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AEROCENTURY CORP  
Form 10QSB  
November 14, 2005

UNITED STATES  
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 September 30, 2005

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.

(Exact name of small business issuer as specified 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)

(650) 340-1888  
(Issuer's telephone number)

None  
(Former name, former address and former fiscal year, if changed since last report)

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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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: As of November 14, 2005 the Issuer had 1,606,557 Shares of Common Stock, par value \$0.001 per share, 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 Quarterly 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 concerning the Company's belief that full adoption of SFAS 153 will not have an impact on the Company's results; the expectation regarding the delivery of two DHC-8 aircraft in the first quarter of 2006, and the expectation of the sale of a Shorts aircraft in the fourth quarter of 2005 and the expected lack of a gain or loss on sale; (ii) in Item 2 "Management's Discussion and Analysis or Plan of Operation -- Liquidity and Capital Resources," statements concerning the Company's belief that it will continue to be in compliance with its credit facility covenants except one regarding interest coverage; the expectation that the interest coverage ratio covenant will be revised pursuant to negotiations with lenders; the Company's belief that it will have adequate cash flow to meet its ongoing operational needs, including credit facility repayments; the Company's belief that its assumptions used to forecast cash flow are reasonable; (iii) in Item 2 "Management's Discussion and Analysis or Plan of Operation -- Outlook," statements concerning the Company's expectation regarding the long-term decline of lease rentals from its current portfolio; the Company's anticipated refinancing of two DHC-8 aircraft; the Company's belief in the strength of the regional aircraft financing market, and the availability of appropriate acquisitions; the expectation that the Company will continue increasing its portfolio; and (iv) in Item 2 "Management's Discussion and Analysis or Plan of Operation -- Factors that May Affect Future Results," statements regarding the Company's belief that it will have sufficient cash funds to make any payments that are required under the credit facility due to collateral pool limitations arising from assets coming off lease; the anticipated increased compliance cost created by the Sarbanes-Oxley Act and the Company's ability to fund such increased costs; the Company's anticipated purchase of used aircraft and concentration on turboprop equipment, the Company's intention to concentrate on future leases to regional air carriers; the Company's belief that overseas markets present opportunities; and the Company's belief 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.

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, particularly those that affect the demand for regional aircraft and engines and the financial status of the Company's primary customers, foreign regional passenger airlines; increasing aircraft fuel costs that weaken the financial health of air carriers; rapidly rising interest rates accompanied by a flat or decreasing lease rental market; further disruptions to the air travel industry due to terrorist attacks; the Company's ability to enlarge its credit facility

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on reasonable business terms; the Company's ability to find additional alternative financing sources; the financial performance of the Company's lessees and their compliance with rental, maintenance and return conditions under their respective leases; unanticipated lease defaults by the Company's lessees; 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.

AeroCentury Corp.  
Condensed Consolidated Balance Sheet  
Unaudited

ASSETS

Assets:

Cash and cash equivalents  
Accounts receivable  
Aircraft and aircraft engines held for lease,  
net of accumulated depreciation of \$17,422,780  
Prepaid expenses and other

Total assets

LIABILITIES AND STOCKHOLDERS' EQUITY

Liabilities:

Accounts payable and accrued expenses  
Notes payable and accrued interest  
Maintenance reserves and accrued costs  
Security deposits  
Prepaid rent  
Deferred taxes  
Taxes payable

Total liabilities

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  
Paid in capital  
Retained earnings

Sep

\$

\$

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Treasury stock at cost, 63,300 shares

Total stockholders' equity

The accompanying notes are an integral part of these statements.

AeroCentury Corp.  
Condensed Consolidated Statements of Operations  
Unaudited

	For the Nine Months Ended September 30,		For the T Ended Se
	2005	2004	2005
Revenues:			
Operating lease revenue	\$8,216,510	\$6,563,800	\$2,956,41
(Loss)/gain on sale of aircraft and aircraft engines	(59,550)	21,070	
Other income	94,600	320,270	13
	-----	-----	-----
	8,251,560	6,905,140	2,956,54
	-----	-----	-----
Expenses:			
Depreciation	2,935,430	2,638,060	1,030,03
Interest	2,456,860	1,730,600	877,00
Management fees	1,705,960	1,459,140	594,47
Professional fees and general and administrative	405,420	550,820	129,50
Insurance	242,140	202,450	75,16
Maintenance	219,870	490,850	169,44
Bad debt expense	88,110	146,750	
Provision for impairment in value of aircraft	12,180	463,300	
	-----	-----	-----
	8,065,970	7,681,970	2,875,60
	-----	-----	-----
Income/(loss) before taxes	185,590	(776,830)	80,94

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Tax provision/(benefit)	47,770	(299,830)	28,84
	-----	-----	-----
Net income/(loss)	\$137,820	\$(477,000)	\$ 52,10
	=====	=====	=====
Weighted average common			
shares outstanding	1,543,257	1,543,257	1,543,25
	=====	=====	=====
Earnings/(loss) per share	\$ 0.09	\$ (0.31)	\$ 0.0
	=====	=====	=====

The accompanying notes are an integral part of these statements.

AeroCentury Corp.  
Condensed Consolidated Statements of Cash Flows  
Unaudited

	For the Nine Month September 30
	2005
Net cash provided by operating activities	\$ 3,240,390
	-----
Investing activities:	
Payments received on note receivable	210,080
Proceeds from disposal of assets	7,900,130
Purchase of aircraft and aircraft engines	(14,488,870)
	-----
Net cash used by investing activities	(6,378,660)
	-----
Financing activities:	
Issuance of notes payable	10,941,000
Repayment of notes payable	(8,800,690)
	-----
Net cash provided/(used) by financing activities	2,140,310
	-----
Net decrease in cash and cash equivalents	(997,960)
Cash and cash equivalents, beginning of period	2,403,630
	-----
Cash and cash equivalents, end of period	\$ 1,405,670
	=====

During the nine months ended September 30, 2005 and 2004, the Company paid interest totaling \$2,442,450 and \$1,673,940, respectively, and income taxes totaling \$1,780,380 and \$1,080, respectively.

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The accompanying notes are an integral part of these statements.

AeroCentury Corp.  
Notes to Condensed Consolidated Financial Statements (Unaudited)  
September 30, 2005

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 wholly-owned subsidiaries, AeroCentury Investments II LLC ("AeroCentury II LLC") and AeroCentury Investments IV LLC ("AeroCentury IV LLC") (collectively, the "Company"), is presented on a consolidated basis. All intercompany balances and transactions have been eliminated in consolidation. During the third quarter of 2005, the title to the aircraft which had been owned by AeroCentury IV LLC was transferred to AeroCentury. AeroCentury IV LLC was dissolved in the fourth quarter.

(b) 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 from the date of acquisition, as cash equivalents.

