

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549**

**FORM 10-Q**

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2014

TRANSITION REPORT PURSUANT TO 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 Registrant as Specified in Its Charter)

**Delaware**

(State or Other Jurisdiction of Incorporation or Organization)

**94-3263974**

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

**1440 Chapin Avenue, Suite 310**

**Burlingame, California 94010**

(Address of Principal Executive Offices)

**(650) 340-1888**

(Registrant's Telephone Number Including Area Code)

**None**

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: As of August 13, 2014 the issuer had 1,606,557 shares of common stock, par value \$0.001 per share, issued, of which 63,300 are held as treasury stock.

**PART I**  
**FINANCIAL INFORMATION**

*Forward-Looking Statements*

This Quarterly Report on Form 10-Q includes "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act") and Section 21E of the Securities Exchange Act of 1934, as amended ("the Exchange Act"). All statements in this Report other than statements of historical fact are "forward-looking statements" for purposes of these provisions, including any statements of plans and objectives for future operations and any statements of assumptions underlying any of the foregoing. Statements that include the use of terminology such as "may," "will," "expects," "plans," "anticipates," "estimates," "potential," or "continue," or the negative thereof, or other comparable terminology are forward-looking statements. Forward-looking statements include these statements: (i) in Part 1, Item 1, "Notes to Financial Statements," that the Company expects to deliver four aircraft for lease in the third quarter of 2014; that it expects to deliver an aircraft for sale in the third quarter of 2014; and that the Company may be out of compliance with a profitability covenant at calculation dates subsequent to June 30, 2014, in the absence of an amendment to the profitability covenant; (ii) in Part 1, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Capital Resources – Credit Facility" that the Company may be out of compliance with a profitability covenant at calculation dates subsequent to June 30, 2014, in the absence of an amendment to the profitability covenant; that the Credit Facility banks will agree to an amendment to cure such noncompliance during the third quarter of 2014; (iii) in Part I, Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations – Cash Flow," that the Company will have adequate cash flow to meet its ongoing operational needs; (iv) in Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations — Outlook," that there is an increased possibility that the Company's current lessees will choose to return leased assets at lease expiration rather than renew the existing leases; and that the Company is likely to experience lower on-lease utilization rates and longer lead times for remarketing of returned assets as well as lower rental rates for remarketed assets through 2014 and that such trend is expected to continue to affect the Company's operating results through 2014; that four of the Company's assets that have leases that will be expiring in the remainder of 2014 will be returned to the Company; that the Credit Facility banks will agree to an amendment to the profitability covenant in the third quarter of 2014; and that available borrowings under the Credit Facility will be sufficient to meet the Company's continuing obligations and to fund anticipated acquisitions; (v) in Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations – Factors that May Affect Future Results," that the Company believes that during the third quarter of 2014, the Credit Facility banks will agree to an amendment to cure the profitability covenant during the third quarter of 2014; that the Company will continue to be in compliance with all of the Credit Facility covenants through the term of the Credit Facility (assuming the profitability covenant is amended as expected); that the Company intends to continue to focus on its customer base of regional air carriers; that the Company will have sufficient cash funds to make any required principal repayment that arise due to borrowing base limitations; that most of the Company's growth will be outside the United States; that the overall industry experience of JMC's personnel and its technical resources should permit the Company to effectively manage new aircraft types and engines; that effective mitigating factors exist against undue compensation-incented risk-taking by JMC; that it is contemplated that the burden and cost of complying with regulatory requirements will fall primarily upon lessees of equipment or the Company as owner of the equipment; that the costs of complying with environmental regulations will not have a material adverse effect on the Company; that the Company has sufficient cyber-security measures in place; and that sufficient replacement mechanisms exist in the event of an interruption in its internet communications ability that there would not be a material adverse financial impact on the Company's business.

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 of Financial Condition and Results of Operations — Factors That May Affect Future Results," including the lack of any unexpected lessee defaults or insolvency; compliance by the Company's lessees with obligations under their respective leases; no sudden current economic downturn or unanticipated future financial crises; the continued availability of financing for acquisitions under the Credit Facility; the Company's success in finding appropriate assets to acquire with such financing; deviations from the assumption that future major maintenance expenses will be relatively evenly spaced over the entire portfolio; and future trends and results which cannot be predicted with certainty. The cautionary statements made in this 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.

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**Item 1. Financial Statements.**

AeroCentury Corp.  
Balance Sheets  
(Unaudited)

ASSETS

	June 30, 2014	December 31, 2013
Assets:		
Cash and cash equivalents	\$ 5,909,600	\$ 2,112,700
Accounts receivable, including deferred rent of \$54,800 and \$217,200 at		

**Item 1. Financial Statements.**

AeroCentury Corp.  
Balance Sheets  
(Unaudited)

ASSETS

	<u>June 30, 2014</u>	<u>December 31, 2013</u>
Assets:		
Cash and cash equivalents	\$ 5,909,600	\$ 2,112,700
Accounts receivable, including deferred rent of \$54,800 and \$217,200 at June 30, 2014 and December 31, 2013, respectively	2,797,800	3,303,800
Finance leases receivable	945,400	1,895,200
Aircraft and aircraft engines held for lease, net of accumulated depreciation of \$53,047,600 and \$50,679,300 at June 30, 2014 and December 31, 2013, respectively	166,922,000	152,954,600
Assets held for sale	509,200	735,000
Prepaid expenses and other	5,005,800	3,633,000
<b>Total assets</b>	<b><u>\$ 182,089,800</u></b>	<b><u>\$ 164,634,300</u></b>

LIABILITIES AND STOCKHOLDERS' EQUITY

Liabilities:		
Accounts payable and accrued expenses	\$ 2,130,700	\$ 1,202,700
Notes payable and accrued interest	101,457,500	77,527,300
Maintenance reserves	14,221,800	16,671,800
Accrued maintenance costs	709,000	1,612,100
Security deposits	6,286,700	6,265,000
Unearned revenues	2,042,200	646,700
Deferred income taxes	12,498,600	14,573,800
Taxes payable	159,200	-
<b>Total liabilities</b>	<b><u>139,505,700</u></b>	<b><u>118,499,400</u></b>
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$0.001 par value, 2,000,000 shares authorized, no shares issued and outstanding	-	-
Common stock, \$0.001 par value, 10,000,000 shares authorized, 1,606,557 shares issued and outstanding	1,600	1,600
Paid-in capital	14,780,100	14,780,100
Retained earnings	28,306,500	31,857,300
	<u>43,088,200</u>	<u>46,639,000</u>
Treasury stock at cost, 63,300 shares	(504,100)	(504,100)
<b>Total stockholders' equity</b>	<b><u>42,584,100</u></b>	<b><u>46,134,900</u></b>
<b>Total liabilities and stockholders' equity</b>	<b><u>\$ 182,089,800</u></b>	<b><u>\$ 164,634,300</u></b>

The accompanying notes are an integral part of these statements.

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AeroCentury Corp.  
Statements of Operations  
(Unaudited)

	For the Six Months Ended June 30,		For the Three Months Ended June 30,	
	2014	2013	2014	2013
Revenues and other income:				
Operating lease revenue, net	\$ 11,183,100	\$ 9,573,100	\$ 5,332,300	\$ 4,672,800
Maintenance reserves revenue, net	3,393,600	7,720,000	1,717,800	1,191,500
Net gain on disposal of assets	1,154,400	2,162,500	762,500	1,944,300
Other income	151,100	606,700	66,700	56,800
	<u>151,100</u>	<u>606,700</u>	<u>66,700</u>	<u>56,800</u>

AeroCentury Corp.  
Statements of Operations  
(Unaudited)

