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AEROCENTURY CORP  
Form 10QSB  
May 14, 2003

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

FORM 10-QSB

(Mark One)

Quarterly Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934 For the quarterly period ended March 31, 2003

Transition Report Under Section 13 or 15(d) of the Securities Exchange Act of 1934 For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-13387

AeroCentury Corp.

(Name of small business issuer in its charter)

Delaware

94-3263974

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

1440 Chapin Avenue, Suite 310

Burlingame, California

94010

(Address of principal executive offices)

(Zip Code)

Issuer's telephone number, including area code: (650) 340-1888

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class  
Common Stock, \$0.001 par value

Name of Exchange on Which Registered  
American Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Check whether the Issuer: (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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As of May 14, 2003 the Issuer had 1,606,557 Shares of Common Stock outstanding, of which 63,300 are held as Treasury Stock.

Transitional Small Business Disclosure Format (check one): Yes \_\_\_\_\_ No  \_\_\_\_\_

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## PART I

### Financial Information

#### Forward-Looking Statements

This Quarterly Report on Form 10-QSB includes "forward-looking statements" within the meaning of Section 27A of the Securities Act and Section 21E of the Exchange Act. All statements in this Report other than statements of historical fact are "forward-looking statements" for purposes of these provisions, including any statements of plans and objectives for future operations and any statements of assumptions underlying any of the foregoing. Statements that include the use of terminology such as "may," "will," "expects," "plans," "anticipates," "estimates," "potential," or "continue," or the negative thereof, or other comparable terminology are forward-looking statements.

Forward-looking statements include: (i) in item 1 "Financial Statements," statements regarding the Company's expectation regarding delivery of aircraft for which lease term sheets have been signed; and the Company's expectations regarding maintenance of covenant compliance through expiration of the credit line facility; (ii) in Item 2 "Management's Discussion and Analysis or Plan of Operation -- Liquidity and Capital Resources," statements regarding the Company's expectation that it will be able to maintain compliance with its credit facility covenants through the expiration of the credit facility on June 28, 2003; the Company's expectation that it will be able to obtain a new revolving credit facility at reasonable market terms; the Company's belief that it has adequate cash flow to fund reasonably expected increases in interest rates applicable to its credit facility obligations; the Company's belief that it will have sufficient funds to meet the reduced payment obligations required by the lender if the lease for the AeroCentury II LLC aircraft is terminated; the Company's belief that a six-month remarketing period for the AeroCentury II LLC aircraft is a reasonable period for re-leasing; the Company's belief that it will have adequate cash flow to meet its ongoing operational needs; the Company's belief that it will have sufficient cash to fund any necessary payments under its guaranty of certain payments to a third party vendor by a lessee; (iii) in Item 6 "Management's Discussion and Analysis or Plan of Operation -- Outlook," statements regarding the Company's belief that it has sufficient cash to fund a repayment if a replacement lender is not found for one of the current credit line participants; and the Company's belief that it will be able to purchase and lease aircraft at prices and lease rates that will have a positive effect on the Company's earnings; (iv) in Item 6 "Management's Discussion and Analysis or Plan of Operation -- Factors that May Affect Future Results," statements regarding the Company's belief that it has sufficient cash to fund a repayment if a replacement lender is not found for one of the current credit line participant; the Company's expectation that it will be able to maintain compliance with its credit facility covenants through the expiration of the credit facility on June 28, 2003; the Company's anticipated acquisition of primarily used aircraft; the opportunities available in overseas markets; JMC's competitiveness due to its experience and operational efficiency in financing transaction types desired by regional air carriers and its global reputation, the Company's ability to obtain third party guaranties, letters of credit or other credit enhancements from future lessees.

These forward-looking statements involve risks and uncertainties, and it is important to note that the Company's actual results could differ materially from those projected or assumed in such forward-looking statements. Among the factors that could cause actual results to differ materially are the factors detailed under the heading "Management's Discussion and Analysis or Plan of Operation -- Factors That May Affect Future Results," including general economic conditions,

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particularly those that affect the demand for regional aircraft and engines and the financial status of the Company's primary customers, regional passenger airlines; lack of any further disruptions to the air travel industry similar to that which occurred on September 11, 2001 or the SARS outbreak; the success of the Company's efforts in remarketing or re-leasing aircraft that are currently or are about to come off-lease and in concluding transactions for which term sheets have been executed; the Company's ability to obtain a new credit facility on reasonable business terms at or prior to the expiration of its current credit facility, as well as locate a replacement lender for a departing credit line participant; the financial performance of the Company's lessees and their compliance with rental, maintenance and return conditions under their respective leases; the availability of suitable aircraft acquisition transactions in the regional aircraft market; and future trends and results which cannot be predicted with certainty. The cautionary statements made in this Quarterly Report should be read as being applicable to all related forward-looking statements wherever they appear herein. All forward-looking statements and risk factors included in this document are made as of the date hereof, based on information available to the Company as of the date hereof, and the Company assumes no obligation to update any forward-looking statement or risk factor. You should consult the risk factors listed from time to time in the Company's filings with the Securities and Exchange Commission.

### Item 1. Financial Statements

AeroCentury Corp.  
Condensed Consolidated Balance Sheet  
Unaudited

#### ASSETS

	March 31, 2003 ----
<b>Assets:</b>	
Cash and cash equivalents	\$ 1,795,810
Deposits	7,440,790
Accounts receivable, net of allowance for doubtful accounts of \$100,000	2,194,080
Aircraft and aircraft engines on operating leases, net of accumulated depreciation of \$19,111,490	64,661,210
Note receivable	4,450
Prepaid expenses and other	373,480
	-----
<b>Total assets</b>	<b>\$ 76,469,820</b> =====

#### LIABILITIES AND STOCKHOLDERS' EQUITY

<b>Liabilities:</b>	
Accounts payable and accrued expenses	\$ 761,750
Notes payable and accrued interest	43,363,870
Maintenance reserves and accrued costs	6,221,530
Security deposits	2,260,270
Prepaid rent	272,380

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Deferred taxes	3,543,790
	-----
Total liabilities	56,423,590
	=====
Stockholders' equity:	
Preferred stock, \$.001 par value, 2,000,000 shares authorized, no shares issued and outstanding	-
Common stock, \$.001 par value, 3,000,000 shares authorized, 1,606,557 shares issued and outstanding	1,610
Paid in capital	13,821,200
Retained earnings	6,727,490
	-----
Treasury stock at cost, 63,300 shares	20,550,300 (504,070)
	-----
Total stockholders' equity	20,046,230
	-----
Total liabilities and stockholders' equity	\$ 76,469,820
	=====

The accompanying notes are an integral part of these statements.

AeroCentury Corp.  
Condensed Consolidated Statements of Income

	For the Three Months Ended March 31	
	2003	2002
	----	----
	Unaudited	
Revenues:		
Operating lease revenue	\$ 2,451,940	\$ 2,193,630
Other income	23,930	31,460
	-----	-----
	2,475,870	2,225,090
	-----	-----
Expenses:		
Management fees	487,060	420,660
Depreciation	840,800	680,710
Interest	511,000	467,510
Maintenance	101,010	76,080
Professional fees and general and administrative	315,760	128,750
	-----	-----
	2,255,630	1,773,710
	-----	-----
Income before taxes	220,240	451,380
Tax provision	45,120	151,760

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	-----	-----
Net income	\$ 175,120	\$ 299,620
	=====	=====
Weighted average common shares outstanding	1,543,257	1,543,257
	=====	=====
Basic earnings per share	\$ 0.11	\$ 0.19
	=====	=====

The accompanying notes are an integral part of these statements.