(c) Aircraft and Aircraft Engines Held For Lease

The Company's interests in aircraft and aircraft engines are recorded at cost, which includes acquisition costs. The Company purchases only used aircraft. It is the Company's policy to hold aircraft for approximately twelve years unless market conditions necessitate earlier disposition. Depreciation is computed using the straight-line method over the twelve year period to an estimated residual value based on appraisal. Decreases in the market value of aircraft could not only affect the current value, but could also affect the assumed residual value. The Company periodically obtains a residual value appraisal for its assets and, historically, has not written down any estimated residuals.

(d) Impairment of Long-lived Assets

The Company periodically reviews its portfolio of assets for impairment in accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets." Such review necessitates estimates of current market values, re-lease rents, residual values and component values. The estimates are based on currently available market data and are subject to fluctuation from time to time. The Company initiates its review periodically, whenever events or changes in circumstances indicate that the carrying amount of a long-lived asset may not be recoverable. Recoverability of an asset is measured by comparison of its carrying amount to the expected future undiscounted cash flows (without interest charges) that the asset is expected to generate. Any impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair market value. Significant management judgment is required in the forecasting of future

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operating results which are used in the preparation of projected undiscounted cash flows and, should different conditions prevail, material write downs may occur.

AeroCentury Corp.  
Notes to Condensed Consolidated Financial Statements (Unaudited)  
September 30, 2005

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

(e) 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.

(f) Maintenance Reserves and Accrued Costs

Maintenance costs under the Company's triple net leases are generally the responsibility of the lessees. The accompanying consolidated balance sheet reflects liabilities for maintenance reserves and accrued costs, which include refundable and non-refundable maintenance payments received from lessees. At September 30, 2005, the Company's maintenance accruals consisted of the following:

Refundable maintenance reserves	\$ 504,770
Non-refundable maintenance reserves	9,949,990
Accrued costs	1,934,010
	-----
	\$ 12,388,770
	=====

Maintenance reserves received by the Company are accounted for as a liability, which is reduced when maintenance work is performed during the lease. Maintenance reserves which are refundable to the lessee are refunded after all return conditions specified in the lease and, in some cases, any other payments due under the lease, are satisfied. Any refundable reserves retained by the Company to satisfy return conditions are reclassified to the Company's own maintenance payable account at lease end. Maintenance reserves which are non-refundable to the lessee are recorded as income at lease end. If an aircraft is returned early, any collected reserves are reclassified to the Company's own maintenance payable account.

The Company periodically reviews its maintenance reserves and maintenance accruals 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 well as the condition of the aircraft upon return or inspection. As a result of such review, when it is probable that the Company has incurred costs for maintenance in excess of amounts accrued, the Company records an expense for the additional work to be performed. Such costs include maintenance such as engine and propeller overhauls, structural inspections and work to comply with airworthiness directives.

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When an aircraft is sold, any remaining accrual is reversed and included in the Company's gain or loss on sale calculation. During the nine months ended September 30, 2005 and 2004, \$282,030 and \$475,010, respectively, of excess accrual was included in gain/(loss) on sale of aircraft and aircraft engines.

AeroCentury Corp.  
Notes to Condensed Consolidated Financial Statements (Unaudited)  
September 30, 2005

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

(f) Maintenance Reserves and Accrued Costs (continued)

Additions to and deductions from the Company's accruals during the nine months ended September 30, 2005 and 2004 for maintenance work were as follows:

	For the Nine Months Ended Se	
	2005	
Additions:		
Charged to expense	\$ 196,800	\$
Charged to other -		
Reclassification of reserves collected from lessees to the Company's own liability account	40,050	
	236,850	
Deductions:		
Paid for previously accrued maintenance	316,570	
Reversals of over-accrued maintenance	760	
Included in gain/(loss) on sale of aircraft and aircraft engines	282,030	
	599,360	
Net decrease in accrued maintenance costs, in excess of amounts received under the leases	(362,510)	(1)
Balance, beginning of period	2,296,520	
	\$ 1,934,010	\$
	1,934,010	1,934,010

(g) Security deposits

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 received by the Company are refundable to the lessee at the end of the lease, upon satisfaction of all lease terms.



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### (h) Income Taxes

As part of the process of preparing the Company's consolidated financial statements, management is required to estimate income taxes in each of the jurisdictions in which the Company operates. This process involves estimating the Company's current tax exposure under the most recent tax laws and assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included in the consolidated balance sheet. Management must also assess the likelihood that the Company's deferred tax assets will be recovered from future taxable income, and, to the extent management believes it is more likely than not that some portion or all of the deferred tax assets will not be realized, the Company must establish a valuation allowance. To the extent the Company establishes a valuation allowance

AeroCentury Corp.  
Notes to Condensed Consolidated Financial Statements (Unaudited)  
September 30, 2005

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

#### (h) Income Taxes (continued)

or changes the allowance in a period, the Company must reflect the corresponding increase or decrease within the tax provision in the consolidated statement of operations.

#### (i) Revenue Recognition and Allowance for Doubtful Accounts

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. The Company estimates and charges to income a provision for bad debts based on its experience in the business and with each specific customer, the level of past due accounts, and its analysis of the lessees' overall financial condition. If the financial condition of the Company's customers deteriorates, it could result in actual losses exceeding the estimated allowances.

#### (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 Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable for making judgments that are not readily apparent from other sources.

The most significant estimates with regard to these financial statements are the residual values of the aircraft, the useful lives of the aircraft, the amount and timing of cash flow associated with each aircraft that are used to evaluate impairment, if any, accrued maintenance costs in excess of amounts received from lessees, the amounts recorded as bad debt allowances and accounting for income taxes.

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### (k) Comprehensive Income

The Company does not have any comprehensive income other than the revenue and expense items included in the consolidated statements of operations. As a result, comprehensive income equals net income for the three months and nine months ended September 30, 2005 and 2004.

### (l) Recent Accounting Pronouncements

In January 2003, the FASB issued interpretation FIN No. 46, Consolidation of Variable Interest Entities ("FIN 46"), which was subsequently revised in December 2003 ("FIN 46R"). FIN 46R requires a variable interest entity to be consolidated by a company if that company is the primary beneficiary of the entity. A company is a primary beneficiary if it is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both.

FIN 46R also requires disclosures about variable interest entities that a company is not required to consolidate but in which it has a significant variable interest. FIN 46R was applicable immediately to variable interest entities created after January 31, 2003, and is effective for all other existing entities in financial statements for periods ending after December 15, 2004. Certain of the disclosure requirements apply in all financial statements issued after December 31, 2003, regardless of when the variable interest entity was established. The Company has no interest in any variable interest entity and, therefore, the full adoption of FIN 46R had no effect on the Company's consolidated financial condition or results of operations.