	For the Six Months Ended June 30,		For the Three Months Ended June 30,	
	2014	2013	2014	2013
<b>Revenues and other income:</b>				
Operating lease revenue, net	\$ 11,183,100	\$ 9,573,100	\$ 5,332,300	\$ 4,672,800
Maintenance reserves revenue, net	3,393,600	7,720,000	1,717,800	1,191,500
Net gain on disposal of assets	1,154,400	2,162,500	762,500	1,944,300
Other income	151,100	606,700	66,700	56,800
	<u>15,882,200</u>	<u>20,062,300</u>	<u>7,879,300</u>	<u>7,865,400</u>
<b>Expenses:</b>				
Provision for impairment in value of aircraft	6,800,000	-	6,800,000	-
Depreciation	3,878,400	3,573,000	2,012,600	1,815,800
Maintenance	3,646,600	3,469,800	1,302,300	1,330,400
Management fees	2,659,900	2,172,600	1,332,600	1,076,700
Interest	2,568,100	2,068,100	1,261,200	1,002,500
Professional fees, general and administrative and other	1,127,500	624,300	822,900	297,500
Insurance	620,600	552,000	313,300	298,000
Other taxes	45,100	45,100	22,500	22,500
	<u>21,346,200</u>	<u>12,504,900</u>	<u>13,867,400</u>	<u>5,843,400</u>
(Loss)/income before income tax provision	(5,464,000)	7,557,400	(5,988,100)	2,022,000
Income tax (benefit)/provision	(1,913,200)	2,403,100	(2,067,700)	685,600
Net (loss)/income	<u>\$ (3,550,800)</u>	<u>\$ 5,154,300</u>	<u>\$ (3,920,400)</u>	<u>\$ 1,336,400</u>
<b>(Loss)/earnings per share:</b>				
Basic	<u>\$ (2.30)</u>	<u>\$ 3.34</u>	<u>\$ (2.54)</u>	<u>\$ 0.87</u>
Diluted	<u>\$ (2.30)</u>	<u>\$ 3.25</u>	<u>\$ (2.54)</u>	<u>\$ 0.84</u>
<b>Weighted average shares used in (loss)/earnings per share computations:</b>				
Basic	<u>1,543,257</u>	<u>1,543,257</u>	<u>1,543,257</u>	<u>1,543,257</u>
Diluted	<u>1,543,257</u>	<u>1,585,666</u>	<u>1,543,257</u>	<u>1,588,331</u>

The accompanying notes are an integral part of these statements.

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AeroCentury Corp.  
Statements of Cash Flows  
(Unaudited)

	For the Six Months Ended June 30,	
	2014	2013
Net cash provided by operating activities	<u>\$ 5,032,200</u>	<u>\$ 5,403,700</u>
<b>Investing activities:</b>		
Proceeds from sale of aircraft and aircraft engines held for lease, net of re-sale fees	9,316,400	4,882,800
Proceeds from sale of assets held for sale, net of re-sale fees	225,800	207,700
Purchases of aircraft and aircraft engines	(32,234,000)	(4,089,000)
Net cash (used in)/provided by investing activities	<u>(22,691,800)</u>	<u>1,001,500</u>
<b>Financing activities:</b>		
Borrowings under Credit Facility	32,100,000	2,000,000
Repayments of Credit Facility	(8,200,000)	(300,000)
Debt issuance costs	(2,443,500)	(2,055,000)
Net cash provided by/(used in) financing activities	<u>21,456,500</u>	<u>(355,000)</u>
Net increase in cash and cash equivalents	3,796,900	6,050,200

AeroCentury Corp.  
Statements of Cash Flows  
(Unaudited)

	For the Six Months Ended June 30,	
	2014	2013
Net cash provided by operating activities	\$ 5,032,200	\$ 5,403,700
Investing activities:		
Proceeds from sale of aircraft and aircraft engines held for lease, net of re-sale fees	9,316,400	4,882,800
Proceeds from sale of assets held for sale, net of re-sale fees	225,800	207,700
Purchases of aircraft and aircraft engines	(32,234,000)	(4,089,000)
Net cash (used in)/provided by investing activities	(22,691,800)	1,001,500
Financing activities:		
Borrowings under Credit Facility	32,100,000	2,000,000
Repayments of Credit Facility	(8,200,000)	(300,000)
Debt issuance costs	(2,443,500)	(2,055,000)
Net cash provided by/(used in) financing activities	21,456,500	(355,000)
Net increase in cash and cash equivalents	3,796,900	6,050,200
Cash and cash equivalents, beginning of period	2,112,700	1,596,800
Cash and cash equivalents, end of period	\$ 5,909,600	\$ 7,647,000

During the six months ended June 30, 2014 and 2013, the Company paid interest totaling \$2,092,700 and \$1,424,300, respectively. The Company paid income taxes of \$800 and \$800 during the six months ended June 30, 2014 and 2013, respectively.

The accompanying notes are an integral part of these statements.

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AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

**1. Organization and Summary of Significant Accounting Policies**

*(a) The Company and Basis of Presentation*

AeroCentury Corp., a Delaware corporation incorporated in 1997, acquires used regional aircraft and engines for lease to foreign and domestic regional carriers.

The condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three-month and six-month periods ended June 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014.

As discussed in Note 2, the Company has adopted an alternate method of accounting for non-refundable maintenance reserves and certain lessor maintenance obligations. The Company has applied this change in accounting principle retrospectively in accordance with ASC 250, *Accounting Changes and Error Corrections* (“ASC 250”).

For further information, refer to the financial statements and footnotes thereto included in the Company’s annual report on Form 10-K for the year ended December 31, 2013.

*(b) Use of Estimates*

The Company’s financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”). The preparation of financial statements in conformity with GAAP 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

AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

**1. Organization and Summary of Significant Accounting Policies**

*(a) The Company and Basis of Presentation*

AeroCentury Corp., a Delaware corporation incorporated in 1997, acquires used regional aircraft and engines for lease to foreign and domestic regional carriers.

The condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information, the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three-month and six-month periods ended June 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014.

As discussed in Note 2, the Company has adopted an alternate method of accounting for non-refundable maintenance reserves and certain lessor maintenance obligations. The Company has applied this change in accounting principle retrospectively in accordance with ASC 250, *Accounting Changes and Error Corrections* (“ASC 250”).

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*(b) Use of Estimates*

The Company’s financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”). The preparation of financial statements in conformity with GAAP 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 and useful lives of the assets, the amount and timing of cash flows associated with each asset that are used to evaluate whether assets are impaired, accrued maintenance costs, accounting for income taxes, and the amounts recorded as allowances for doubtful accounts.

*(c) Fair Value Measurements*

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs, to the extent possible. The fair value hierarchy under GAAP is based on three levels of inputs.

Level 1 - Quoted prices in active markets for identical assets or liabilities.

Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

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AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

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

*(c) Fair Value Measurements (continued)*

AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

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

*(c) Fair Value Measurements (continued)*

Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

Assets and Liabilities Measured and Recorded at Fair Value on a Recurring Basis

The following table shows by level, within the fair value hierarchy, the fair value of the Company's assets that are measured and recorded at fair value on a recurring basis:

	June 30, 2014			December 31, 2013				
	Total	Level 1	Level 2	Level 3	Total	Level 1	Level 2	Level 3
Money market funds included in cash and cash equivalents	\$ 5,543,100	\$ 5,543,100	\$ -	\$ -	\$ 1,842,000	\$ 1,842,000	\$ -	\$ -
Total	<u>\$ 5,543,100</u>	<u>\$ 5,543,100</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,842,000</u>	<u>\$ 1,842,000</u>	<u>\$ -</u>	<u>\$ -</u>

As of June 30, 2014 and December 31, 2013, there were no liabilities that were required to be measured and recorded at fair value on a recurring basis.

Assets Measured and Recorded at Fair Value on a Nonrecurring Basis

The Company determines fair value of long-lived assets held and used, such as aircraft and aircraft engines held for lease and held for sale, by reference to independent appraisals, quoted market prices (e.g., offers to purchase) and other factors. An impairment charge is recorded when the Company believes that the carrying value of an asset will not be recovered through future net cash flows and that the carrying value exceeds its fair value. At June 30, 2014, the Company determined that the carrying values of five of its Fokker 100 aircraft were not recoverable and consequently recorded an impairment charge of \$6,800,000 based on the appraised values of those aircraft.

Fair Value of Other Financial Instruments

The Company's financial instruments, other than cash and cash equivalents, consist principally of finance leases receivable and amounts borrowed under its credit facility (the "Credit Facility," as defined in Note 5). The fair value of accounts receivable, finance leases receivable, accounts payable and the Company's maintenance reserves and accrued maintenance costs approximates the carrying value of these financial instruments.