AeroCentury Corp.  
Condensed Consolidated Statements of Cash Flows

		For the Three Months Ended Ma	
		2003	20
		----	--
			Unaudited
Net cash provided by operating activities	\$	891,810	\$
Investing activity -			
Purchase of aircraft and aircraft engines		-	(
		-----	-----
Net cash used by investing activity		-	(
Financing activities:			
Payments received on note receivable		13,150	
Repayment of notes payable		(816,800)	(1,6
		-----	-----
Net cash used by financing activities		(803,650)	(1,6
Net increase/(decrease) in cash and cash equivalents		88,160	(8
Cash and cash equivalents, beginning of period		1,707,650	2,
		-----	-----
Cash and cash equivalents, end of period	\$	1,795,810	\$ 1,
		=====	=====

The accompanying notes are an integral part of these statements.

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AeroCentury Corp.  
Notes to Condensed Consolidated Financial Statements  
March 31, 2003  
Unaudited

1. Organization and Summary of Significant Accounting Policies

(a) Basis of Presentation

AeroCentury Corp. ("AeroCentury"), a Delaware corporation, uses leveraged financing to acquire leased aircraft assets. The Company purchases used regional aircraft on lease to foreign and domestic regional carriers. Financial information for AeroCentury and its two wholly-owned subsidiaries, AeroCentury Investments LLC ("AeroCentury LLC") and AeroCentury Investments II LLC ("AeroCentury II LLC") (collectively, the "Company"), is presented on a consolidated basis. All intercompany balances and transactions have been eliminated in consolidation.

Although the Company believes that it has included all adjustments necessary for a fair presentation of the interim periods presented and that the disclosures are adequate to make the information presented not misleading, the Company suggests that these condensed consolidated financial statements be read in conjunction with the consolidated financial statements and related notes included in the Company's annual report on Form 10-KSB for the fiscal year ended December 31, 2002.

(b) Capitalization

In 1998, in connection with the adoption of a stockholder rights plan, the Company filed a Certificate of Designation, setting forth the rights, preferences and privileges of a new Series A Preferred Stock. Pursuant to the plan, the Company issued rights to its stockholders, giving each stockholder the right to purchase one one-hundredth of a share of Series A Preferred Stock for each share of Common Stock held by the stockholder. Such rights are exercisable only under certain circumstances concerning a proposed acquisition or merger of the Company.

As discussed above, AeroCentury is the sole member and manager of AeroCentury LLC and AeroCentury II LLC.

(c) Cash and Cash Equivalents/Deposits

The Company considers highly liquid investments readily convertible into known amounts of cash, with original maturities of 90 days or less, as cash equivalents. Deposits represent cash balances held related to maintenance reserves and security deposits and generally are subject to withdrawal restrictions.

At March 31, 2003, the Company held security deposits of \$2,260,270, refundable maintenance reserves received from lessees of \$953,810 and non-refundable maintenance reserves of \$4,226,710.

The Company's leases are typically structured so that if any event of default occurs under a lease, the Company may apply all or a portion of the lessee's security deposit to cure such default. If such application of the security deposit is made, the lessee typically is required to replenish and maintain the full amount of the deposit during the remaining term of the lease. All of the security deposits currently held by the Company are refundable to the

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lessee at the end of the lease, upon satisfaction of all lease terms.

AeroCentury Corp.  
Notes to Consolidated Financial Statements  
March 31, 2003  
Unaudited

1. Organization and Summary of Significant Accounting Policies (continued)

(c) Cash and Cash Equivalents/Deposits (continued)

Maintenance reserves which are refundable to the lessee at the end of the lease may be retained by the Company if such amounts are necessary to meet the return conditions specified in the lease and, in some cases, to satisfy any other payments due under the lease.

Non-refundable maintenance reserves held by the Company are accounted for as a liability until the aircraft has been returned at the end of the lease, at which time the Company evaluates the adequacy of the remaining reserves in light of maintenance to be performed as a result of hours flown. At that time, any excess is recorded as income. When an aircraft is sold, any excess non-refundable maintenance reserves are recorded as income.

(d) Aircraft and Aircraft Engines On Operating Leases

The Company's interests in aircraft and aircraft engines are recorded at cost, which includes acquisition costs. Depreciation is computed using the straight-line method over the aircraft's estimated economic life (generally assumed to be twelve years from the date of acquisition), to an estimated residual value based on appraisal.

(e) Impairment of Long-lived Assets

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets," assets are reviewed for impairment whenever events or changes in circumstances indicate that the book value of the asset may not be recoverable. Periodically, the Company reviews its long-lived assets for impairment based on third party valuations. In the event such valuations are less than the recorded value of the assets, the assets are written down to their estimated realizable value.

(f) Loan Commitment and Related Fees

To the extent that the Company is required to pay loan commitment fees and legal fees in order to secure debt, such fees are amortized over the life of the related loan.

(g) Maintenance Reserves and Accrued Costs

Maintenance costs under the Company's triple net leases are generally the responsibility of the lessees. Maintenance reserves and accrued costs in the accompanying balance sheet include refundable and non-refundable maintenance payments received from lessees. The Company periodically reviews maintenance reserves for adequacy in light of the number of hours flown, airworthiness directives issued by the manufacturer or government authority, and the return conditions specified in the lease. As a result of such review, when it is

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probable that the Company has incurred costs for maintenance in excess of amounts received from lessees, the Company accrues its share of costs for work to be performed as a result of hours flown. At March 31, 2003, the Company had accrued maintenance costs of approximately \$251,000 related to several of its aircraft.

AeroCentury Corp.  
Notes to Consolidated Financial Statements  
March 31, 2003  
Unaudited

### 1. Organization and Summary of Significant Accounting Policies (continued)

#### (h) Income Taxes

The Company follows the liability method of accounting for income taxes. Under the liability method, deferred income taxes are recognized for the tax consequences of "temporary differences" by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. The effect on deferred taxes of a change in the tax rates is recognized in income in the period that includes the enactment date.

#### (i) Revenue Recognition

Revenue from leasing of aircraft assets is recognized as operating lease revenue on a straight-line basis over the terms of the applicable lease agreements.

#### (j) Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures 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.

The most significant estimates with regard to these financial statements are the residual values of the aircraft, the useful lives of the aircraft, and the estimated amount and timing of cash flow associated with each aircraft that are used to evaluate impairment, if any.

#### (k) Comprehensive Income

The Company does not have any comprehensive income other than the revenue and expense items included in the consolidated statements of income. As a result, comprehensive income equals net income for the quarters ended March 31, 2003 and 2002.

#### (l) Recent Accounting Pronouncements

In November 2002, the Financial Accounting Standards Board issued SFAS Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45"). FIN 45 is effective for guarantees issued or modified after December 31, 2002.



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The Company has one guarantee, which was issued prior to December 31, 2002 (Note 6). The Company has not recorded a liability for the fair value of the obligations it has assumed under this guarantee.

AeroCentury Corp.  
Notes to Consolidated Financial Statements  
March 31, 2003  
Unaudited

### 2. Aircraft and Aircraft Engines On Operating Leases

At March 31, 2003, the Company owned five deHavilland DHC-8s, two deHavilland DHC-7s, three deHavilland DHC-6s, one Fairchild Metro III, two Shorts SD 3-60s, six Fokker 50s, two Saab 340As and 26 turboprop engines. The Company did not acquire or sell any aircraft during the first three months of 2003.