AeroCentury Corp.  
Notes to Condensed Consolidated Financial Statements (Unaudited)  
September 30, 2005

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

#### (l) Recent Accounting Pronouncements (continued)

SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities, was effective for activities that were initiated after December 31, 2002. SFAS 146 addresses significant issues regarding the recognition, measurement and reporting of costs that are associated with exit and disposal activities, including restructuring activities that were previously accounted for under Emerging Issues Task Force ("EITF") No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). The adoption of SFAS 146 had no effect on the Company's consolidated financial condition or results of operations.

SFAS 153, Exchanges of Nonmonetary Assets, addresses the measurement of exchanges of nonmonetary assets. It eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets in paragraph 21(b) of APB Opinion No. 29, Accounting for Nonmonetary Transactions, and replaces it with an exception for exchanges that do not have commercial substance. SFAS 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. The provisions of SFAS 153 will be effective for nonmonetary asset exchanges occurring in fiscal periods beginning

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after June 15, 2005. The Company does not expect the full adoption of SFAS 153 to have an impact on the Company's consolidated financial condition or results of operations.

### (m) Reclassifications

Certain prior year amounts within the footnotes have been reclassified to conform to the current year presentation.

### 2. Aircraft and Aircraft Engines Held for Lease

At September 30, 2005, the Company owned eleven deHavilland DHC-8s, three deHavilland DHC-6s, two Shorts SD 3-60s, ten Fokker 50s, two Saab 340As, one Saab 340B and one turboprop engine which are held for lease.

During the third quarter of 2005:

Pursuant to lessee extension options, the Company extended the leases for two of its Fokker 50 aircraft for 18 months each.

The Company purchased a deHavilland DHC-8 aircraft which is subject to a lease with a regional carrier in the Caribbean for a term expiring in August 2008. The lessee also leases another DHC-8 aircraft owned by the Company.

The leases for two of the Company's DHC-8 aircraft remained in effect from their expiration in June 2005. As discussed in Note 8, one of the aircraft was returned in November 2005 and the other is undergoing maintenance. In addition, two other deHavilland DHC-8 aircraft are undergoing maintenance and are expected to be returned at lease end during the fourth quarter. The Company has signed term sheets for three of the four aircraft.

At September 30, 2005, the Company's two Saab 340A aircraft, one of the Company's Shorts SD 3-60 aircraft and the Company's spare turboprop engine were off lease. As discussed in Note 8, the Company signed an agreement to sell the Shorts SD 3-60 in the fourth quarter of 2005. The Company is seeking re-lease or sale opportunities for the other off-lease assets.

AeroCentury Corp.  
Notes to Condensed Consolidated Financial Statements (Unaudited)  
September 30, 2005

### 3. Notes Receivable

In connection with a lease default during the third quarter of 2003, the former lessee paid \$20,000 to the Company at the time of the settlement and signed a note in the amount of \$480,000. The lessee made all payments due through December 31, 2004 but, as a result of a late payment and subsequent non-payment, and the Company's evaluation of the debtor's intention to make future payments, the Company fully reserved the balance of the note at December 31, 2004. The balance of the fully reserved note is \$370,090 at September 30, 2005. During the second quarter of 2005, the Company obtained a default judgment against the lessee in the United States and is evaluating the cost/benefit of enforcing it abroad.

During 2004, the former lessee of one of the Company's aircraft signed a note in the amount of approximately \$625,000, to be paid in 18 monthly installments. The Company received all payments due through June 30, 2005. The note was for rent and maintenance in excess of the security deposit held by the Company. The Company had previously recorded a \$250,000 allowance against the amount receivable. Upon receiving notice that the lessee had filed for reorganization, the Company recorded additional bad debt expense of \$88,110

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during the second quarter of 2005 to fully reserve the balance of the note. The Company continues to monitor the lessee's reorganization proceedings.

### 4. Notes Payable and Accrued Interest

#### (a) Credit facility

In 2004, the Company's credit facility was renewed through October 31, 2005. In connection with the renewal, the LIBOR margin was set at 375 basis points through March 2005, after which a margin of 275 to 375 basis points is determined by certain financial ratios. As discussed in Note 8, the credit facility has been renewed through October 31, 2007.

During the first nine months of 2005, the Company repaid a total of \$8,600,000 of the outstanding principal under its credit facility. The Company must maintain compliance with certain covenants under its credit facility agreement. As of September 30, 2005, the Company was in compliance with all covenants, \$49,146,000 was outstanding under the credit facility, and interest of \$171,180 was accrued.

#### (b) Special purpose financing

In September 2000, the Company acquired a deHavilland DHC-8 aircraft using cash and bank financing separate from its credit facility. The financing resulted in a note obligation in the amount of \$3,575,000, due April 15, 2006, which bears interest at the rate of one-month LIBOR plus 3%. The note is collateralized by the 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 financing also provides for a six month remarketing period at the expiration or early termination of the lease. Payments due on the financing are reduced during this remarketing period and the balloon principal payment is deferred to the end of the six month period. The balance of the note payable at September 30, 2005 was \$1,695,010 and interest of \$1,610 was accrued. As of September 30, 2005, the Company was in compliance with all covenants of this note obligation.

AeroCentury Corp.  
Notes to Condensed Consolidated Financial Statements (Unaudited)  
September 30, 2005

### 5. Stockholder Rights Plan

On April 8, 1998, the Company's Board of Directors adopted a stockholder rights plan granting a dividend of one stock purchase right for each share of the Company's common stock outstanding as of April 23, 1998. The rights will become exercisable only upon the occurrence of certain events specified in the plan, including the acquisition of 15% of the Company's outstanding common stock by a person or group. Each right entitles the holder to purchase one one-hundredth of a share of Series A Preferred Stock of the Company at an exercise price of \$66.00 per one-one-hundredth of a share. Each right entitles the holder, other than an "acquiring person," to acquire shares of the Company's common stock at a 50% discount to the then prevailing market price. The Company's Board of Directors may redeem outstanding rights at a price of \$0.01 per right.

### 6. Income Taxes

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The items comprising income tax expense are as follows:

	For the Nine Months E
	2005
Current tax provision:	
Federal	\$ 175,390
State	1,630
	-----
Current tax provision	177,020
	-----
Deferred tax benefit:	
Federal	(103,330)
State	(25,920)
	-----
Deferred tax benefit	(129,250)
	-----
Total provision/(benefit) for income taxes	\$ 47,770
	=====

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 Nine Months E
	2005
Income tax provision at statutory federal income tax rate	\$ 63,100
State tax provision, net of federal benefit	1,090
Adjustment to asset tax basis	10,100
Tax rate differences	(26,520)
	-----
Total income tax provision/(benefit)	\$ 47,770
	=====

Tax rate differences result from a decrease in the Company's effective state tax rate due to changes in state apportionment percentages.

