its sole expense, convert it to satisfy all requirements established by Franchisor, including without limitation, color and signage, prior to the opening day of the Franchised Business.

**3.17. Proprietary Product**

"Proprietary Product" means "the Remover" or other product prepared and distributed by Franchisor or an Affiliate of Franchisor, which must be used by the Franchisee in operating the Franchised Business.

**3.18. System**

"System" means the business methods, technical knowledge and marketing concepts licensed by Franchisor to Franchisee under this Agreement, including, but not limited to, the right to use products, product formulas, processes, trade secrets, trademarks, commercial ideas, advertising materials, marketing strategies, information on sources of supply, administrative procedures, business forms, distinctive signage, and employee training techniques of Franchisor, all as are or may become protected by applicable patent, trademark and copyright law.

**3.19. Termination**

"Termination" means expiration of this Agreement; nonrenewal of this Agreement; or termination by law or, under the circumstances described in Article 10 of this Agreement, of the then-current term of this Agreement before its normal expiration date.

**3.20. Territory**

"Territory" means the geographic area granted by Franchisor to Franchisee in Section 4.2 of this Agreement.

**3.21. Trade Name**

"Trade Name" means the commercial name "Aero-Colours."

**3.22. Transfer**

"Transfer" means any sale, gift, or other change in ownership of (a) all or any part of the rights and obligations of this Agreement, (b) any Franchised Business, or (c) the ownership interest in Franchisee of a magnitude at least as great as that described in this section. If Franchisee is an individual or a partnership, then one or more transactions (regardless of whether or not they are related) in which there is a cumulative change in the ownership rights to thirty-four percent (34%) or more of the capital or profits of Franchisee; if Franchisee is a corporation, then one or more transactions (regardless of whether or not they are related) in which there is a cumulative change in beneficial ownership of thirty-four percent (34%) or more of the voting stock of Franchisee.

## 4. GRANT OF FRANCHISE

### 4.1. Granting Clause

Franchisor grants to Franchisee and Franchisee accepts from Franchisor a franchise to operate the Franchised Business as specified in the Development Schedule set out in Attachment B to this Agreement at Approved Locations within the Territory using the Trade Name, Marks and System in accordance with the terms of this Agreement. Franchisor expressly reserves all rights in the Trade Name, Marks, and System and Goodwill not expressly granted in this Agreement, including the right to sell the Remover or other proprietary product within the Territory through any means of distribution not specifically prohibited in Section 4.2 of this Agreement.

### 4.2. Territorial Rights

The Territory will consist of the geographic area described in Attachment C to this Agreement. The Territory will contain not less than twenty (20) new-car dealerships at the time this Agreement is executed. If the Territory contains less than twenty (20) new-car dealerships prior to the time this Agreement is executed, Franchisor will consider reducing the Initial Franchise Fee. Franchisor shall not be responsible to Franchisee in any fashion should the number of new-car dealerships in the Territory decrease or fall below the number of new-car dealerships in existence in the Territory at the time this Agreement is executed. Franchisee acknowledges that the size and exclusivity of the Territory is dependent upon compliance with the Development Schedule by the Franchisee as set forth in Section 7.3 of this Agreement, and that failure by the Franchisee to comply gives Franchisor the right to reduce the Territory in size and/or to re-establish the boundaries of the Territory. So long as the Franchisee remains in Good Standing and is in compliance with its obligations under the Development Schedule, Franchisor agrees not to operate a competing business or authorize any other franchisee to base its Franchised Business within the Territory, and further agrees not to base any Company-Owned Unit that uses the Trade Name or System within the Territory, nor allow any other franchisee or Company-Owned Unit using the Trade Name or System to relocate to a site within the Territory.

Franchisor may operate a Company-Owned Unit or allow another franchisee to operate a franchise in any territory that is adjoining or contiguous to the Territory.

Franchisee shall not establish a Fixed Site outside of the Territory. Franchisee may perform Franchised Business services from a Mobile Unit in areas outside of the Territory only if the following conditions are met: (i) the Franchisee reasonably describes in writing to Franchisor the area in which it proposes to operate, (ii) such area is not subject to a grant of a franchise by Franchisor to another franchisee, (iii) such area is not already being serviced by a Company-Owned Unit, and (iv) the Franchisee obtains the consent of Franchisor, which consent shall not be unreasonably withheld. In the event any area in which the Franchisee is operating outside of its Territory becomes subject to a grant in favor of another franchisee, the

Franchisee agrees to promptly stop operating in such area and to relinquish all rights to any accounts established by the Franchisee in such area to the new franchisee. In the event the Franchise establishes a Fixed Site, or operates the Franchised Business, outside of its Territory in violation of this Section 4.2, all revenue derived therefrom shall be deemed to be the property of Franchisor and shall be held in trust by the Franchisee for the benefit of Franchisor.

Franchisee may relocate the Franchised Business or Fixed Site within the Territory only upon the prior written consent of Franchisor, such consent not to be unreasonably withheld. Such written consent of Franchisor is not required for Franchisee to relocate the Franchised Business if Franchisee is operating the franchise out of its personal residence, has no Fixed Site, and is simply moving its residence.

**4.3. Term and Renewal**

4.3.1. Initial Term. The initial term of the Franchise will begin on the Commencement Date and will continue for a period of ten (10) years.

4.3.2. Renewal. Franchisee will have the right to automatically renew the Franchise for a ten year term on the same terms and conditions as those on which Franchisor is customarily granting new franchises at the time of renewal if at the time of renewal the following conditions have been fulfilled:

(a) Franchisee and its Affiliates are in Good Standing under this Agreement, any other agreement with Franchisor or any Affiliate of Franchisor;

(b) Franchisee has notified Franchisor in writing at least ninety (90) days before the expiration date of this Agreement of its desire to renew;

(c) Franchisee and any Affiliates that have signed this Agreement have signed a copy of the new Franchise Agreement not less than thirty (30) days before the expiration of this Agreement;

(d) Franchisee will, before commencement of the renewal term, at its own expense, remodel, modernize, and redecorate the Franchised Business premises, if any, the mobile unit(s), and replace and modernize the fixtures, equipment, and signage used in the Franchised Business so that the premises and mobile unit(s) of the Franchised Business meet the standards of appearance and function applicable to the premises and mobile unit(s) of new Franchised Businesses at the time of renewal;

(e) Franchisee has renewed or has the right to renew the lease for the Approved Location for a term equal to or greater than the renewal term; and