At March 31, 2003, all but two of the Company's aircraft were subject to operating lease agreements.

In February 2003, the Company and the lessee for two of the Company's deHavilland DHC-8 aircraft, the leases for which were due to expire in April 2003, signed lease amendments providing for a two-year extension of both leases and for the deferral of certain amounts due under the leases.

In March 2003, the Company and the lessee of one of the Company's deHavilland DHC-8 aircraft agreed to extend the lease from April 15, 2003 to November 15, 2003. The Company and the lessee are currently discussing a long-term extension of the lease.

The lease for one of the Company's Fokker 50 aircraft expired in September 2002, but the lessee, which is in financial difficulty, is required to continue to pay rent until the aircraft is returned and accepted by the Company, which is expected to occur in the second quarter of 2003. The Company and the lessee have signed an agreement regarding the return of the aircraft and the amounts owed by the lessee. Although the Company holds a security deposit from this lessee, the amount of the deposit is not sufficient to pay the rent accrued at March 31, 2003 and reimburse the Company for the estimated maintenance work which must be performed to meet the return conditions of the lease. Therefore, the Company established an allowance for doubtful accounts in the amount of \$100,000 on March 31, 2003. In February 2003, the Company signed a term sheet with a new customer for the re-lease of this aircraft and expects to deliver the aircraft in the second quarter of 2003.

The leases for one of the Company's Saab 340A aircraft and one of the Company's turboprop engines remained in effect from their expiration dates of December 31, 2002 and October 31, 2002, respectively, until the pre-return inspections of the aircraft and engine were complete. Both were returned and accepted by the Company in the first quarter of 2003. The Company has signed a term sheet with a new customer for the re-lease of this aircraft, as well as another Saab 340A which has been off lease since the third quarter of 2002 and expects to deliver the aircraft in the second quarter of 2003.

As discussed in Note 8, several of the Company's aircraft were re-leased to new customers or were subject to leases which were amended in the second quarter of 2003.

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AeroCentury Corp.  
Notes to Consolidated Financial Statements  
March 31, 2003  
Unaudited

3. Note Receivable

At March 31, 2003, the Company's note receivable consisted of a loan to one of the Company's long-standing lessees in connection with a manufacturer-required inspection of the aircraft and repair of certain components. The Company and the lessee agreed to a cost sharing arrangement whereby a portion of the cost was funded by maintenance reserves previously paid by the lessee and the remaining cost was allocated between the Company and the lessee. The Company recorded a note receivable for the lessee's portion, net of interest to be received at a rate of 5%, which is being repaid through increased rent during the remainder of the original lease term, which expires on April 30, 2003.

4. Notes Payable and Accrued Interest

The Company has a revolving credit facility totaling \$50 million. The facility, which expires on June 28, 2003, bore interest through March 30, 2002, at the Company's option, at either (i) prime or (ii) LIBOR plus a margin of 200 to 250 basis points depending on certain financial ratios. On March 7, 2002, the Company and its lenders agreed to modify certain financial covenants contained in the loan agreement for the facility in order to enable the Company to continue to take advantage of business opportunities in the current industry environment of increased market demand for shorter-term leases. The changes, originally in effect through December 31, 2002, were extended through February 28, 2003. In return for granting such changes, the Company's lenders increased the margin on the interest rates chosen by the Company from a floating margin to a fixed margin of 275 basis points, effective March 31, 2002. On March 1, 2003, the margin returned to its original floating rate. The Company expects that it will be able to maintain compliance with its credit facility covenants, including those which reverted on March 1, 2003, through the expiration of the credit facility on June 28, 2003. The Company is currently discussing the terms of a new credit facility with its agent bank.

The Company's assets, excluding those of AeroCentury LLC and AeroCentury II LLC, serve as collateral under the facility and, in accordance with the credit agreement, the Company must maintain compliance with certain financial covenants. As of March 31, 2003, the Company was in compliance with all such covenants, \$40,705,000 was outstanding under the credit facility, and interest of \$183,340 was accrued, using a combination of prime and LIBOR rates.

In November 1999 the Company acquired two aircraft using cash and bank financing separate from its credit facility. During 2002, the Company used funds from its revolving credit facility to repay the outstanding bank financing related to both aircraft.

A similar financing was concluded in September 2000, consisting of a note in the amount of \$3,575,000, due April 18, 2003, which bears fixed interest at 8.36% for the acquisition of a deHavilland DHC-8 aircraft. The note is collateralized by this aircraft and is non-recourse to the Company. Payments due under the note consist of monthly principal and interest and a balloon principal

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payment due on the maturity date. The balance of the note payable at March 31, 2003 was \$2,468,650 and interest of \$6,880 was accrued. As of March 31, 2003, the Company was in compliance with all covenants of the loan agreement pertaining to the financing of this aircraft. As discussed in Note 8, the lease for the aircraft has been extended and the lender has agreed to extend the financing.

AeroCentury Corp.  
Notes to Consolidated Financial Statements  
March 31, 2003  
Unaudited

5. Income Taxes

The items comprising income tax expense are as follows:

	For the Three Months 2003 ----
Current tax provision:	
Federal	\$ 252,080
State	12,090
Foreign	-
	-----
Current tax provision	264,170
	-----
Deferred tax provision/(benefit):	
Federal	(183,000)
State	(36,050)
	-----
Deferred tax provision	(219,050)
	-----
Total provision for income taxes	\$ 45,120
	=====

Total income tax expense differs from the amount that would be provided by applying the statutory federal income tax rate to pretax earnings as illustrated below:

	For the Three Months 2003 ----
Income tax expense at	
statutory federal income tax rate	\$ 74,880
State taxes net of federal benefit	1,080
Tax rate differences	(30,840)
	-----
Total income tax expense	\$ 45,120
	=====

Temporary differences and carryforwards that gave rise to a significant portion of deferred tax assets and liabilities as of March 31, 2003 are as follows:

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Deferred tax assets:	
Allowance for doubtful accounts	\$ 34,490
Maintenance reserves	1,649,100
Deferred maintenance	99,570
Prepaid rent and other	94,210
	-----
Deferred tax assets	1,877,370
Deferred tax liabilities:	
Depreciation on aircraft and aircraft engines	(5,151,850)
Unearned income	(38,450)
Other	(230,860)
	-----
Net deferred tax liabilities	\$ (3,543,790)
	=====

No valuation allowance is deemed necessary, as the Company anticipates generating adequate future taxable income to realize the benefits of all deferred tax assets on the balance sheet.

AeroCentury Corp.  
Notes to Consolidated Financial Statements  
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6. Commitments and Contingencies

In connection with the re-lease of two of the Company's aircraft, the Company has guaranteed, up to a maximum of \$150,000, the lessee's payments under a contract with a third party vendor for spare parts. The term of the guarantee extends for 90 days after the expiration or termination of the leases in November 2005. The lessee has agreed to reimburse the Company for any payments made under the guarantee, upon demand by the Company. If the lessee does not make such reimbursements or does not comply with any provisions of the parts agreement, the Company may declare an event of default under the leases.