AeroCentury Corp.  
Notes to Condensed Consolidated Financial Statements (Unaudited)  
September 30, 2005

6. Income Taxes (continued)

Temporary differences and carry-forwards that give rise to a significant portion of deferred tax assets and liabilities as of September 30, 2005 are as follows:

Deferred tax assets:	
Bad debt allowance	\$ 240,830
Deferred maintenance	595,300
Maintenance reserves	3,383,590
Prepaid rent and other	157,010

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	-----
Deferred tax assets	4,376,730
Deferred tax liabilities:	
Depreciation on aircraft and aircraft engines	(5,194,680)
Unearned income	(5,030)
Other	(145,350)
	-----
Net deferred tax liabilities	\$ (968,330)
	=====

No valuation allowance is deemed necessary, as the Company has concluded, based on an assessment of all available evidence, that it is more likely than not that future taxable income will be sufficient to realize the tax benefits of all the deferred tax assets on the consolidated balance sheet.

### 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 \$1,705,960 and \$1,459,140 during the nine months ended September 30, 2005 and 2004, respectively. The Company accrued acquisition fees totaling \$520,900 and \$260,000, payable to JMC, during the first nine months of 2005 and 2004, respectively. The Company recorded remarketing fees totaling \$73,250 and \$55,500 to JMC in connection with the sale of aircraft in 2005 and 2004, respectively.

AeroCentury Corp.  
Notes to Condensed Consolidated Financial Statements (Unaudited)  
September 30, 2005

### 8. Subsequent Events

In October 2005, the lease for one of the Company's Fokker 50 aircraft was extended for three years, through November 2, 2008.

In November 2005, the Company negotiated the terms for the return of two of its deHavilland DHC-8 aircraft, the leases for which had been extended from their original expiration dates in April 2005 to June 2005 and had been in effect on a month-to-month basis since then. The Company accepted the return of one of the aircraft in November 2005 and has a signed term sheet for its re-lease to a Kenyan subsidiary of a Canadian operator for a term of 36 months. The re-lease term is expected to commence in the fourth quarter. The second aircraft is undergoing maintenance and the Canadian operator has expressed

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interest in re-leasing the aircraft.

Two other deHavilland DHC-8 aircraft are undergoing maintenance before being returned to the Company at lease end. The Company has a signed term sheet and has received a security deposit for the re-lease of both aircraft. Delivery of the aircraft to the new lessee is expected to occur in the first quarter of 2006.

In October 2005, the credit facility was extended through November 9, 2005 and subsequently renewed through October 31, 2007. In connection with the renewal, certain financial covenants were modified, including the applicable margin, which was revised to 275 to 325 basis points, determined by certain financial ratios.

In November 2005, the Company signed an agreement to sell its off-lease Shorts SD 3-60 aircraft, and delivery of the aircraft to the buyer is expected to occur in the fourth quarter. Proceeds from the sale are expected to approximate the net book value of the aircraft and, therefore, the Company does not expect to record a gain or loss in connection with the sale.

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

#### Overview

The Company is a lessor of turboprop aircraft and engines which are used by customers pursuant to triple net operating leases. The acquisition of such equipment is generally made using debt financing. The Company's profitability and cash flow are dependent in large part upon its ability to acquire equipment, obtain and maintain favorable lease rates on such equipment, and re-lease or sell owned equipment that comes off lease. The Company is subject to the credit risk of its lessees, both as to collection of rent and to performance by the lessees of obligations for maintaining the aircraft. Since lease rates for assets in the Company's portfolio generally decline as the assets age, the Company's ability to maintain revenue and earnings over the medium and long term is dependent upon the Company's ability to grow its asset portfolio.

The Company's principal expenditures are for interest costs on its financing, management fees, and maintenance of its aircraft assets. Maintenance expenditures are generally incurred only when aircraft are off lease, are being prepared for re-lease, or require maintenance in excess of lease return conditions.

The most significant non-cash expenses include accruals of maintenance costs to be borne by the Company and aircraft depreciation, both of which are the result of significant estimates. Maintenance expenses are estimated and accrued based upon utilization of the aircraft. Depreciation is recognized based upon the estimated residual value of the aircraft at the end of their estimated lives. Deviation from these estimates could have a substantial effect on the Company's cash flow and profitability.

#### Critical Accounting Policies, Judgments and Estimates

The discussion and analysis of the Company's financial condition and results of operations are based upon the consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the

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United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities, revenues and expenses, and the related disclosure of contingent assets and liabilities at the date of the financial statements. Actual results may differ from these estimates under different assumptions or conditions.

The Company's significant accounting policies are described in Note 1 to the consolidated financial statements. The Company believes that the most critical accounting policies include the following: Impairment of Long-lived Assets; Depreciation Policy, Maintenance Reserves and Accrued Costs; Revenue Recognition and Allowance for Doubtful Accounts; and Accounting for Income Taxes.

### a. Impairment of Long-lived Assets

The Company periodically reviews its portfolio of assets for impairment in accordance with Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets." Such review necessitates estimates of current market values, re-lease rents, residual values and component values. The estimates are based on currently available market data and third-party appraisals and are subject to fluctuation from time to time. The Company initiates its review periodically, whenever events or changes in circumstances indicate that the carrying amount of a long-lived asset may not be recoverable. Recoverability of an asset is measured by comparison of its carrying amount to the expected future undiscounted cash flows (without interest charges) that the asset is expected to generate. Any impairment to be recognized is measured by the amount by which the carrying amount of the asset exceeds its fair market value. Significant management judgment is required in the forecasting of future operating results which are used in the preparation of projected undiscounted cash flows and should different conditions prevail, material write downs may occur. No impairment charges resulted from the appraisals obtained by the Company during the third quarter of 2005.

### b. Depreciation Policy

The Company's interests in aircraft and aircraft engines are recorded at cost, which includes acquisition costs. The Company purchases only used aircraft. It is the Company's policy to hold aircraft for approximately twelve years unless market conditions necessitate earlier disposition. Depreciation is computed using the straight-line method over the twelve year period to an estimated residual value based on appraisal. Decreases in the market value of aircraft could not only affect the current value, discussed above, but could also affect the assumed residual value. The Company periodically obtains a residual value appraisal for its assets and, historically, has not written down any estimated residuals.

### c. 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 consolidated balance sheet include refundable and non-refundable maintenance payments received from lessees. The Company periodically reviews maintenance reserves for each of its aircraft 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 well as the condition of the aircraft upon return or inspection. As a result of such review, if 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.

Significant management judgment is required in determining aircraft condition and estimating maintenance costs. Absent fixed price maintenance agreements,



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these costs cannot be determined until such work is completed. Because of the potential magnitude of maintenance costs, even slight changes in work scope may have a material impact on operating results.

With respect to estimated maintenance costs, the Company has found its accruals to be generally accurate. Nevertheless, the Company has incurred significant maintenance expense in connection with aircraft which were returned early during the last two years in a condition worse than required by the lease. Specifically, the Company incurred maintenance expense of approximately \$442,000 and \$1,864,000 in connection with the early return of aircraft in 2004 and 2003, respectively.