Borrowings under the Company's Credit Facility bear floating rates of interest that reset periodically to a market benchmark rate plus a credit margin. The Company believes the effective interest rate of this debt agreement approximates current market rates for such indebtedness at the balance sheet date, and therefore that the carrying amount of its floating rate debt at the balance sheet dates approximates its fair value. The fair value of the Company's outstanding balance of its Credit Facility would be categorized as Level 3 under the GAAP fair value hierarchy.

AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

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

*(d) Finance Leases*

The lease for one of the Company's aircraft contains a lessee purchase option at a price substantially below the assets' estimated residual values at the exercise date for the option. Consequently, the Company considers the purchase option to be a "bargain purchase option" and has classified the lease as a finance lease for financial accounting purposes. The Company does not include the value, purchase price or accumulated depreciation of finance lease assets on its balance sheet. Instead, the discounted present value of (i) future minimum lease payments (including the bargain purchase option) and (ii) any residual value not subject to a bargain purchase option are reported as a finance lease receivable. Rental revenue and depreciation expense are not recognized on

AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

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

*(d) Finance Leases*

The lease for one of the Company's aircraft contains a lessee purchase option at a price substantially below the assets' estimated residual values at the exercise date for the option. Consequently, the Company considers the purchase option to be a "bargain purchase option" and has classified the lease as a finance lease for financial accounting purposes. The Company does not include the value, purchase price or accumulated depreciation of finance lease assets on its balance sheet. Instead, the discounted present value of (i) future minimum lease payments (including the bargain purchase option) and (ii) any residual value not subject to a bargain purchase option are reported as a finance lease receivable. Rental revenue and depreciation expense are not recognized on finance leases. Rather, the Company accrues interest on the balance of the finance lease receivable based on the interest rate inherent in the applicable lease.

Two engines that were previously subject to finance leases were returned to the Company during the second quarter of 2014 and the finance lease receivable balances were reclassified to aircraft and aircraft engines held for lease on the Company's balance sheet.

The Company recognized interest earned on finance leases as "other income" in the amount of \$66,200 and \$34,600 in the quarters ended June 30, 2014 and 2013, respectively, and \$150,000 and \$65,000 in the six months ended June 30, 2014 and 2013, respectively.

*(e) Recent Accounting Pronouncements*

On May 28, 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update No. 2014-09 (the "ASU") that created the new Topic 606 in the Accounting Standards Codification ("ASC"). The ASU also included numerous conforming additions and amendments to other Topics within the ASC. Topic 606 establishes new rules that affect the amount and timing of revenue recognition for contracts with customers, but does not affect lease accounting and reporting. As such, adoption of these provisions will not affect the Company's lease revenues but may affect the reporting of other of the Company's revenues. The provisions included in the ASU are effective for years commencing after December 15, 2016, cannot be adopted early, and may be reflected using either a full retrospective method or a simplified method that does not recast prior periods but does disclose the effect of the adoption on the current period financial statements. The Company has not determined either the potential impact on its financial statements nor the method it will elect to use in connection with the adoption of the changes included in the ASU.

**2. Adjustment of Previously Reported Financial Information**

The Company adopted the direct expensing method under Financial Accounting Standards Board ("FASB") Staff Position AUG AIR-1, *Accounting for Planned Major Maintenance Activities* ("FSP AUG AIR-1") on January 1, 2007. Under FSP AUG AIR-1, non-refundable maintenance reserves were recorded as maintenance reserves revenue (assuming cash was received or collections was reasonably assured), and associated maintenance work was recorded as maintenance expense when the work was performed. The Company has evaluated its method of accounting for maintenance reserves and lessor maintenance obligations and has elected to change its method of accounting, effective January 1, 2014, to:

- (i) Recognize non-refundable maintenance reserves as liabilities for deposits against future maintenance reimbursements of maintenance reserves received in the normal course of ongoing leases;
- (ii) Recognize reimbursements from such collected reserves as disbursements against the liability when claims are submitted for payment against previously collected maintenance reserves;
- (iii) Reflect as liabilities non-refundable reserves received by the prior lessor upon acquisition of an aircraft which are claimable by the lessee when maintenance is performed;

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AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

**2. Adjustment of Previously Reported Financial Information (continued)**

- (iv) Recognize as income non-refundable reserves not refunded to lessees upon termination of the lease and return of the aircraft to the Company in accordance with all lease return requirements; and
- (v) Record lessor maintenance obligations as liabilities upon acquisition of an aircraft subject to a lease under which the Company assumes the prior lessor's obligation to pay a portion of a first-time maintenance event.

AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

**2. Adjustment of Previously Reported Financial Information (continued)**

- (iv) Recognize as income non-refundable reserves not refunded to lessees upon termination of the lease and return of the aircraft to the Company in accordance with all lease return requirements; and
- (v) Record lessor maintenance obligations as liabilities upon acquisition of an aircraft subject to a lease under which the Company assumes the prior lessor's obligation to pay a portion of a first-time maintenance event.

In management's judgment, the change to this accounting method is preferable in that it will provide the user of the Company's financial statements a better understanding of the underlying business terms of the Company's leasing transactions and provide additional clarity with respect to the Company's sources of income, its non-refundable reserve obligations, and its lessor maintenance obligations. The change in accounting method resulted in a cumulative net decrease of \$8,088,200 in stockholders' equity as of January 1, 2013.

The effects on the Company's December 31, 2013 balance sheet as a result of the retroactive application of the change in accounting principle in accordance with ASC 250 were as follows:

	December 31, 2013		
	As reported previously	As adjusted	Effect of change
Cash and cash equivalents	\$ 2,112,700	\$ 2,112,700	\$ -
Accounts receivable, net	3,313,700	3,303,800	(9,900)
Finance leases receivable	1,895,200	1,895,200	-
Aircraft and aircraft engines held for lease, net	152,375,200	152,954,600	579,400
Assets held for sale	735,000	735,000	-
Prepaid expenses and other	3,633,000	3,633,000	-
<b>Total assets</b>	<b>\$ 164,064,800</b>	<b>\$ 164,634,300</b>	<b>\$ 569,500</b>
Accounts payable and accrued expenses	\$ 1,175,300	\$ 1,202,700	\$ 27,400
Notes payable and accrued interest	77,527,300	77,527,300	-
Maintenance reserves and accrued maintenance costs	13,254,100	18,283,900	5,029,800
Security deposits	6,265,000	6,265,000	-
Unearned revenues	646,700	646,700	-
Deferred income taxes	16,099,700	14,573,800	(1,525,900)
<b>Total liabilities</b>	<b>114,968,100</b>	<b>118,499,400</b>	<b>3,531,300</b>
Preferred stock	-	-	-
Common stock	1,600	1,600	-
Paid-in capital	14,780,100	14,780,100	-
Retained earnings	34,819,100	31,857,300	(2,961,800)
Treasury stock	(504,100)	(504,100)	-
<b>Total stockholders' equity</b>	<b>49,096,700</b>	<b>46,134,900</b>	<b>(2,961,800)</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 164,064,800</b>	<b>\$ 164,634,300</b>	<b>\$ 569,500</b>

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AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

**2. Adjustment of Previously Reported Financial Information (continued)**

The effects on the Company's statements of operations for the six months and three months ended June 30, 2013 as a result of the retroactive application of the change in accounting principle in accordance with ASC 250 were as follows:

AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

**2. Adjustment of Previously Reported Financial Information (continued)**

The effects on the Company's statements of operations for the six months and three months ended June 30, 2013 as a result of the retroactive application of the change in accounting principle in accordance with ASC 250 were as follows:

	For the Six Months Ended June 30, 2013			For the Three Months Ended June 30, 2013		
	As reported previously	As adjusted	Effect of change	As reported previously	As adjusted	Effect of change
Operating lease revenue, net	\$ 9,573,100	\$ 9,573,100	\$ -	\$ 4,672,800	\$ 4,672,800	\$ -
Maintenance reserves income, net	7,703,600	7,720,000	16,400	569,300	1,191,500	622,200
Gain on disposal of assets and other income	2,769,200	2,769,200	-	2,001,100	2,001,100	-
	<u>20,045,900</u>	<u>20,062,300</u>	<u>16,400</u>	<u>7,243,200</u>	<u>7,865,400</u>	<u>622,200</u>
Maintenance	3,788,700	3,469,800	(318,900)	1,383,600	1,330,400	(53,200)
Depreciation	3,549,400	3,573,000	23,600	1,803,400	1,815,800	12,400
Management fees	2,164,500	2,172,600	8,100	1,072,400	1,076,700	4,300
Interest	2,068,100	2,068,100	-	1,002,500	1,002,500	-
Professional fees, general and administrative and other	669,400	669,400	-	320,000	320,000	-
Insurance	552,000	552,000	-	298,000	298,000	-
	<u>12,792,100</u>	<u>12,504,900</u>	<u>(287,200)</u>	<u>5,879,900</u>	<u>5,843,400</u>	<u>(36,500)</u>
Income before taxes	7,253,800	7,557,400	303,600	1,363,300	2,022,000	658,700
Tax provision	2,299,800	2,403,100	103,300	461,600	685,600	224,000
Net income	<u>\$ 4,954,000</u>	<u>\$ 5,154,300</u>	<u>\$ 200,300</u>	<u>\$ 901,700</u>	<u>\$ 1,336,400</u>	<u>\$ 434,700</u>
Earnings per share:						
Basic	<u>\$ 3.21</u>	<u>\$ 3.34</u>	<u>\$ 0.13</u>	<u>\$ 0.58</u>	<u>\$ 0.87</u>	<u>\$ 0.29</u>
Diluted	<u>\$ 3.12</u>	<u>\$ 3.25</u>	<u>\$ 0.13</u>	<u>\$ 0.57</u>	<u>\$ 0.84</u>	<u>\$ 0.27</u>

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AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

**3. Aircraft and Aircraft Engines Held for Lease or Sale**

*(a) Assets Held for Lease*

At June 30, 2014 and December 31, 2013, the Company's aircraft and aircraft engines, which were on lease or held for lease, consisted of the following:

Model	June 30, 2014		December 31, 2013	
	Number owned	% of net book value	Number owned	% of net book value
Bombardier Dash-8-300	9	21%	9	23%
Bombardier CRJ-700	3	18%	-	-
Fokker 100	7	13%	7	19%

AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

**3. Aircraft and Aircraft Engines Held for Lease or Sale**

*(a) Assets Held for Lease*

At June 30, 2014 and December 31, 2013, the Company's aircraft and aircraft engines, which were on lease or held for lease, consisted of the following:

Model	June 30, 2014		December 31, 2013	
	Number owned	% of net book value	Number owned	% of net book value
Bombardier Dash-8-300	9	21%	9	23%
Bombardier CRJ-700	3	18%	-	-
Fokker 100	7	13%	7	19%
Bombardier Dash-8-Q400	3	15%	3	17%
Bombardier CRJ-705	1	10%	1	12%
Saab 340B Plus	6	8%	6	8%
Fokker 50	9	8%	10	10%
General Electric CF34-8E5 engine	2	4%	3	6%
Saab 340B	1	1%	4	4%
Tay 650-15 engine	1	1%	1	1%
General Electric CT7-9B engine	2	1%	2	-
Saab 340A	1	-	1	-

Net book value at June 30, 2014 and December 31, 2013 excludes the Company's Saab 340A aircraft, which is subject to a finance lease. Net book value at December 31, 2013 also excludes the Company's two General Electric CT7-9B engines, which were subject to finance leases at that time.

As described in Note 1, the Company recorded a \$6,800,000 impairment charge on five of its Fokker 100 aircraft on June 30, 2014, which has been reflected in the carrying value of the aircraft on that date.

During the second quarter of 2014, the Company used cash of \$9,000 for acquisitions related to aircraft purchased during the first quarter. During the second quarter of 2013, the Company used cash of \$2,323,000 for the purchase and capital improvement of aircraft and engines.

During the second quarter of 2014, the Company recorded a net gain of \$762,500 related to the sale of three Saab 340B aircraft and a General Electric CF34-8E5 Engine. During the second quarter of 2013, the Company recorded gains of \$1,871,000 upon the sale of a Dash-8-100 aircraft and \$73,300 related to the finance lease of a General Electric CB7-9B engine.

During the second quarter of 2014, the Company extended the leases for five of its assets. During the same period, six Saab 340B Plus aircraft and two General Electric CT7-9B engines were returned by a customer when it ceased operations.

At June 30, 2014, twenty-one of the Company's assets, comprised of six Fokker 100 aircraft, six Saab 340B Plus aircraft, three Fokker 50 aircraft, one Dash-8-300 aircraft, two General Electric CF34-8E5 engines, two General Electric CT7-9B engines and one Tay 650-15 engine, which represented 31% of the net book value of the Company's aircraft and engines, were off lease.

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AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

**3. Aircraft and Aircraft Engines Held for Lease or Sale (continued)**

*(a) Assets Held for Lease (continued)*

As discussed in Note 8, the Company sold a Fokker 50 aircraft in July 2014. The Company has a signed letter of intent for the lease of two Saab 340B Plus aircraft and a deposit for one of the aircraft. The Company also has a signed lease and deposit for the lease of a Fokker 100 aircraft, as well as a signed letter of intent and deposit for the lease of a second Fokker 100 aircraft to the same customer. The Company expects to deliver all four aircraft during the third

AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

### 3. Aircraft and Aircraft Engines Held for Lease or Sale (continued)

#### (a) Assets Held for Lease (continued)

As discussed in Note 8, the Company sold a Fokker 50 aircraft in July 2014. The Company has a signed letter of intent for the lease of two Saab 340B Plus aircraft and a deposit for one of the aircraft. The Company also has a signed lease and deposit for the lease of a Fokker 100 aircraft, as well as a signed letter of intent and deposit for the lease of a second Fokker 100 aircraft to the same customer. The Company expects to deliver all four aircraft during the third quarter of 2014. The Company also has a signed purchase agreement and non-refundable deposit for the sale of a Fokker 50 aircraft and expects to deliver the aircraft during the third quarter of 2014. The Company is seeking re-lease opportunities for the other off-lease assets, other than the Tay 650-15 engine that is being held as a spare and used in connection with required maintenance on the Company's Fokker 100 aircraft.

#### (b) Assets Held for Sale

Assets held for sale include two airframes. During the three months ended June 30, 2014 and 2013, the Company received \$10,500 and \$171,700, respectively, from the sale of parts belonging to the two airframes. No adjustments to the carrying value of the Company's assets held for sale were recorded during the three months or six months ended June 30, 2014 and 2013.

### 4. Maintenance Reserves and Accrued Maintenance Costs

Maintenance costs under the Company's triple net leases are generally the responsibility of the lessees. Most of the Company's leases require payment of maintenance reserves, which are based upon lessee-reported usage and billed monthly, and are intended to accumulate and be applied by the Company toward reimbursement of most or all of the cost of the lessees' performance of certain maintenance obligations under the leases. Maintenance reserves are characterized as either refundable or non-refundable depending on their disposition at lease end. Non-refundable maintenance reserves are retained by the Company at lease end, even if the lessee has met all of its obligations under the lease, including any return conditions applicable to the leased asset, while refundable reserves are returned to the lessee under such circumstances.

Maintenance reserves in the accompanying balance sheets include refundable and non-refundable maintenance reserves payments billed to lessees, which are paid out as related maintenance is performed and, in the case of refundable reserves, at the end of the lease. Accrued maintenance costs include (i) maintenance for work performed for off-lease aircraft, which is not related to the release of reserves received from lessees and (ii) lessor maintenance obligations assumed upon acquisition of aircraft subject to a lease with such provisions.

Maintenance reserves received by the Company are accounted for as a liability, which is reduced when maintenance work is performed during the lease and reimbursement to the lessee is paid. Any reserves retained by the Company at lease end are recorded as revenue at that time.