7. Related Party Transactions

Since the Company has no employees, the Company's portfolio of leased aircraft assets is managed and administered under the terms of a management agreement with JetFleet Management Corp. ("JMC"), which is an integrated aircraft management, marketing and financing business and a subsidiary of JetFleet Holding Corp. ("JHC"). Certain officers of the Company are also officers of JHC and JMC and hold significant ownership positions in both JHC and the Company. Under the management agreement, JMC receives a monthly management fee based on the net asset value of the assets under management. JMC may also receive an acquisition fee for locating assets for the Company, provided that the aggregate purchase price including chargeable acquisition costs and any acquisition fee does not exceed the fair market value of the asset based on appraisal, and a remarketing fee in connection with the sale or re-lease of the Company's assets. The management fees, acquisition fees and remarketing fees may not exceed the customary and usual fees that would be paid to an unaffiliated party for such services. The Company recorded management fees of \$487,060 and \$420,660 during the three months ended March 31, 2003 and 2002, respectively. Because the Company did not acquire any aircraft during the first three months of 2003 or 2002, no acquisition fees were paid to JMC. No remarketing fees were accrued to JMC during 2003 or 2002.

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### 8. Subsequent Events

In April 2003, the Company and the lessee for three of the Company's aircraft signed lease amendments which cured the lessee's recent default for rent and reserves due for the Company's two deHavilland DHC-7 aircraft. The amendments provide for deferral of the overdue rent and reserves and for payment of such amounts over time in installments. The Company and the lessee also agreed to terminate the lease for the third aircraft, a Shorts SD 3-60. All amounts due for this aircraft were paid by the lessee in April 2003 and the Company anticipates accepting the aircraft in May 2003.

In April 2003, the Company's Fairchild Metro III aircraft, which was returned by the original lessee in October 2002 was delivered to a new lessee for a term of one year, with options to extend for two additional one-year periods.

The lease for one of the Company's Fokker 50 aircraft, which had previously been extended to March 31, 2003, was extended through May 31, 2003 in April 2003. The Company and the lessee are currently discussing a long-term extension of this lease as well as that for another Fokker 50 which expires in June 2003.

AeroCentury Corp.  
Notes to Consolidated Financial Statements  
March 31, 2003  
Unaudited

### 8. Subsequent Events (continued)

As discussed in Note 2, the Company and the lessee of one of the Company's deHavilland DHC-8 aircraft have agreed to a short-term extension of the lease through November 15, 2003, with periodic options to terminate the lease, and are currently discussing a long-term extension of the lease. The lender has agreed to extend the financing through March 19, 2006, with prepayment options at June 30, 2003 and November 30, 2003. During the term of the extension, the note bears interest at the rate of one-month LIBOR plus 3%, with a balloon payment at maturity. The financing also provides for a six month remarketing period at the expiration of the lease or if the lease is terminated prior to its expiration date. Payments due on the financing are reduced during this six month period and the balloon principal payment is due at the end of the six month period.

In May 2003, the Company and the lessee of one of the Company's deHavilland DHC-6 aircraft agreed to a one-month extension of the lease to May 31, 2003 and are currently discussing a long-term extension.

In May 2003, the Company and the lessee for one of the Company's Fokker 50 aircraft agreed to extend the lease, which had previously been extended through May 8, 2003, through May 15, 2004.

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### Item 2. Management's Discussion and Analysis or Plan of Operation.

#### Critical Accounting Policies

In response to the Securities and Exchange Commission's Release No. 33-8040, "Cautionary Advice Regarding Disclosure About Critical Accounting Policies", the Company has identified the most critical accounting policies upon which its financial status depends. It determined the critical policies by considering those that involve the most complex or subjective decisions or assessments. The Company identified these policies to be those related to lease rental revenue recognition, depreciation policies, valuation of aircraft and maintenance reserves and accrued costs.

#### Revenue Recognition

Revenue from leasing of aircraft assets is recognized as operating lease revenue on a straight-line basis over the terms of the applicable lease agreements.

#### Depreciation Policies

The Company's interests in aircraft and aircraft engines are recorded at cost, which includes acquisition costs. Depreciation is computed using the straight-line method over the aircraft's estimated economic life (generally assumed to be twelve years from the date of acquisition), to an estimated residual value based on appraisal.

#### Valuation of Aircraft

In accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets," assets are reviewed for impairment whenever events or changes in circumstances indicate that the book value of the asset may not be recoverable. Periodically, the Company reviews its long-lived assets for impairment based on third party valuations. In the event such valuations are less than the recorded value of the assets, the assets are written down to their estimated realizable value.

#### Maintenance Reserves and Accrued Costs

Maintenance costs under the Company's triple net leases are generally the responsibility of the lessees. Maintenance reserves and accrued costs in the accompanying balance sheet include refundable and non-refundable maintenance payments received from lessees. The Company periodically reviews maintenance reserves for adequacy in light of the number of hours flown, airworthiness directives issued by the manufacturer or government authority, and the return conditions specified in the lease. As a result of such review, when it is probable that the Company has incurred costs for maintenance in excess of amounts received from lessees, the Company accrues its share of costs for work to be performed as a result of hours flown.

#### Results of Operations

##### Revenues

The Company had revenues of \$2,475,870 and net income of \$175,120 for the three months ended March 31, 2003 versus revenues of \$2,225,090 and net income of \$299,620 for the three months ended March 31, 2002. Operating lease revenue was

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approximately \$258,000 higher in 2003 versus 2002 primarily because of an increase in operating lease revenue from aircraft purchased during the second half of 2002 and from the re-lease of several aircraft which had been off lease during the first quarter of 2002. These increases more than offset a decrease in operating lease revenue resulting from lower overall lease rates and aircraft off lease during the quarter. Other income was lower by approximately \$8,000 during 2003 versus 2002 because of lower interest rates on lower cash balances during 2003 versus 2002.

### Expense Items

Management fees, which are calculated on the net book value of the aircraft owned by the Company, were approximately \$66,000 higher in 2003 versus 2002 as a result of the Company's purchase of two aircraft during the second half of 2002, the effect of which was only partially offset by decreased net book value of the Company's other aircraft as a result of depreciation. Depreciation was approximately \$160,000 higher in 2003 versus 2002 as a result of aircraft purchased during 2002.

Interest expense was approximately \$43,000 higher in 2003 versus 2002 because of a higher average principal balance during 2003, the effect of which was only partially offset by lower interest rates during 2003. Maintenance expense was higher in 2003 primarily due to work to be performed on an off-lease aircraft. Professional fees and general and administrative expenses were approximately \$187,000 higher in 2003 versus 2002, primarily due to an allowance for doubtful accounts, higher legal and accounting expense, and higher premiums for aircraft insurance.

The Company's effective tax rate in 2003 was approximately 20% versus approximately 34% in 2002 primarily because of a change in the mix of domestic and foreign leased assets and a related change in the proportion of revenue generated within and outside of California.

### Liquidity and Capital Resources

The Company is currently financing its assets primarily through credit facility borrowings and excess cash flow. The Company has a revolving credit facility totaling \$50 million. The facility, which expires on June 28, 2003, bore interest through March 30, 2002, at the Company's option, at either (i) prime or (ii) LIBOR plus a margin of 200 to 250 basis points depending on certain financial ratios. The Company's assets, excluding those of AeroCentury LLC and AeroCentury II LLC, serve as collateral under the revolving credit facility and, in accordance with the credit agreement, the Company must maintain compliance with certain financial covenants. The Company made a repayment on its facility in the amount of \$700,000 during the first quarter of 2003 because of certain collateral borrowing base limitations.