### d. Revenue Recognition and Allowance for Doubtful Accounts

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. The Company estimates and charges to income a provision for bad debts based on its experience in the business and with each specific customer, the level of past due accounts, and its analysis of the lessees' overall financial condition. If the financial condition of the Company's customers deteriorates, it could result in actual losses exceeding the estimated allowances.

### e. Accounting for Income Taxes

As part of the process of preparing the Company's consolidated financial statements, management is required to estimate income taxes in each of the jurisdictions in which the Company operates. This process involves estimating the Company's current tax exposure under the most recent tax laws and assessing temporary differences resulting from differing treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included in the consolidated balance sheet. Management must also assess the likelihood that the Company's deferred tax assets will be recovered from future taxable income, and, to the extent management believes it is more likely than not that some portion or all of the deferred tax assets will not be realized, the Company must establish a valuation allowance. To the extent the Company establishes a valuation allowance or changes the allowance in a period, the Company must reflect the corresponding increase or decrease within the tax provision in the consolidated statement of operations.

Significant management judgment is required in determining the Company's future taxable income for purposes of assessing the Company's ability to realize any benefit from its deferred taxes. In the event that actual results differ from these estimates or the Company adjusts these estimates in future periods, the Company's operating results and financial position could be materially affected.

## Results of Operations

### a. Revenues

Operating lease revenue was approximately \$1,653,000 and \$710,000 higher in the nine months and three months ended September 30, 2005 versus the same periods in 2004, respectively, primarily because of increased operating lease revenue from aircraft purchased beginning in April 2004. This increase, totaling approximately \$2,946,000 and \$1,015,000 for the nine-month and three-month periods, respectively, was partially offset by decreases totaling \$1,293,000 and \$305,000, respectively, which were due to the sale of a pool of turboprop engines in December 2004 and aircraft that were on lease in 2004 but off lease during 2005. Lower lease rates for several aircraft in 2005 also adversely affected revenues.

Loss on sale of aircraft and aircraft engines was approximately \$60,000 for the nine months ended September 30, 2005 as a result of the sale of a deHavilland

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DHC-7. The aircraft had been written down to its estimated net sale value at December 31, 2004; however, at the time of sale, the Company recognized an additional loss of approximately \$60,000 incurred subsequent to December 31, 2004. There were no sales during the three months ended September 30, 2005. During the nine months ended September 30, 2004, the Company recognized a net gain on sale of approximately \$21,000, as a result of two asset sales in the third quarter.

Other income was approximately \$226,000 lower in the nine months ended September 30, 2005 versus the same period in 2004, primarily because of lower interest income in 2005 and payments received in 2004 on one of the Company's notes receivable and because, in 2004, based on the lessee's payment history to date, the Company reversed a portion of the note receivable allowance. These decreases were partially offset by the reversal in 2005 of previously accrued maintenance expenses. Other income was approximately \$206,000 lower in the three months ended September 30, 2005 versus the three month period in 2004, primarily as a result of lower interest income in 2005, payments received in 2004 on one of the Company's notes receivable and the partial reversal of the note receivable allowance in 2004.

### b. Expense items

Depreciation was approximately \$297,000 and \$136,000 higher in the nine months and three months ended September 30, 2005 versus the same periods in 2004, respectively, primarily because of the purchase of aircraft beginning in April 2004 and during 2005, the effect of which was partially offset by the sale of assets in the fourth quarter of 2004 and first half of 2005. Management fees were approximately \$247,000 and \$95,000 higher in the nine month and three month periods of 2005 compared to 2004, respectively, for the same reasons.

Interest expense was approximately \$726,000 and \$270,000 higher in the nine months and three months ended September 30, 2005, respectively, versus the same periods in 2004, primarily as a result of higher market interest rates and a higher average principal balance in 2005 compared to 2004.

Professional fees and general and administrative expenses were approximately \$145,000 and \$127,000 lower in the nine months and three months ended September 30, 2005, respectively, primarily because of lower legal fees. This decrease was partially offset by higher accounting fees.

The Company's insurance expense for off-lease aircraft and aircraft engines varies depending on the type of aircraft and engines insured during each period and the length of time each asset is insured. As a result of the combination of assets insured during each period, insurance expense was approximately \$40,000 higher in the nine-month period in 2005 versus the same period in 2004 and approximately \$4,000 lower in the three-month period in 2005 versus the same period in 2004.

Maintenance expense was approximately \$271,000 and \$228,000 lower in the nine months ended September 30, 2005 versus the same periods in 2004. The Company incurred maintenance expense in 2005, for storage and preparation of several aircraft for re-lease. In 2004, maintenance expense was comprised primarily of estimated costs necessary to ready two aircraft, which were returned early by a lessee, for re-lease.

During the second quarter of 2005, the Company recorded bad debt expense of approximately \$88,000, to fully reserve the balance of a note receivable from the former lessee of one of the Company's aircraft, based on a notice received from the lessee that it had filed for reorganization. During the third quarter of 2004, the Company recorded bad debt expense of approximately \$147,000 for rent and reserves written off in connection with a lessee's early return of two aircraft.

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During the first quarter of 2005, the Company recorded an impairment charge of approximately \$12,000, based on the estimated net sales proceeds pursuant to an agreement to sell an aircraft in April 2005. During the third quarter of 2004, in accordance with its periodic review of its portfolio of assets for impairment, the Company recorded a provision for impairment of approximately \$463,000 for one of its aircraft, based on the Company's cash flow analysis and third party appraisals.

The Company's effective tax rates for the period ended September 30, 2005 and 2004 were approximately 26% and 39%, respectively. The change in rate was primarily a result of the recognition of tax benefits relating to different state tax rates that had been accrued in prior years. Since the Company incurred a loss for the nine month period ended September 30, 2004, the recognition of tax benefits related to the reduced state tax rates increased the Company's tax benefit from the loss and its effective tax rate. Conversely, the Company had income for the nine month period ended September 30, 2005, and the recognition of tax benefits related to the reduced state tax rates decreased the effective tax rate for the nine month period ended September 30, 2005.

For the three month periods ending September 30, 2005 and 2004 the Company's effective tax rates were 36% for both periods. Since the Company had income for the three month period ended September 30, 2005, the recognition of tax benefits related to the reduced state tax rates decreased the Company's effective tax rate for that period. However, the recognition of tax expense related to adjustments to the tax basis of disposed assets off-set these recognized tax benefits and slightly increased the Company's effective tax rate for the three month period ended September 30, 2005. Conversely, the Company incurred a loss for the three month period ended September 30, 2004, so that the recognition of the tax benefits related to reduced state tax rates increased the Company's tax benefit from the loss and its effective tax rate for that three month period.

### Liquidity and Capital Resources

The Company is currently financing its assets primarily through credit facility borrowings, special purpose financing and excess cash flow.