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AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

### 5. Notes Payable and Accrued Interest

At June 30, 2014 and December 31, 2013, the Company's notes payable and accrued interest consisted of the following:

	June 30, 2014	December 31, 2013
Credit Facility principal	\$ 101,400,000	\$ 77,500,000
Credit Facility accrued interest	57,500	27,300
	<u>\$ 101,457,500</u>	<u>\$ 77,527,300</u>

During May 2014, the Company's \$130 million Credit Facility (the "Credit Facility"), which is provided by a syndicate of banks, was increased to \$180 million and extended through May 31, 2019. The Credit Facility is secured by all of the assets of the Company, including its aircraft and engine portfolio.

In November 2013, the Company obtained a waiver of compliance with a customer concentration covenant at the September 30, 2013 and December 31, 2013 calculation dates. The Company was in compliance with all covenants other than the waived covenant under the Credit Facility agreement at December 31,

AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

## 5. Notes Payable and Accrued Interest

At June 30, 2014 and December 31, 2013, the Company's notes payable and accrued interest consisted of the following:

	June 30, 2014	December 31, 2013
Credit Facility principal	\$ 101,400,000	\$ 77,500,000
Credit Facility accrued interest	57,500	27,300
	<u>\$ 101,457,500</u>	<u>\$ 77,527,300</u>

During May 2014, the Company's \$130 million Credit Facility (the "Credit Facility"), which is provided by a syndicate of banks, was increased to \$180 million and extended through May 31, 2019. The Credit Facility is secured by all of the assets of the Company, including its aircraft and engine portfolio.

In November 2013, the Company obtained a waiver of compliance with a customer concentration covenant at the September 30, 2013 and December 31, 2013 calculation dates. The Company was in compliance with all covenants other than the waived covenant under the Credit Facility agreement at December 31, 2013.

As of June 30, 2014, the Company was out of compliance with a profitability covenant. The non-compliance resulted primarily from the Company recognizing aircraft impairment charges totaling \$6,800,000 at June 30, 2014. Based on its current projections, the Company believes that it may be out of compliance with this covenant, which is calculated on a trailing 12 months basis, at subsequent calculation dates. The Company is in discussions with the agent bank to amend the credit facility agreement to exclude impairment charges from the profitability covenant calculation, and retroactively cure the covenant default on June 30, 2014 and subsequent calculation dates. There is, however, no assurance that such an amendment agreement will eventually be entered into between the Company and the Credit Facility banks.

The Company was in compliance with all other covenants at June 30, 2014.

The unused amount of the Credit Facility was \$78,600,000 and \$52,500,000 as of June 30, 2014 and December 31, 2013, respectively.

The weighted average interest rate on the Credit Facility was 3.69% and 3.94% at June 30, 2014 and December 31, 2013, respectively.

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AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

## 6. Computation of Earnings Per Share

Basic and diluted earnings per share are calculated as follows:

	For the Six Months Ended June 30,		For the Three Months Ended June 30,	
	2014	2013	2014	2013
Net (loss)/income	\$ (3,550,800)	\$ 5,154,300	\$ (3,920,400)	\$ 1,336,400
Weighted average shares outstanding for the period	1,543,257	1,543,257	1,543,257	1,543,257
Dilutive effect of warrants	-	42,409	-	45,074
Weighted average diluted shares used in calculation of diluted (loss)/earnings per share	<u>1,543,257</u>	<u>1,585,666</u>	<u>1,543,257</u>	<u>1,588,331</u>
Basic (loss)/earnings per share	<u>\$ (2.30)</u>	<u>\$ 3.34</u>	<u>\$ (2.54)</u>	<u>\$ 0.87</u>
Diluted (loss)/earnings per share	<u>\$ (2.30)</u>	<u>\$ 3.25</u>	<u>\$ (2.54)</u>	<u>\$ 0.84</u>

Basic earnings per common share is computed using net income and the weighted average number of common shares outstanding during the period. Diluted

AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

## 6. Computation of Earnings Per Share

Basic and diluted earnings per share are calculated as follows:

	For the Six Months Ended June 30,		For the Three Months Ended June 30,	
	2014	2013	2014	2013
Net (loss)/income	\$ (3,550,800)	\$ 5,154,300	\$ (3,920,400)	\$ 1,336,400
Weighted average shares outstanding for the period	1,543,257	1,543,257	1,543,257	1,543,257
Dilutive effect of warrants	-	42,409	-	45,074
Weighted average diluted shares used in calculation of diluted (loss)/earnings per share	1,543,257	1,585,666	1,543,257	1,588,331
Basic (loss)/earnings per share	\$ (2.30)	\$ 3.34	\$ (2.54)	\$ 0.87
Diluted (loss)/earnings per share	\$ (2.30)	\$ 3.25	\$ (2.54)	\$ 0.84

Basic earnings per common share is computed using net income and the weighted average number of common shares outstanding during the period. Diluted earnings per common share are computed using net income and the weighted average number of common shares outstanding, assuming dilution. Weighted average common shares outstanding, assuming dilution, include potentially dilutive common shares outstanding during the period. Potentially dilutive common shares include the assumed exercise of warrants using the treasury stock method. For the three months and six months ended June 30, 2014, the dilutive effect of outstanding warrants was 39,393 and 39,589 potentially outstanding shares issuable upon the assumed exercise of all outstanding warrants. However, the effect of these potentially outstanding shares was not included in the calculation of diluted loss per share for the applicable period because the effect would have been anti-dilutive.

## 7. Related Party Transactions

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 also receives an acquisition fee for locating assets for the Company. Acquisition fees are included in the cost basis of the asset purchased. JMC may receive a remarketing fee in connection with the re-lease or sale of the Company's assets. Remarketing fees are amortized over the applicable lease term or included in the gain or loss on sale recognized upon sale of the applicable asset.

Fees incurred during the three months and six months ended June 30, 2014 and 2013 were as follows:

	For the Six Months Ended June 30,		For the Three Months Ended June 30,	
	2014	2013	2014	2013
Management fees	\$ 2,659,900	\$ 2,172,600	\$ 1,332,600	\$ 1,076,700
Acquisition fees	980,000	148,000	980,000	88,000
Remarketing fees	64,000	241,000	64,000	173,000

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AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

## 8. Subsequent Events

In July 2014, the Company sold a Fokker 50 aircraft and recorded a gain of approximately \$332,000.

AeroCentury Corp.  
Notes to Financial Statements (Unaudited)  
June 30, 2014

## 8. Subsequent Events

In July 2014, the Company sold a Fokker 50 aircraft and recorded a gain of approximately \$332,000.

### Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following discussion should be read in conjunction with the Company's Form 10-K for the year ended December 31, 2013 and the unaudited financial statements and related notes that appear elsewhere in this report.

#### *Critical Accounting Policies, Judgments and Estimates*

The Company's discussion and analysis of its financial condition and results of operations are based upon the financial statements, which have been prepared in accordance with accounting principles generally accepted in the 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. 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. For a discussion of Critical Accounting Policies, Judgments and Estimates, refer to Note 1 to the Company's financial statements in Item 1 of this Quarterly Report on Form 10-Q.

For a discussion of the Company's accounting policies regarding maintenance reserves, refer to Note 4 to the Company's financial statements in Item 1 of this Quarterly Report on Form 10-Q. For a discussion of the Company's change in method of accounting for certain maintenance reserves and lessor maintenance obligations and its application to prior periods, refer to Note 2 to the Company's financial statements in Item 1 of this Quarterly Report on Form 10-Q.

#### *Results of Operations*

##### *Quarter ended June 30, 2014 compared to the quarter ended June 30, 2013*

The Company recorded a net loss of \$3.9 million in the quarter ended June 30, 2014 compared to net income of \$1.3 million in the same period of 2013.

Quarterly operating lease revenue increased 14% from \$4.7 million in the quarter ended June 30, 2013 to \$5.3 million in the second quarter of 2014, primarily as a result of increases in operating lease revenue from assets purchased during 2013 and 2014. These increases were partially offset by the effect of: (i) assets on lease in the 2013 period but off lease in the 2014 period; (ii) asset sales during 2013; and (iii) lower revenue received from those lessees from which the Company records revenue only on cash receipt as a result of substantial uncertainty of collectability.

Maintenance reserves revenue increased 44% from \$1.2 million in the quarter ended June 30, 2013 to \$1.7 million in the quarter ended June 30, 2014. The amount recorded in the 2013 period represents maintenance reserves retained at lease end for one aircraft. The amount recorded in the 2014 period represents maintenance reserves retained at lease end when six aircraft were returned to the Company.