On March 7, 2002, the Company and its lenders agreed to modify certain financial covenants contained in the loan agreement for the facility in order to enable the Company to continue to take advantage of business opportunities in the industry environment of increased market demand for shorter-term leases. The changes, originally in effect through December 31, 2002, were extended through February 28, 2003. In return for granting such changes, the Company's lenders increased the margin on the interest rates chosen by the Company from a floating margin to a fixed margin of 275 basis points, effective March 31, 2002. On March 1, 2003, the margin returned to its original floating rate. The Company expects that it will be able to maintain compliance with its credit facility covenants, including those which reverted on March 1, 2003, through the expiration of the credit facility on June 28, 2003. The Company is currently discussing the terms of a new credit facility with its agent bank and expects to be able to obtain

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such facility at reasonable market terms.

At March 31, 2003, principal of \$40,705,000 was outstanding under the credit facility and interest of \$183,340 was accrued. The Company is currently in compliance with all covenants of the revolving credit facility. The majority of the Company's borrowings are currently financed using one-month LIBOR rates. The Company believes it has adequate cash flow to fund reasonably expected increases in interest rates applicable to its credit facility obligations.

The Company's interest expense generally moves up or down with the prevailing interest rates, as the Company has not entered into any interest rate hedge transactions. Because aircraft owners seeking financing generally can obtain financing through either leasing transactions or traditional secured debt financings, prevailing interest rates are a significant factor in determining market lease rates, and market lease rates generally move up or down with prevailing interest rates, assuming supply and demand of the desired equipment remain constant. However, because lease rates for the Company's assets typically are fixed under existing leases, the Company usually does not experience any positive or negative impact in revenue from changes in market lease rates due to interest rate changes until existing leases have terminated.

In November 1999, AeroCentury LLC acquired two aircraft using cash and bank financing separate from its credit facility. During 2002, the Company used funds from its revolving credit facility to repay the outstanding bank financing related to both aircraft.

A similar special purpose entity financing for AeroCentury II LLC was concluded in September 2000, consisting of a note in the amount of \$3,575,000, due April 18, 2003, which bears fixed interest at 8.36% for the acquisition of one aircraft. The note is collateralized by this aircraft and is non-recourse to the Company. Payments due under the note consist of monthly principal and interest and a balloon principal payment due on the maturity date. The balance of the note payable at March 31, 2003 was \$2,468,650 and interest of \$6,880 was accrued. At March 31, 2003, the Company was in compliance with all covenants of the loan agreement pertaining to the financing of this aircraft.

The Company and the lessee of the aircraft have agreed to a short-term extension of the lease through November 15, 2003, with periodic options to terminate the lease, and are currently discussing a long-term extension of the lease. The lender has agreed to extend the financing through March 19, 2006, with prepayment options at June 30, 2003 and November 30, 2003. During the term of the extension, the note bears interest at the rate of one-month LIBOR plus 3%, with a balloon payment at maturity. The financing also provides for a six month remarketing period at the expiration of the lease or if the lease is terminated prior to its expiration date. Payments due on the financing are reduced during this six month period and the balloon principal payment is due at the end of the six month period. The Company believes it will have sufficient cash to meet the reduced payment obligations required by the lender if the lease is terminated, assuming that the aircraft is re-leased within six months, which the Company believes is a reasonable period.

The Company's primary source of revenue is lease rentals collected from lessees of its aircraft assets. It is the Company's policy to monitor each lessee's needs in periods before leases are due to expire. If it appears that a lessee will not be renewing its lease, the Company immediately initiates marketing efforts to locate a potential new lessee or purchaser for the aircraft. This procedure helps the Company reduce the time that an asset will be "off-lease." The Company's aircraft are subject to leases with varying expiration dates through November 2005. Although the Company has recently amended the leases for several of its aircraft to defer rent and reserve payments, given the varying



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lease terms and expiration dates for the aircraft in the Company's portfolio, management believes that the Company will have adequate cash flow to meet its on-going operational needs.

In connection with the re-lease of two of the Company's aircraft during 2002, the Company has guaranteed, up to a maximum of \$150,000, the lessee's payments under a contract with a third party vendor for spare parts. The lessee has agreed to reimburse the Company for any payments made under the guarantee, upon demand by the Company. If the lessee does not make such reimbursements or does not comply with any provisions of the parts agreement, the Company may declare an event of default under the leases. During the fourth quarter of 2002 and April 2003, the Company and the lessee agreed to lease amendments which deferred certain overdue rent and reserve payments. The Company is monitoring this lessee's performance very closely. If the Company does have to perform, the Company believes it will have sufficient cash to fund any necessary payments.

See "Outlook" below for a discussion of factors which may affect the Company's cash flow.

The Company's cash flow from operations for the quarter ended March 31, 2002 versus 2001 increased by approximately \$28,000. The increase was due primarily to the effect of the change in accounts payable and accrued expenses and maintenance deposits and accrued costs. The effect of these changes was only partially offset by the negative effect of the change in deposits and deferred taxes.

No cash flow was used for equipment purchases during 2003. Equipment purchases of \$24,630, for equipment added to aircraft already owned, were made in 2002. The decrease in cash flow used by financing activities from year to year was primarily a result of lower repayments on the Company's revolving credit facility in 2003 versus 2002.

### Outlook

The Company's credit facility expires on June 28, 2003. The Company and its agent bank have begun discussing the terms of a new credit facility. The Company expects to be able to obtain such facility at reasonable market terms. The agent bank and one of the participating banks, which account for a total of \$40 million of the current \$50 million credit facility, have expressed their willingness to provide financing to the Company under a new credit facility. The third bank, representing the remaining \$10 million of the current credit facility, has notified the Company that it will not participate in a new credit facility because it no longer wishes to participate in aviation finance. If the Company and the agent bank are unable to find a new participant or participants by June 28, 2003, the Company would be required to repay approximately \$800,000 on the credit facility in order to reduce the outstanding principal to an amount less than \$40 million. The Company believes that it will have sufficient cash to fund such a repayment.

The Company has previously used special purpose asset-based financing for the acquisition of three aircraft and will continue to seek such financing as transactions suitable for such special purpose financing become available.

In order to increase earnings, the Company will need to add aircraft to its portfolio. Such growth will be possible only with additional financing, such as an increased credit facility, additional special purpose non-recourse financing,

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or the issuance of debt and/or equity securities, all of which the Company is considering.

While the Company's revenues would increase with the purchase of additional aircraft, management fees, depreciation and interest expense, as well as other operating expenses, would also increase. It is likely that market lease rates will remain significantly below prior market levels as a result of downward pressure from low interest rates and the slowdown in the air carrier industry in particular and the worldwide economy in general. The Company nonetheless believes that it will be able to purchase and lease such aircraft at prices and lease rates that will have a positive effect on the Company's earnings. While additional aircraft acquisitions would likely add to earnings, whether the Company will show an overall increase in the Company's earnings in the near term will be affected by the success and timeliness of remarketing of aircraft that were off lease at March 31, 2003 and those with leases due to expire during 2003.

The Company continues to review its asset valuations in light of the worldwide economic downturn. Although the Company did not make any valuation adjustments during 2002 or the first quarter of 2003, any future adjustments, if necessary, could negatively affect the Company's financial results and the collateral available for the Company's revolving credit facility. In addition, the Company's periodic review of the adequacy of its maintenance reserves, as well as routine and manufacturer-required maintenance for off-lease aircraft, may result in changes to estimated maintenance expense, further reducing earnings.