#### (a) Credit facility

In 2004, the Company's credit facility was renewed through October 31, 2005. In connection with the renewal, the LIBOR margin was set at 375 basis points through March 2005, after which a margin of 275 to 375 basis points was determined by certain financial ratios.

In October 2005, the credit facility was extended through November 9, 2005 and subsequently renewed through October 31, 2007. In connection with the renewal, certain financial covenants were modified, including the applicable margin, which was revised to 275 to 325 basis points, determined by certain financial ratios.

During the first nine months of 2005, the Company repaid a total of \$8,600,000 of the outstanding principal under its credit facility. As of September 30, 2005, \$49,146,000 was outstanding under the credit facility, and interest of \$171,180 was accrued. The Company was in compliance with all covenants as of September 30, 2005 and is currently in compliance. Based on its current projections, the Company believes it will continue to be in compliance with all covenants of its credit facility, with the exception of one covenant related to its interest coverage ratio, which the Company is currently in negotiations with its lenders to revise. The Company anticipates that such negotiations will be successful, but there can be no assurance of such success. See "Factors That May Affect Future Results - 'Credit Facility Obligations' and 'Risks of Debt Financing'," below.

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The Company's interest expense in connection with the credit facility generally moves up or down with prevailing interest rates, as the Company has not entered into any interest rate hedge transactions for the credit facility indebtedness. 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 normally 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.

### (b) Special purpose financing

In September 2000, the Company acquired a deHavilland DHC-8 aircraft using cash and bank financing separate from its credit facility. The financing resulted in a note obligation in the amount of \$3,575,000, due April 15, 2006, which bears interest at the rate of one-month LIBOR plus 3%. The note is collateralized by the 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 financing also provides for a six month remarketing period at the expiration or early termination of the lease. Payments due on the financing are reduced during this remarketing period and the balloon principal payment is deferred to the end of the six month period. The balance of the note payable at September 30, 2005 was \$1,695,010 and interest of \$1,610 was accrued. The Company was in compliance with all covenants of this note obligation as of that date and is currently in compliance.

The availability of special purpose financing in the future will depend on several factors including (1) the availability of funds to be used for the equity portion of the financing, (2) the type of asset being financed and (3) the creditworthiness of the underlying lessee. The availability of funds for the equity portion of the financing will be dependent on the Company's cash flow, as discussed in "Cash Flow," below and certain requirements under its credit facility.

### (c) Cash flow

The Company's primary source of revenue is lease rentals 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 customer will not be renewing its lease, the Company immediately initiates marketing efforts to locate a potential new lessee or purchaser for the aircraft. The goal of this procedure is to reduce the time that an asset will be off lease. The Company's aircraft are subject to leases with varying expiration dates through July 2009.

Management believes that the Company will have adequate cash flow to meet its ongoing operational needs, including required repayments under its credit facility, based upon its estimates of future revenues and expenditures. The Company's expectations concerning such cash flows are based on existing lease terms and rents, as well as numerous estimates, including (i) rents on assets to be re-leased, (ii) sale proceeds of certain assets currently under lease, (iii) the cost and anticipated timing of maintenance to be performed and (iv) acquisition of additional aircraft and the lease thereof at favorable lease terms. While the Company believes that the assumptions it has made in forecasting its cash flow are reasonable in light of experience, actual results could deviate from such assumptions. Among the more significant external factors outside the Company's control that could have an impact on the accuracy of cash flow assumptions are (i) an increase in interest rates that negatively affects the Company's profitability and causes the Company to violate covenants of its

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credit facility, requiring repayment of some or all of the amounts outstanding under its credit facility, (ii) lessee non-performance or non-compliance with lease obligations (which may affect credit facility collateral limitations as well as revenue and expenses) and (iii) an unexpected deterioration of demand for aircraft equipment.

### (i) Operating activities

The Company's cash flow from operations for the nine months ended September 30, 2005 versus 2004 decreased by approximately \$166,000. The change in cash flow is a result of changes in several cash flow items during the period, including principally the following:

#### Lease rents and security deposits

Payments received from lessees for rent were approximately \$1,276,000 higher in the nine months ended September 30, 2005 versus the same period in 2004, due primarily to the effect of increased lease revenue from aircraft purchased beginning in April 2004 and during 2005, which was partially offset by the effect of lower lease rates for several aircraft in 2005. In addition, the Company received approximately \$193,000 more of cash payments for deferred rent during 2005 compared to 2004. Although, as a result of increased demand generally in the turboprop market, lease rates have stabilized and, in some cases, risen, it cannot be predicted that rental rates on aircraft to be re-leased will not decline, so that, absent additional acquisitions by the Company, aggregate lease revenues for the current portfolio can be expected to decline over the long term.

Security deposits received increased by approximately \$331,000 in the first nine months of 2005 versus the same period in 2004, primarily because of the cash deposits received in connection with acquisitions of aircraft in 2005.

#### Expenditures for maintenance

Expenditures for maintenance were approximately \$970,000 lower in the first nine months of 2005 versus the first nine months of 2004 as a result of payments during 2004 for maintenance performed to ready two of the Company's aircraft for remarketing. The amount of expenditures for maintenance in future periods will be dependent on the amount and timing of maintenance paid from lessee maintenance reserves held by the Company and the off-lease status of the Company's aircraft.

#### Expenditures for interest

Expenditures for interest expense increased by approximately \$816,000 in the nine months ended September 30, 2005 versus the same period in 2004, primarily as a result of higher average interest rates and a higher average principal balance in 2005. Interest expenditures in future periods will be a product of prevailing interest rates and the outstanding principal balance on financings, which may be influenced by future acquisitions and/or required repayments resulting from changes in the collateral base.

#### Expenditures for management fees

Expenditures for management fees increased by approximately \$257,000 in the nine months ended September 30, 2005 versus the nine months ended September 30, 2004, as a result of aircraft purchases since April 2004.

#### Expenditures for prepaid expenses

Expenditures for prepaid expenses increased by approximately \$297,000 in the first nine months of 2005 versus the first nine months of 2004 primarily as a

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result of deposits paid for equipment to be installed on several of the Company's aircraft.

### Income taxes

Income tax payments were approximately \$1,779,000 higher in the first nine months of 2005 compared to the same period in 2004 as a result of the payment of the 2005 payment of the 2004 tax expense. The 2005 higher tax payment resulted from the gain on sale of a pool of twenty-four turboprop engines at the end of 2004.

### (ii) Investing activities

The decrease in cash flow used by investing activities in the first nine months of 2005 versus the same period in 2004 was primarily due to the Company's sale of two aircraft in 2005 and the receipt of sales proceeds in 2005 from a sale of a pool of turboprop engines in the fourth quarter of 2004, the effect of which was partially offset by the purchase of aircraft with a combined higher total purchase price in 2005 than in 2004.