The average net book value of assets held for lease during the second quarters of 2014 and 2013 was approximately \$173.7 million and \$141.7 million, respectively, representing an increase of 22%. The average portfolio utilization during the quarters ended June 30, 2014 and 2013 was 77% and 75%, respectively.

During the second quarter of 2014, the Company recorded a net gain of \$0.8 million related to the sale of two aircraft and an aircraft engine. During the second quarter of 2013, the Company recorded a gain of \$1.9 million related to the sale of one aircraft and the finance lease of an engine.

During the second quarter of 2014, the Company recorded impairment charges totaling \$6.8 million for five of its Fokker 100 aircraft, based on the appraised values of those aircraft. There were no recorded impairment charges of long-lived assets during the second quarter of 2013.

During the second quarters of 2014 and 2013, the Company added equipment to the lease portfolio of approximately \$1.8 million and \$2.4 million, respectively. The 2014 amount was comprised of capital equipment added to aircraft and the reclassification of two aircraft engines from finance lease receivables to aircraft and aircraft engines held for lease. The Company sold equipment with a book value of approximately \$5.3 million and \$2.1 million during the second quarters of 2014 and 2013, respectively. Depreciation and management fees in the second quarter of 2014 increased by 11% and 24%, respectively, over the previous year, primarily as a result of acquisitions and changes in residual assumptions from year to year.

The Company's interest expense increased by 26% from \$1.0 million in the second quarter of 2013 to \$1.3 million in the second quarter of 2014, primarily as a result of a higher average Credit Facility balance.

The Company's professional fees, general and administrative and other expenses increased by 177% from \$0.3 million in the second quarter of 2013 to \$0.8 million in the second quarter of 2014, primarily as a result of pilot, fuel, insurance and other expenses incurred in connection with the return of six aircraft and two General Electric CT7-9B engines by one of the Company's customers when it ceased operations in the 2014 period.

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*Six months ended June 30, 2014 compared to the six months ended June 30, 2013*

The Company recorded a net loss of \$3.6 million in the six months ended June 30, 2014 compared to net income of \$5.2 million in the same period of 2013.

Quarterly operating lease revenue increased 17% from \$9.6 million in the first half of 2013 to \$11.2 million in the first half of 2014, primarily as a result of increases in operating lease revenue from assets purchased during 2013 and 2014. The effect of these increases was partially offset by the effect of: (i) assets that were on lease in the 2013 period but off lease in the 2014 period, (ii) asset sales during 2013 and (iii) lower revenue received from those lessees from which the Company records revenue only on cash receipt as a result of substantial uncertainty of collectability.

Maintenance reserves revenue decreased 56% from \$7.7 million in the first half of 2013 to \$3.4 million in the first half of 2014. The amount recorded in the 2013 period was received from the prior lessee of two of the Company's aircraft when the leases were assigned to a new lessee in 2012 and recognized as maintenance reserves revenue upon termination of those leases in the first quarter of 2013, and from maintenance reserves retained at lease end for another aircraft. The amount recorded in the 2014 period represents maintenance reserves retained at lease end when seven aircraft were returned to the Company

The average net book value of assets held for lease during the six months ended June 30, 2014 and 2013 was approximately \$177.9 million and \$142.8 million, respectively, representing an increase of 25%. The average portfolio utilization during the six months ended June 30, 2014 and 2013 was 79% and 76%, respectively.

During the first half of 2014, the Company recorded net gains totaling \$1.2 million related to the sale of four aircraft and an aircraft engine. During the six months ended June 30, 2013, the Company recorded net gains of \$2.2 million related to the sale of two aircraft and the finance lease of an engine.

During the first half of 2014, the Company recorded impairments totaling \$6.8 million for five of its Fokker 100 aircraft, based on appraisal. There were no recorded impairments of long-lived assets during the first half of 2013.

During the six months ended June 30, 2014 and 2013, the Company added equipment to the lease portfolio of approximately \$33.0 million and \$4.3 million, respectively. The Company sold equipment with a book value of approximately \$7.9 million and \$4.4 million during the six months ended June 30, 2014 and 2013, respectively. Depreciation and management fees in the first six months of 2014 increased by 9% and 22%, respectively, over the previous year, primarily as a result of acquisitions and changes in residual assumptions from year to year.

The Company's interest expense increased by 24% from \$2.1 million in the first six months of 2013 to \$2.6 million in the same period of 2014, primarily as a result of a higher average Credit Facility balance.

The Company's professional fees, general and administrative and other expenses increased by 81% from \$0.6 million in the first half of 2013 to \$1.1 million in the first half of 2014, primarily as a result of pilot, fuel, insurance and other expenses incurred in connection with the return of six aircraft and two General Electric CT7-9B engines by one of the Company's customers when it ceased operations in the 2014 period.

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*Liquidity and Capital Resources*

The Company is currently financing its assets primarily through debt financing and excess cash flows.

*(a) Credit Facility*

During May 2014, the Company's \$130 million Credit Facility (the "Credit Facility"), which is provided by a syndicate of banks, was increased to \$180 million and extended through May 31, 2019. The Credit Facility is secured by all of the assets of the Company, including its aircraft and engine portfolio.

In November 2013, the Company obtained a waiver of compliance with a lessee concentration covenant under its Credit Facility agreement at the September 30, 2013 and December 31, 2013 calculation dates. The Company was in compliance with all covenants other than the waived covenant under the Credit Facility agreement at December 31, 2013.

As of June 30, 2014, the Company was out of compliance with a profitability covenant. The non-compliance resulted primarily from the Company recognizing aircraft impairment charges totaling \$6.8 million at June 30, 2014. Based on its current projections, the Company believes that it may be out of compliance with this covenant, which is calculated on a trailing 12 months basis, at subsequent calculation dates. The Company is in discussions with the agent bank to amend the credit facility agreement to exclude impairment charges from the profitability covenant calculation, and retroactively cure the covenant default on June 30, 2014 and subsequent calculation dates. The Company believes that the Credit Facility banks will agree to such an amendment during the third quarter of 2014; there is, however, no assurance that such an amendment agreement will eventually be entered into between the Company and the Credit Facility banks. Furthermore, if such an amendment is agreed to, the Credit Facility banks could require terms and conditions that increase the cost of the Credit Facility to the Company and/or that are less favorable to the Company than the current agreement. The Company was in compliance with all other covenants at June 30, 2014.

### *Liquidity and Capital Resources*

The Company is currently financing its assets primarily through debt financing and excess cash flows.

#### *(a) Credit Facility*

During May 2014, the Company's \$130 million Credit Facility (the "Credit Facility"), which is provided by a syndicate of banks, was increased to \$180 million and extended through May 31, 2019. The Credit Facility is secured by all of the assets of the Company, including its aircraft and engine portfolio.

In November 2013, the Company obtained a waiver of compliance with a lessee concentration covenant under its Credit Facility agreement at the September 30, 2013 and December 31, 2013 calculation dates. The Company was in compliance with all covenants other than the waived covenant under the Credit Facility agreement at December 31, 2013.

As of June 30, 2014, the Company was out of compliance with a profitability covenant. The non-compliance resulted primarily from the Company recognizing aircraft impairment charges totaling \$6.8 million at June 30, 2014. Based on its current projections, the Company believes that it may be out of compliance with this covenant, which is calculated on a trailing 12 months basis, at subsequent calculation dates. The Company is in discussions with the agent bank to amend the credit facility agreement to exclude impairment charges from the profitability covenant calculation, and retroactively cure the covenant default on June 30, 2014 and subsequent calculation dates. The Company believes that the Credit Facility banks will agree to such an amendment during the third quarter of 2014; there is, however, no assurance that such an amendment agreement will eventually be entered into between the Company and the Credit Facility banks. Furthermore, if such an amendment is agreed to, the Credit Facility banks could require terms and conditions that increase the cost of the Credit Facility to the Company and/or that are less favorable to the Company than the current agreement. The Company was in compliance with all other covenants at June 30, 2014.

For additional information regarding the Company's credit facility, refer to Note 5 to the Company's financial statements in Item 1 of this Quarterly Report on Form 10-Q.