### Factors that May Affect Future Results

**Renewal or Replacement of the Credit Facility.** As discussed in "Outlook" above, the Company's credit facility will expire on June 28, 2003. If the Company is not able to renew the credit facility for the full outstanding amount, and cannot find suitable alternative financing, it may be required to make a principal repayment of the outstanding balance, or that portion of the balance for which replacement financing is not obtained. The Company does not have sufficient cash reserves to make a repayment of a significant portion of the outstanding credit facility indebtedness and would be forced to sell assets in order to raise funds to make such repayment. Such sales would likely not be on favorable terms to the Company as the full market value of the assets sold may not be realized by the Company in order to expedite the consummation of the sales.

Even if the Company is able to successfully sell a portion of its assets and use the proceeds to repay the credit line facility, if a renewed or replacement facility is not obtained, the Company's future ability to acquire assets would be significantly impaired, as the credit facility is the Company's primary means of financing acquisitions and no other sources of acquisition financing are immediately available. Thus the renewal or replacement of the Company's credit line facility in an amount equal or greater than the current \$50 million limit will be critical to the Company's liquidity as well as the potential for asset and revenue growth.

**Non-renewal by Credit Line Participant.** One of the participating banks in the credit line facility has indicated that it will not participate in the anticipated renewal of the Company's credit line. Therefore, unless a new participating bank is found to replace the departing bank in the lending syndicate, the maximum credit line amount available under a renewed credit line may be decreased by \$10 million. The Company currently believes it has sufficient funds to repay any outstanding indebtedness in excess of \$40 million, but such repayment will significantly reduce the Company's available cash and working capital. The reduced credit line facility maximum will make further

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aircraft acquisitions under the credit line much more difficult, as the Company will be fully drawn under the new reduced credit line indebtedness limit. A reduced credit line would make the Company more dependent on special purpose financing for acquisitions.

**Credit Facility Repayment Obligations.** As discussed in "Outlook", above, the Company's ability to draw on its \$50 million credit facility is dependent upon the status of its collateral base. If a significant portion of the collateral base is off-lease for an extended period of time (see "Ownership Risks" below), this could trigger a covenant default and an obligation to repay a portion of the outstanding indebtedness under the credit facility. The Company believes it will remain in compliance with its covenants through the expiration of the facility on June 28, 2003. In all events, the Company's beliefs regarding the future collateral base repayment obligations are based on certain assumptions regarding renewal of existing leases, a lack of extraordinary interest rate increases, no lessee defaults or bankruptcies, and certain other matters that the Company deems reasonable in light of its experience in the industry. There can be no assurance that these assumptions will turn out to be correct. If the assumptions do not prove to be true, and the Company has not obtained an applicable waiver or amendment of applicable covenants from its lenders to deal with the situation, the Company may have to sell a significant portion of its portfolio in order to maintain compliance with the covenants, or, if that is not possible, default on its credit facility.

**General Economic Conditions.** The Company's business is dependent upon general economic conditions and the strength of the travel and transportation industry. The industry is experiencing a cyclical downturn which began in mid-2001. This downturn was exacerbated by the terrorist attacks of September 11, 2001. More recently, fears surrounding Severe Acute Respiratory Syndrome ("SARS") have caused a reduction in airline passenger loads, particularly in markets where the outbreak is concentrated. As a result, there has been a severe reduction in air travel and less demand for aircraft capacity by the major air carriers. The duration of the downturn is uncertain.

The Company's lessees and targeted potential lessees have been primarily outside the U.S. If those lessees experience financial difficulties, this could, in turn, affect the Company's financial performance. It appears that the downturn has had an impact on some non-U.S. regional carriers, but it remains to be seen how widespread the impact will be and how severely such carriers will be affected. It is possible that in certain instances, current economic circumstances may favor the Company, in that planned aircraft replacements for the Company's leased aircraft by its lessees may be cancelled or postponed, resulting in greater likelihood of renewals by existing lessees. Further, demand for more economically operated turboprop aircraft, which make up the Company's portfolio, relative to the more expensive new regional jets, may increase (see "Leasing Risks" below). However, there can be no assurance that the Company will realize any increase in renewals of existing leases or experience an increase in demand for turboprop aircraft.

Since regional carriers are generally not as well-capitalized as major air carriers, the downturn may result in the increased possibility of an economic failure of one or more of the Company's lessees. The combined effect of decreased air travel, further weakening of the industry as a result of subsequent threats of attacks similar to the September 11 events, an increase in the price of jet fuel due to fears of hostilities, and increased costs and reduced operations by air carriers due to new security directives, depending on their scope and duration, could have a material adverse impact on the Company's lessees and thus the Company's results.

At this time, in response to lower passenger loads, many carriers have reduced capacity, and as a result there has been a reduced demand for aircraft. As a result, market lease rental rates have decreased. This reduced market value for

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aircraft could affect the Company's results if the market value of an asset or assets in the Company's aircraft portfolio falls below book value, and the Company determines that a writedown of the value on the Company's book is appropriate.

Another anticipated result of the economic situation is that lessees are likely to desire shorter-term leases which will give those lessees more flexibility to deal with the current downturn. The Company's ability to enter into such short-term leases is somewhat limited by credit facility covenants that govern to what extent aircraft on short-term leases can be added to the collateral base that determines how much the Company can draw under the revolving credit facility and how much debt may be outstanding under the facility (see "Credit Facility Repayments Based on Collateral Base" below).

Risks of Debt Financing. The Company's use of acquisition financing under its revolving credit facility and its special purpose financings subject the Company to increased risks of leveraging. If, due to a lessee default, the Company is unable to repay the debt secured by the aircraft acquired, then the Company could lose title to the acquired aircraft in a foreclosure proceeding. With respect to the revolving credit facility, the loans are secured by the Company's existing assets as well as the assets acquired with each financing. Any default under the revolving credit facility could result in foreclosure upon not only the asset acquired using such financing, but also the existing assets of the Company securing the revolving loan.

In order to achieve optimal benefit from the revolving credit facility, the Company intends to seek subordinated debt or equity financings. Such financing would permit the Company to optimize use of its revolving credit facility. There can be no assurance that the Company will be able to obtain the necessary amount of supplemental subordinated debt or equity financing on favorable terms so as to permit optimal use of its revolving credit facility.

All of the Company's current credit facility indebtedness carries a floating interest rate based upon either the lender's prime rate or a floating LIBOR rate. Interest rates are currently at historically low levels and this has partially offset the effect of falling market lease rates. If interest rates rise, and lease rates do not increase at the same time, the Company would experience lower net revenues and, if the interest rate increase were great enough, may not be able to cover its interest expense with lease revenue.

Leasing Risks. The Company's successful negotiation of lease extensions, re-leases and sales may be critical to its ability to achieve its financial objectives, and involves a number of risks. Demand for lease or purchase of the assets depends on the economic condition of the airline industry which is, in turn, sensitive to general economic conditions. The ability to remarket equipment at acceptable rates may depend on the demand and market values at the time of remarketing. The Company anticipates that the bulk of the equipment it acquires will be used aircraft equipment. The market for used aircraft is cyclical, and generally reflects economic conditions and the strength of the travel and transportation industry. The demand for and value of many types of used aircraft in the recent past has been depressed by such factors as airline financial difficulties, increased fuel costs, the number of new aircraft on order and the number of aircraft coming off-lease. The Company's expected concentration in a limited number of airframe and aircraft engine types (generally, turboprop equipment) subjects the Company to economic risks if those airframe or engine types should decline in value. If "regional jets" were to be used on short routes previously served by turboprops, even though regional jets are more expensive to operate than turboprops, the demand for turboprops could be decreased. This could result in lower lease rates and values for the Company's existing turboprop aircraft.