### (iii) Financing activities

The Company borrowed approximately \$5,741,000 more on its credit facility in the first nine months of 2005 versus 2004 and repaid approximately \$2,536,000 more of its outstanding debt in 2005.

### Outlook

The Company's future growth will depend on the availability of additional financing for acquisitions of leased assets which, due to rising interest rates, will need to be leased at increased rental rates to offset the anticipated decreased lease rates resulting from future re-leases of the Company's current portfolio.

The Company expects two of its deHavilland DHC-8 aircraft to be refinanced using bank financing separate from its credit facility in November 2005. The financing will result in a note obligation of approximately three years in the amount of \$6,400,000. The note will be collateralized by the aircraft and will be non-recourse to the Company. Payments due under the note will consist of monthly principal and interest and a balloon principal payment due on the maturity date. The financing will also provide for a six month remarketing period at the expiration or early termination of the lease. Payments due on the financing are reduced during this remarketing period and the balloon principal payment is deferred to the end of the six month period.

The repayment of a portion of the Company's credit line indebtedness in connection with the anticipated refinancing of two aircraft should give the Company increased borrowing power under its credit facility. The Company believes the near term market demand for regional aircraft lease financing will remain fairly strong, and that appropriate acquisitions will be available to enable the Company to take advantage of its available credit facility financing resources. This should enable the Company to continue to increase its aircraft portfolio. The Company is also continuing to pursue additional sources of acquisition financing.

The Company currently has three aircraft and one turboprop engine off lease. In November 2005, the Company signed an agreement to sell one of the off-lease aircraft. The Company is seeking remarketing opportunities for the remaining off-lease assets, and anticipates these aircraft going back on-lease on or about the beginning of the first quarter of 2006. Four additional aircraft have leases expiring in the fourth quarter of 2005. The Company has signed term sheets for three of the four. If, however, any of these proposed transactions does not

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result in a lease and the Company is not successful in timely locating a new lessee, the Company may be required to make principal repayments under its credit facility due to collateral base covenant restrictions. See "Factors that May Affect Future Results - Credit Facility Obligations" below

The Company continually monitors the financial condition of its lessees to prevent unanticipated creditworthiness issues, and where possible, work with lessees of concern to remind them of, and ensure continued compliance with, both monetary and non-monetary obligations under their respective leases. Currently, the Company is closely monitoring the performance of one lessee with a total of two aircraft under lease. These leases were amended in 2004 to defer a portion of rent and maintenance reserves payments due during the second half of 2004 to 2005. The deferred portion has been fully repaid, but the Company continues to work closely with the lessee to ensure its compliance with its current obligations. Any weakening in the aircraft industry may also affect the performance of lessees that currently appear to the Company to be creditworthy. See "Factors that May Affect Future Results - General Economic Conditions," below.

### Factors that May Affect Future Results

**Credit Facility Obligations.** The Company is obligated to make repayment of principal under the credit facility in order to maintain certain debt ratios with respect to its assets in the borrowing base. Assets that come off lease and remain off-lease for a period of time are removed from the borrowing base. The Company believes it will have sufficient cash funds to make any payment that arises due to borrowing base limitations caused by assets scheduled to come off lease in the near term. The Company's belief is based on certain assumptions regarding renewal of existing leases, a lack of extraordinary interest rate increases, continuing profitability, 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 the Company's assumptions will prove to be correct. If the assumptions are incorrect (for example, if an asset in the collateral base unexpectedly goes off lease for an extended period of time) 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 covenants or face default on its credit facility.

**Concentration of Lessees and Aircraft Type.** The Company's four largest customers, in Taiwan, Norway, Sweden and the Caribbean, currently account for approximately 26%, 16%, 14% and 14%, respectively, of the Company's monthly lease revenue. A lease default by or collection problems with one of these customers could have a disproportionate negative impact on the Company's financial results, and therefore, the Company's operating results are especially sensitive to any negative developments with respect to these customers in terms of lease compliance or collection. Such concentration of lessee credit risk will diminish in the future only if the Company is able to lease additional assets to new lessees.

The acquisition of four Fokker 50 aircraft and six DHC-8 aircraft in 2004 and 2005 made these two aircraft types the dominant aircraft types in the portfolio, constituting 10 and 11, respectively, of the 29 aircraft and representing 32% and 55%, respectively, based on book value. As a result, a change in the desirability and availability of either or both of these types of aircraft, which would in turn affect valuations of such aircraft, would have a disproportionately large impact on the Company's portfolio value. Such aircraft type concentration will diminish if the Company acquires additional assets of other types. Conversely, acquisition of additional Fokker 50 or DHC-8 aircraft will increase the Company's risks related to its concentration of those aircraft types.

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Interest Rate Risk. The Company's current credit facility and special purpose subsidiary indebtedness carry a floating interest rate based upon either the lender's prime rate or a floating LIBOR rate. Lease rates, generally, but not always, move with interest rates, since market demand for the asset also affects lease rates. Because lease rates are fixed at the origination of leases, interest rate increases during the term of a lease have no effect on existing lease payments. Therefore, if interest rates rise significantly, and there is relatively little lease origination by the Company following such rate increases, the Company could experience lower net earnings. Further, even if significant lease origination occurs following such rate increases, if the contemporaneous aircraft market forces result in lower or flat rental rates, the Company could experience lower net earnings as well.

It appears the economy is continuing a period of sustained increasing interest rates, particularly with respect to the rates for short-term borrowings, upon which the Company's financing rates are based. The Company has not hedged its interest rate obligations. Consequently, if an interest rate increase were great enough, the Company might not be able to generate sufficient lease revenue to meet its interest payment and other obligations and comply with the net earnings covenant of its credit facility.

Risks of Debt Financing. The Company's use of acquisition financing under its 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 credit facility, the loans are secured by the Company's existing assets as well as the specific assets acquired with each financing. In addition to payment obligations, the credit facility also requires the Company to comply with certain financial covenants, including a requirement of positive quarterly earnings, interest coverage and net worth ratios. Any default under the credit facility, if not waived by the lenders, could result in foreclosure upon not only the asset acquired using such financing, but also the existing assets of the Company securing the loan.

Increased Compliance Costs. Due to new Sarbanes-Oxley Act of 2000 requirements applicable to the Company for the year ending December 31, 2007 relating to internal controls and auditors' responsibilities to review and opine on those controls, the Company anticipates that the fees and expenses in connection with audit services are likely to significantly increase. The increase will generally arise from increased auditor responsibilities as well as an increased scope of examination of the Company which will broaden to include the Company's internal controls. Audit fees are expected to increase significantly and there may be additional costs arising from mandated testing of internal controls that will begin to take place in late 2006 and will be required to be performed on a continual basis thereafter. The exact amount of these costs can only be determined as the Company proceeds further with its analysis of current internal controls. The Company, however, anticipates that it will have sufficient funds to pay for the increased compliance cost.