#### *(b) Cash flow*

The Company's primary sources of cash are (i) rent payments due under the Company's operating and finance leases and (ii) maintenance reserves billed monthly to lessees based on asset usage.

The Company's primary uses of cash are for purchase of aircraft and engines, maintenance expense and reimbursement to lessees from collected maintenance reserves, management fees, professional fees, insurance, and Credit Facility interest and principal payments. The amount of interest paid by the Company depends on the outstanding balance of its Credit Facility, which carries a floating interest rate as well as an interest rate margin, and is therefore also dependent on changes in prevailing interest rates.

The timing and amount of the Company's payments for maintenance vary, depending on the timing of lessee-performed maintenance that is eligible for reimbursement, the aggregate amount of such claims and the timing and amount of maintenance incurred in connection with preparation of off-lease assets for re-lease to new customers. The Company's maintenance payments typically constitute a large portion of its cash needs, and the Company may from time to time borrow additional funds under the Credit Facility to provide funding for such payments.

Management believes that the Company will have adequate cash flow to meet its ongoing operational needs, including any required repayments under the Credit Facility due to borrowing base limitations, based upon its estimates of future revenues and expenditures, which include assumptions regarding (i) revenues for assets to be re-leased, (ii) required debt payments, (iii) interest rates, (iv) the cost and anticipated timing of maintenance to be performed and (v) timely use of proceeds of unused debt capacity toward additional acquisitions of income producing assets.

Although 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 factors that could have an impact on the accuracy of cash flow assumptions are (i) lessee non-compliance with lease obligations, (ii) inability to locate new lessees for returned equipment within a reasonable remarketing period, or at a rent level consistent with projected rates for the asset, (iii) lessee performance of maintenance, and payment of related maintenance claims, earlier than anticipated, (iv) inability to locate and acquire a sufficient volume of additional assets at prices that will produce acceptable net returns, (v) increases in interest rates, (vi) inability to timely dispose of off-lease assets at prices commensurate with their market value, and (vii) any one or a combination of the above factors that causes the Company to violate covenants under the Credit Facility agreement, which may in turn require repayment of some or all of the amounts outstanding.

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#### *(i) Operating activities*

The Company's cash flow from operations was approximately the same in the first six months of 2014 compared to the same period in 2013. As discussed below, the change in cash flow was primarily a result of increases in payments received for operating lease revenue and security deposits as well as a decrease in payments for aircraft insurance, the effects of which were partially offset by increases in payments for maintenance, interest and management fees.

#### Payments for operating lease revenue and maintenance reserves

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Payments for operating lease revenue and maintenance reserves

Payments received from lessees for rent increased by \$2.8 million in the first half of 2014 compared to the first half of 2013, primarily due to rent from assets purchased during late 2013 and early 2014. Payments received for maintenance reserves decreased by \$1.1 million in the first half of 2014 compared to the same period in 2013, primarily as a result of payment delinquencies and lower utilization of some assets for which the Company collects maintenance reserves.

The Company is receiving no lease revenue for its assets that are currently off lease, which assets are comprised of six Fokker 100 aircraft, six Saab 340B Plus aircraft, two Fokker 50 aircraft, one Dash-8-311 aircraft, two General Electric CF34-8E5 engines, two General Electric CT7-9B engines and one Tay 650-15 engine. The Tay 650-15 engine, which was acquired during the first quarter of 2013, is being held as a spare and used in connection with required maintenance on the Company's Fokker 100 aircraft.

Payments for security deposits

Payments for security deposits increased by \$0.6 million in the first half of 2014 compared to the first half of 2013 primarily as a result of a 100% deposit received in the 2014 period for the sale of an aircraft in July 2014.

Payments for maintenance

Payments for maintenance increased by \$1.4 million in the first half of 2014 compared to the first half of 2013, primarily as a result of an increase in maintenance costs for off-lease aircraft. The amount of payments for maintenance in future periods will depend on the amount and timing of maintenance paid as reimbursement to lessees for maintenance reserves claims, which are dependent upon utilization and required maintenance intervals, and maintenance paid for off-lease assets.

Payment for interest and management fees

Payments for interest and management fees increased by \$0.7 million and \$0.9 million, respectively, in the first half of 2014 compared to the same period of 2013 as a result of a higher Credit Facility balance and asset purchases.

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Payment for professional fees, general and administrative and other expenses

Payments for professional fees, general and administrative and other expenses increased by \$0.5 million in the first half of 2014 compared to the same period in 2013 primarily as a result of pilot, fuel, insurance and other expenses incurred in connection with the return of six aircraft and two engines by one of the Company's customers in the 2014 period when it ceased operations.

*(ii) Investing activities*

During the six months ended June 30, 2014 and 2013, the Company received cash of \$9.5 million and \$5.1 million, respectively, from the sale of assets. During the same time periods, the Company used cash of \$32.2 million and \$4.1 million, respectively, for purchases and capital improvement of aircraft.

*(iii) Financing activities*

The Company borrowed \$32.1 million and \$2.0 million under the Credit Facility during the first six months of 2014 and 2013, respectively. In these same time periods, the Company repaid \$8.2 million and \$0.3 million, respectively, of its total outstanding debt under the Credit Facility. Such repayments were funded by excess cash flow. During the first six months of 2014 and 2013, the Company paid \$2.4 million and \$2.1 million of fees related to the extension and administration of the Company's Credit Facility. Such fees are amortized over the term of the Credit Facility.

*Outlook**(a) General*

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*Outlook**(a) General*

While certain areas of the world air carrier industry are now beginning to experience growth after a period of contraction following the global downturn of recent years, other areas of the world continue to experience slow recovery and shakeouts of weaker air carrier competitors that were unable to survive the aftermath of the global downturn. Overall, the Company continues to experience a reduction in the number of aircraft and aircraft engines needed for operation by carriers in nearly all geographic areas, especially in Western Europe, as compared to periods before the global downturn. The overall low-growth environment, combined with the unanticipated cessation of operations by a regional Thai carrier and return to the Company of six leased aircraft and two aircraft engines, and continuing delays in re-leasing certain of the Company's older off-lease aircraft will present an ongoing and challenging environment for the Company in four respects:

- Lessees who are located in low- or no- growth areas of the world carry heightened risk of an unanticipated lessee default. A lessee's default and the unscheduled return of an asset to the Company for remarketing could result not only in reduced operating lease revenue but also in unanticipated, unrecoverable expenses arising from the lessee's default on its maintenance and return condition obligations. The Company monitors the performance of all of its customers and has noted that several of the Company's customers continue to experience weakened operating results and have not yet achieved financial stability.
- The current environment heightens the possibility that the Company's existing lessees will choose to return leased assets at lease expiration rather than renew the existing leases, notwithstanding that any such lessee may incur significant expenses to satisfy return conditions. Due to the flat demand for aircraft capacity, it is likely that the Company will experience lower on-lease utilization rates and longer lead times for remarketing of returned assets, as well as lower rental rates for remarketed assets, as was the case with several lease extensions and re-leases since 2011. This trend is expected to continue to affect the Company's operating revenue through 2014.
- The lack of significant growth in the pool of customers requiring aircraft for lease creates a challenge for the Company in maintaining a high utilization rate for its aircraft portfolio. It could also cause the Company's overall credit risk profile to increase as the Company considers leasing its off-lease assets to start-up air carriers that have higher credit risk profiles than the Company's current lessees. Failure to bring new lessees into the portfolio could increase the Company's reliance on a small number of lessees, which increases the Company's risk of financial covenant compliance (see "*Factors That May Affect Future Results – Concentration of Lessees and Aircraft Type*," below).
- The inability to timely remarket the Company's off-lease aircraft could affect the Company's collateral base and impact its ability to access acquisition funds, and, if it continues over the medium term, could affect the Company's compliance with its collateral base financial covenants.

*(b) Operating Segments*

The Company operates in one business segment, the leasing of regional aircraft to foreign and domestic regional airlines, and therefore does not present separate segment information for lines of business.

At July 31, 2014, the dominant types of aircraft in the Company's portfolio were as follows:

*(b) Operating Segments*

The Company operates in one business segment, the leasing of regional aircraft to foreign and domestic regional airlines, and therefore does not present separate segment information for lines of business.