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Reliance on JMC. All management of the Company is performed by JMC under a management agreement which is in its seventh year of a 20-year term and provides for an asset-based management fee. JMC is not a fiduciary to the Company or its stockholders. The Company's Board of Directors, however, has ultimate control and supervisory responsibility over all aspects of the Company and owes fiduciary duties to the Company and its stockholders. In addition, while JMC may not owe any fiduciary duties to the Company by virtue of the management agreement, the officers of JMC are also officers of the Company, and in that capacity owe fiduciary duties to the Company and the stockholders by virtue of holding such offices with the Company. In addition, certain officers of the Company hold significant ownership positions in JHC and the Company. JMC is also the management company for two other aircraft portfolio owners, JetFleet III, which raised approximately \$13,000,000 from investors, and AeroCentury IV, Inc. ("AeroCentury IV"), which raised approximately \$5,000,000 from investors. JetFleet III and AeroCentury IV are in the liquidation or wrap-up phase. In the first quarter of 2002, AeroCentury IV defaulted on certain obligations to noteholders. The indenture trustee for AeroCentury IV's noteholders has foreclosed and has taken over management of the remaining two assets. JetFleet III is in compliance with the terms of its trust indenture.

The management agreement may be terminated upon a default in the obligations of JMC to the Company, and provides for liquidated damages in the event of a wrongful termination of the agreement by the Company. All of the officers of JMC are also officers of the Company, and certain directors of the Company are also directors of JMC. Consequently, the directors and officers of JMC may have a conflict of interest in the event of a dispute over obligations between the Company and JMC. Although the Company has taken steps to prevent conflicts of interest arising from such dual roles, such conflicts may still occur.

Ownership Risks. Most of the Company's portfolio is leased under operating leases, where the terms of the leases are less than the entire anticipated useful life of an asset. The Company's ability to recover its purchase investment in an asset subject to an operating lease is dependent upon the Company's ability to profitably re-lease or sell the asset after the expiration of the initial lease term. Some of the factors that have an impact on the Company's ability to re-lease or sell include worldwide economic conditions, general aircraft market conditions, regulatory changes that may make an asset's use more expensive or preclude use unless the asset is modified, changes in the supply or cost of aircraft equipment and technological developments which cause the asset to become obsolete. In addition, a successful investment in an asset subject to an operating lease depends in part upon having the asset returned by the lessee in serviceable condition as required under the lease. If the Company is unable to remarket its aircraft equipment on favorable terms when the operating lease for such equipment expires, the Company's business, financial condition, cash flow, ability to service debt and results of operation could be adversely affected.

Lessee Credit Risk. If a lessee defaults upon its obligations under a lease, the Company may be limited in its ability to enforce remedies. Most of the Company's lessees are small regional passenger airlines, which may be even more sensitive to airline industry market conditions than the major airlines. As a result, the Company's inability to collect rent under a lease or to repossess equipment in the event of a default by a lessee could have a material adverse effect on the Company's revenue. If a lessee that is a certified U.S. airline is in default under the lease and seeks protection under Chapter 11 of the United States Bankruptcy Code under Section 1110 of the Bankruptcy Code, the Company would be automatically prevented from exercising any remedies for a period of 60 days. By the end of the 60-day period, the lessee must agree to perform the obligations and cure any defaults, or the Company would have the right to repossess the

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equipment. This procedure under the Bankruptcy Code has been subject to significant recent litigation, however, and it is possible that the Company's enforcement rights may be further adversely affected by a declaration of bankruptcy by a defaulting lessee.

**International Risks.** The Company has focused on leases in overseas markets, which the Company believes present opportunities. Leases with foreign lessees, however, may present somewhat different credit risks than those with domestic lessees.

Foreign laws, regulations and judicial procedures may be more or less protective of lessor rights than those which apply in the United States. The Company could experience collection problems related to the enforcement of its lease agreements under foreign local laws and the remedies in foreign jurisdictions. The protections potentially offered by Section 1110 of the Bankruptcy Code would not apply to non-U.S. carriers, and applicable local law may not offer similar protections. Certain countries do not have a central registration or recording system with which to locally establish the Company's interest in equipment and related leases. This could add difficulty in recovering an aircraft in the event that a foreign lessee defaults.

A lease with a foreign lessee is subject to risks related to the economy of the country or region in which such lessee is located, which may be weaker than the U.S. economy. On the other hand, a foreign economy may remain strong even though the U.S. economy does not. A foreign economic downturn may impact a foreign lessee's ability to make lease payments, even though the U.S. and other economies remain stable. Furthermore, foreign lessees are subject to risks related to currency conversion fluctuations. Although the Company's current leases are all payable in U.S. dollars, the Company may agree in the future to leases that permit payment in foreign currency, which would subject such lease revenue to monetary risk due to currency fluctuations. Even with U.S. dollar-denominated lease payment provisions, the Company could still be affected by a devaluation of the lessee's local currency which would make it more difficult for a lessee to meet its U.S. dollar-denominated lease payments, increasing the risk of default of that lessee, particularly if its revenue is primarily derived in the local currency.

**Government Regulation.** There are a number of areas in which government regulation may result in costs to the Company. These include aircraft registration, safety requirements, required equipment modifications, and aircraft noise requirements. Although it is contemplated that the burden and cost of complying with such requirements will fall primarily upon lessees of equipment, there can be no assurance that the cost will not fall on the Company. Furthermore, future government regulations could cause the value of any non-complying equipment owned by the Company to decline substantially.

**Competition.** The aircraft leasing industry is highly competitive. The Company competes with aircraft manufacturers, distributors, airlines and other operators, equipment managers, leasing companies, equipment leasing programs, financial institutions and other parties engaged in leasing, managing or remarketing aircraft, many of which have significantly greater financial resources and more experience than the Company. The Company, however, believes that it is competitive because of JMC's experience and operational efficiency in identifying and obtaining financing for the transaction types desired by regional air carriers. This market segment, which is characterized by transaction sizes of less than \$10 million and lessee credits that may be strong, but are generally unrated, is not well served by the Company's larger competitors in the aircraft industry. JMC has developed a reputation as a global participant in this segment of the market, and the Company believes this will benefit the Company. There is, however, no assurance that the lack of

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significant competition from the larger aircraft leasing companies will continue or that the reputation of JMC will continue to be strong in this market segment and benefit the Company.

**Casualties, Insurance Coverage.** The Company, as owner of transportation equipment, may be named in a suit claiming damages for injuries or damage to property caused by its assets. As a triple net lessor, the Company is generally protected against such claims, since the lessee would be responsible for, insure against and indemnify the Company for, such claims. Further, some protection may be provided by the United States Aviation Act with respect to its aircraft assets. It is, however, not clear to what extent such statutory protection would be available to the Company and such act may not apply to aircraft operated in foreign countries. Also, although the Company's leases generally require a lessee to insure against likely risks, there may be certain cases where the loss is not entirely covered by the lessee or its insurance. Though this is a remote possibility, an uninsured loss with respect to the equipment, or an insured loss for which insurance proceeds are inadequate, would result in a possible loss of invested capital in and any profits anticipated from, such equipment, as well as a potential claim directly against the Company.