Lessee Credit Risk. If a customer defaults upon its lease obligations, 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, Section 1110 of the Bankruptcy Code would automatically prevent the Company from exercising any remedies for a period of 60 days. After the 60-day period has passed, the lessee must agree to perform the obligations and



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cure any defaults, or the Company will have the right to repossess the 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. Most of the Company's lessees are foreign and not subject to U.S. bankruptcy laws but there may be similar applicable foreign bankruptcy debtor protection schemes available to foreign carriers.

**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 lessen. This could result in lower lease rates and values for the Company's existing turboprop aircraft.

**Risks Related to Regional Air Carriers.** Because the Company has concentrated its existing leases, and intends to concentrate on future leases, to regional air carriers, it is subject to additional risks. 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. 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 enhancements, if it deems them necessary. There is no assurance, however, that such enhancements will be available or that if obtained they will fully protect the Company from losses resulting from a lessee default or bankruptcy. Also, 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.

**Reliance on JMC.** All management of the Company is performed by JMC under a management agreement which is in the eighth 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 has ultimate control and supervisory responsibility over all aspects of the Company and owes fiduciary duties to the Company and its stockholders. 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 the Company and JMC, the parent company of JMC.

The JMC management agreement may be terminated if JMC defaults on its obligations to the Company. However, the agreement provides for liquidated damages in the event of its wrongful termination by the Company. All of the officers of JMC are also officers of the Company, and certain directors of the

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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 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.

JMC has acted as 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.

In the first quarter of 2002, AeroCentury IV defaulted on certain obligations to noteholders. In June 2002, the indenture trustee for AeroCentury IV's noteholders repossessed AeroCentury IV's assets and took over management of AeroCentury IV's remaining assets. JetFleet III defaulted on its bond obligation of \$11,076,350 in May 2004. The indenture trustee for JetFleet III bondholders repossessed JetFleet III's unsold assets in late May 2004.

**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 leases for such equipment expire, the Company's business, financial condition, cash flow, ability to service debt and results of operations could be adversely affected.

Furthermore, during the ownership of an asset, an asset impairment charge against the Company's earnings may result from the occurrence of unexpected adverse changes that impact the Company's estimates of expected cash flows generated from such asset. The Company periodically reviews long-term assets for impairments, in particular, when events or changes in circumstances indicate the carrying value of an asset may not be recoverable. An impairment loss is recognized when the carrying amount of an asset is not recoverable and exceeds its fair value. The Company may be required to recognize asset impairment charges in the future as a result of a prolonged weak economic environment, challenging market conditions in the airline industry or events related to particular lessees, assets or asset types.

**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 or repossession 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 do 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 make it more difficult for the Company to recover an aircraft in the event of a default by a foreign

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lessee.

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 that 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. However, the Company 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 that JMC's reputation will benefit the Company. There is, however, no assurance that the lack of 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.

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 the Company's aircraft assets. It is, however, not clear to what extent such statutory protection would be available to the Company, and the United States Aviation 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.

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General Economic Conditions. The Company's business is dependent upon general economic conditions and the strength of the travel and transportation industry. The industry has experienced a severe cyclical downturn which began in 2001. There are signs that the industry is beginning to recover from the downturn, but it is unclear whether any recovery will be a sustained one. Any recovery could be stalled or reversed by any number of events or circumstances, including the global economy slipping back into recession, or specific events related to the air travel industry, such as further weakening of the air carrier or travel industries as a result of terrorist attacks, or an increase in operational or labor costs. Recent spikes in oil prices, if they persist, may have a negative effect on airline profits and increase the likelihood of weakening results for airlines that have not hedged aircraft fuel costs, and in the most extreme cases, may initiate or accelerate the failure of many already marginal carriers.

Since regional carriers are generally not as well-capitalized as major air carriers, any economic setback in the industry may result in the increased possibility of an economic failure of one or more of the Company's lessees, particularly since many carriers are undertaking expansion of capacity to accommodate the recovering air passenger traffic. If lessees experience financial difficulties, this could, in turn, affect the Company's financial performance.

During any periods of economic contraction, carriers generally reduce capacity, in response to lower passenger loads, and as a result there is a reduced demand for aircraft and a corresponding decrease in market lease rental rates and aircraft values. This reduced market value for 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 write-down of the value on the Company's balance sheet is appropriate. Furthermore, as older leases expire and are replaced by lease renewals or re-leases at decreasing lease rates, the lease revenue of the Company on its existing portfolio is likely to decline, with the magnitude of the decline dependent on the length of the downturn and the depth of the decline in market rents.

Economic downturns can affect specific regions of the world exclusively. As the Company's portfolio is not entirely globally diversified, a localized downturn in one of the key regions in which the Company leases aircraft (e.g., Europe or Asia) could have a significant adverse impact on the Company.

Possible Volatility of Stock Price. The market price of the Company's common stock could be subject to fluctuations in response to the Company's operating results, 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 Company's shares. Consequently, a single or small number of trades could result in a market fluctuation not related to any business or financial development concerning the Company.

### Item 3. Controls and Procedures.

Quarterly evaluation of the Company's Disclosure Controls and Internal Controls. As of the end of the period covered by this report, the Company evaluated the effectiveness of the design and operation of its "disclosure controls and procedures" ("Disclosure Controls"), and its "internal controls over 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 Securities and Exchange Commission ("SEC")

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require that in this section of the 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. Attached as exhibits to this report 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 report 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 (the "Exchange Act"), such as this report, is recorded, processed, summarized and reported within the time periods specified in the SEC's 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 consolidated 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 errors 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 report. In the course of the Controls Evaluation, the CEO and CFO 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 Controls are also evaluated on an ongoing basis by other personnel in the

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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 item 5 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 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 there has been no significant change in Internal Controls that occurred during our most recent fiscal quarter that has materially affected or is reasonably likely to materially affect our Internal Controls.

Conclusions. Based upon the Controls Evaluation, the Company's CEO and CFO have concluded that, (i) the Company's Disclosure Controls are effective to ensure that the information required to be disclosed by the Company in the reports that it files under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms and then accumulated and communicated to Company management, including the CEO and CFO, as appropriate to make timely decisions regarding required disclosures, and (ii) that the Company's Internal Controls are effective to provide reasonable assurance that the Company's consolidated financial statements are fairly presented in conformity with generally accepted accounting principles.

### PART II OTHER INFORMATION

Items 1, 2, 3, 4 and 5 have been omitted as they are not applicable.

Item 6. Exhibits

Exhibits

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Exhibit Number	Description
31.1	Certification of Neal D. Crispin, Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Toni M. Perazzo, Chief Financial Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1*	Certification of Neal D. Crispin, Chief Executive Officer, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2*	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.

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: November 14, 2005 By: /s/ Toni M. Perazzo  
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Toni M. Perazzo

Title: Senior Vice President-Finance and  
Chief Financial Officer