**Risks Related to Regional Air Carriers.** Because the Company has concentrated its existing leases and intends to concentrate on leases to regional air carriers, it is subject to certain risks. First, some of the lessees in the regional air carrier market are companies that are start-up, low capital, low margin operations. Often, the success of such carriers is dependent upon arrangements with major trunk carriers, which may be subject to termination or cancellation by such major carrier. Leasing transactions with these types of lessees result in a generally higher lease rate on aircraft, but may entail higher risk of default or lessee bankruptcy. The Company evaluates the credit risk of each lessee carefully, and attempts to obtain a third party guaranty, letters of credit or other credit enhancement, if it deems them necessary. There is no assurance, however, that such enhancements will be available or that even if obtained will fully protect the Company from losses resulting from a lessee default or bankruptcy. Second, a significant area of growth of this market is in areas outside of the United States, where collection and enforcement are often more difficult and complicated than in the United States.

**Possible Volatility of Stock Price.** The market price of the Company's common stock could be subject to fluctuations in response to operating results of the Company, changes in general conditions in the economy, the financial markets, the airline industry, changes in accounting principles or tax laws applicable to the Company or its lessees, or other developments affecting the Company, its customers or its competitors, some of which may be unrelated to the Company's performance. Also, because the Company has a relatively small capitalization of approximately 1.5 million shares, there is a correspondingly limited amount of trading of the shares. Consequently, a single or small number of trades could result in a market fluctuation not related to any business or financial development relating to the Company.

### Item 3. Controls and Procedures

**Quarterly evaluation of the Company's Disclosure Controls and Internal Controls.** Within the 90 days prior to the date of this quarterly report on Form 10-QSB, the Company evaluated the effectiveness of the design and operation of its "disclosure controls and procedures" ("Disclosure Controls"), and its "internal controls and procedures for financial reporting" ("Internal Controls"). This evaluation (the "Controls Evaluation") was done under the supervision and with the participation of management, including the Company's Chief Executive Officer (CEO) and Chief Financial Officer (CFO). Rules adopted by the SEC require that

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in this section of the Annual Report the Company present the conclusions of the CEO and the CFO about the effectiveness of our Disclosure Controls and Internal Controls based on and as of the date of the Controls Evaluation.

CEO and CFO Certifications. Appearing immediately following the Signatures section of this annual report there are two separate forms of "Certifications" of the CEO and the CFO. The first form of Certification is required in accordance with Section 302 of the Sarbanes-Oxley Act of 2002 (the Section 302 Certification). This section of the annual report which you are currently reading is the information concerning the Controls Evaluation referred to in the Section 302 Certifications and this information should be read in conjunction with the Section 302 Certifications for a more complete understanding of the topics presented.

Disclosure Controls and Internal Controls. Disclosure Controls are procedures that are designed with the objective of ensuring that information required to be disclosed in the Company's reports filed under the Securities Exchange Act of 1934 (Exchange Act), such as this annual report, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's (SEC) rules and forms. Disclosure Controls are also designed with the objective of ensuring that such information is accumulated and communicated to the Company's management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure. Internal Controls are procedures which are designed with the objective of providing reasonable assurance that (1) the Company's transactions are properly authorized; (2) the Company's assets are safeguarded against unauthorized or improper use; and (3) the Company's transactions are properly recorded and reported, all to permit the preparation of the Company's financial statements in conformity with generally accepted accounting principles.

Limitations on the Effectiveness of Controls. The Company's management, including the CEO and CFO, does not expect that its Disclosure Controls or its Internal Controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Scope of the Controls Evaluation. The CEO/CFO evaluation of the Company's Disclosure Controls and the Company's Internal Controls included a review of the controls objectives and design, the controls implementation by the company and the effect of the controls on the information generated for use in this annual report. In the course of the Controls Evaluation, we sought to identify data errors, controls problems or acts of fraud and to confirm that appropriate corrective action, including process improvements, were being undertaken. This type of evaluation will be done on a quarterly basis so that the conclusions concerning controls effectiveness can be reported in the Company's quarterly reports on Form 10-QSB and annual report on Form 10-KSB. The Company's Internal



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Controls are also evaluated on an ongoing basis by other personnel in the Company's finance organization and by the Company's independent auditors in connection with their audit and review activities. The overall goals of these various evaluation activities are to monitor the Company's Disclosure Controls and the Company's Internal Controls and to make modifications as necessary; the Company's intent in this regard is that the Disclosure Controls and the Internal Controls will be maintained as dynamic systems that change (including with improvements and corrections) as conditions warrant.

Among other matters, the Company sought in its evaluation to determine whether there were any "significant deficiencies" or "material weaknesses" in the Company's Internal Controls, or whether the Company had identified any acts of fraud involving personnel who have a significant role in the Company's Internal Controls. This information was important both for the Controls Evaluation generally and because items 5 and 6 in the Section 302 Certifications of the CEO and CFO require that the CEO and CFO disclose that information to the Audit Committee of the Company's Board and to the Company's independent auditors and to report on related matters in this section of the Annual Report. In the professional auditing literature, "significant deficiencies" are referred to as "reportable conditions"; these are control issues that could have a significant adverse effect on the ability to record, process, summarize and report financial data in the financial statements. A "material weakness" is defined in the auditing literature as a particularly serious reportable condition where the internal control does not reduce to a relatively low level the risk that misstatements caused by error or fraud may occur in amounts that would be material in relation to the financial statements and not be detected within a timely period by employees in the normal course of performing their assigned functions. The Company also sought to deal with other controls matters in the Controls Evaluation, and in each case if a problem was identified, the Company considered what revision, improvement and/or correction to make in accordance with our on-going procedures.

In accordance with SEC requirements, the CEO and CFO note that, since the date of the Controls Evaluation to the date of this report, there have been no significant changes in Internal Controls or in other factors that could significantly affect Internal Controls, including any corrective actions with regard to significant deficiencies and material weaknesses.

Conclusions. Based upon the Controls Evaluation, the Company's CEO and CFO have concluded that, subject to the limitations noted above, the Company's Disclosure Controls are effective to ensure that material information relating to the Company and its consolidated subsidiaries is made known to management, including the CEO and CFO, particularly during the period when periodic reports are being prepared, and that the Company's Internal Controls are effective to provide reasonable assurance that the Company's financial statements are fairly presented in conformity with generally accepted accounting principles.

### Item 6. Exhibits and Reports on Form 8-K.

#### (a) Exhibits.

Exhibit Number	Description
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- 10.14 Employment Agreement between the Company and Neal D. Crispin, dated April 24, 2003.
- 10.15 Employment Agreement between the Company and Marc J. Anderson, dated April 24, 2003.
- 99.1\* Certification of Neal D. Crispin, Chief Executive Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 99.2\* Certification of Toni M. Perazzo, Chief Financial Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\*These certificates are furnished to, but shall not be deemed to be filed with, the Securities and Exchange Commission ("SEC").

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(b) Reports on Form 8-K.

Report on Form 8-K disclosing the Second Amendment to Amended and Restated Credit Agreement between the Company, National City Bank, as Agent, and participating lenders, filed with the SEC on February 20, 2003.

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

AEROCENTURY CORP.

Date: May 14, 2003                      By: /s/ Toni M. Perazzo  
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Toni M. Perazzo  
  
Title: Senior Vice President-Finance and  
Chief Financial Officer

CERTIFICATION

I, Neal D. Crispin, certify that:

- 1. I have reviewed this quarterly report on Form 10-QSB of AeroCentury Corp.;
- 2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to

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make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 14, 2003

/s/ Neal D. Crispin

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Neal D. Crispin  
Chief Executive Officer

CERTIFICATION

I, Toni M. Perazzo, certify that:

1. I have reviewed this quarterly report on Form 10-QSB of AeroCentury Corp.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such

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statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 14, 2003

/s/ Toni M. Perazzo

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Toni M. Perazzo  
Chief Financial Officer