At July 31, 2014, the dominant types of aircraft in the Company's portfolio were as follows:

Model	Number owned	% of net book value
Bombardier Dash-8-300	9	21%
Bombardier CRJ-700	3	18%
Bombardier Dash-8-Q400	3	15%
Fokker 100	7	13%
Bombardier CRJ-705	1	11%

For the month ended July 31, 2014, the Company's sources of operating lease revenue were from the following regions:

Region	Number of lessees	% of operating lease revenue
North America	2	34%
Africa	2	28%
Caribbean	1	15%
Europe	2	11%
Asia	3	10%
South America	1	2%

*(c) Remarketing Efforts*

In July 2014, the Company sold a Fokker 50 aircraft. The Company has a signed letter of intent for the lease of two Saab 340B Plus aircraft and a deposit for one of the aircraft. The Company expects to deliver the aircraft during the third quarter of 2014. The Company also has a signed purchase agreement and non-refundable deposit for the sale of a Fokker 50 aircraft.

The Company is seeking remarketing opportunities for four Saab 340B Plus aircraft, a Fokker 50 aircraft, two General Electric CF34-8E5 engines and two General Electric CT7-9B engines.

Six of the Company's Fokker 100 aircraft are off lease. The Company also has a signed lease and deposit for the lease of a Fokker 100 aircraft, as well as a signed letter of intent and deposit for the lease of a second Fokker 100 aircraft to the same customer. The Company expects to deliver both aircraft during the third quarter of 2014. The Company is seeking remarketing opportunities for its other off-lease Fokker 100 aircraft.

Leases for four of the Company's assets will expire during the remainder of 2014 and the Company believes that is likely that they will be returned at lease end.

The Company is considering selling some or all of its off-lease aircraft. The Company is analyzing the amount and timing of maintenance required to remarket the aircraft, the amount of which may differ significantly if the aircraft are sold rather than re-leased.

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*(d) Credit Facility*

As of June 30, 2014, the Company was out of compliance with a profitability covenant. The non-compliance resulted primarily from the Company recognizing aircraft impairment charges totaling \$6.8 million at June 30, 2014. Based on its current projections, the Company believes that it may be out of compliance with this covenant, which is calculated on a trailing 12 months basis, at subsequent calculation dates. The Company is in discussions with the agent bank to amend the credit facility agreement to exclude impairment charges from the profitability covenant calculation, effective as of the June 30, 2014 and subsequent calculation dates. The Company believes that the Credit Facility banks will agree to such an amendment during the third quarter of 2014; however, there is no assurance that such agreement will eventually be reached. Furthermore, if such an amendment is agreed to, it could result in an increase in cost of the Credit Facility and/or a change in terms of the Credit Facility less favorable to the Company than the current agreement.

The Company was in compliance with all other covenants at June 30, 2014.

The Company believes that available borrowings under the Credit Facility, considering possible lessee arrearages or off-lease periods, will be sufficient to meet its continuing obligations and to fund anticipated acquisitions. However, there can be no assurance the Company's beliefs will prove to be correct and that the Company will have sufficient cash to make any required Credit Facility repayments.

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*Factors that May Affect Future Results*

*Noncompliance with Credit Facility Financial Covenant.* The Company's use of debt as the primary form of acquisition financing subjects the Company to increased risks associated with leveraging. In addition to payment obligations, the Credit Facility agreement includes financial covenants, including some requiring the Company to have positive earnings, meet minimum net worth standards and be in compliance with certain other financial ratios.

As discussed above in "Outlook – Credit Facility," as of June 30, 2014, the Company was out of compliance with a profitability covenant. The Company is in discussions with the agent bank to amend the covenant to exclude impairment charges from the profitability covenant calculation and retroactively cure the covenant default on the June 30, 2014 and subsequent calculation dates. The Company believes that the Credit Facility banks will agree to such an amendment during the third quarter of 2014; however, there is no assurance that the Company and the Credit Facility banks will reach an agreement to such an amendment. Furthermore, if such an amendment is agreed to, the Credit Facility banks could require terms and conditions that increase the cost of the Credit Facility to the Company and/or that are less favorable to the Company than the current agreement. If the Company and the Credit Facility banks cannot agree to such an amendment, the Credit Facility banks would have the right to declare a default under the Credit Facility based on the noncompliance and exercise their default remedies, including, declaring the Credit Facility immediately due and payable. The Company's assets secure its debt financing, and any default in payment obligations or other covenants under the Credit Facility could result in foreclosure upon any or all of the assets of the Company.

Although the Company believes it will continue to be in compliance with all of the Credit Facility covenants through the term of the Credit Facility (assuming the profitability covenant is amended as expected), there can be no assurance of such compliance, and in the event of any non-compliance, the Company will need to seek further waivers or amendment of applicable covenants from its lenders if such compliance failure is not timely cured. Any default under the Credit Facility, if not cured in the time permitted under the facility or waived by the lenders, could result in foreclosure upon any or all of the assets of the Company.

*Ownership Risks.* The Company's leases are typically less than the entire anticipated remaining useful life of the leased assets. The Company's ability to recover its investment in an asset subject to such a lease is dependent upon the Company's ability to profitably re-lease or sell the asset after the expiration of the lease term. The Company's ability to re-lease or sell the asset is dependent on worldwide economic conditions, general aircraft market conditions, regulatory changes that may make an asset's use more expensive or preclude use due to the age of the aircraft or unless the asset is modified, changes in the supply or cost of aircraft equipment and technological developments that cause the asset to become obsolete. If the Company is unable to remarket its assets on favorable terms when the leases for such assets expire, the Company's financial condition, cash flow, ability to service debt and results of operations could be adversely affected.

The Company acquires used aircraft equipment. The market for used aircraft equipment has been 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, the number of new aircraft on order and the number of aircraft coming off lease, as well as introduction of new aircraft models and types that may be more technologically advanced, more fuel efficient and/or less costly to maintain and operate. Values may also increase for certain aircraft types that become desirable based on market conditions and changing airline capacity.

In addition, a successful investment in an asset subject to a lease depends in part upon having the asset returned by the lessee in the condition as required under the lease. Each lease typically obligates a customer to return an asset to the Company in a specified condition, which generally requires it be returned in equal or better condition than at delivery to the lessee. If the lessee becomes insolvent during the term of its lease and the Company has to repossess the asset, it is unlikely that the lessee will have the financial ability to meet these return obligations and it is likely that the Company would be required to expend funds in excess of any maintenance reserves collected to return the asset to a remarketable condition. If the lessee files for bankruptcy and rejects the aircraft lease, although the lessee is required to return the aircraft, the lessee is relieved from all further obligations under the lease, including the obligation to return the aircraft in the condition required under the lease. In that case, it is also likely that the Company would be required to expend funds in excess of any maintenance reserves collected to return the asset to a remarketable condition.

Several of the Company's leases do not require payment of monthly maintenance reserves, which serve as the lessee's advance payment for its future repair and maintenance obligations. If repossession due to lessee default or bankruptcy occurs under such a lease, the Company will be left with the costs of unperformed repair and maintenance under the applicable lease and the Company may incur an unanticipated expense in order to re-lease or sell the asset.

Furthermore, the occurrence of unexpected adverse changes that impact the Company's estimates of expected cash flows generated from an asset may result in an asset impairment charge against the Company's earnings. The Company periodically reviews long-term assets for impairment, 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 estimated to be not recoverable and exceeds its fair value. The Company recognized impairment charges for five of its Fokker 100 aircraft at June 30, 2014 and 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.

*Lessee Credit Risk.* The Company carefully evaluates the credit risk of each customer and attempts to obtain a third party guaranty, letters of credit or other credit enhancements, if it deems them necessary in addition to customary security deposits. There can be no assurance, however, that such enhancements will be available, or that, if obtained, will fully protect the Company from losses resulting from a lessee default or bankruptcy.

If a lessee that is a certified U.S. airline were in default under a lease and sought 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 against such lessee for a period of 60 days. After the 60-day period had passed, the lessee would have to agree to perform the lease obligations and cure any defaults, or the Company would have the right to repossess the equipment. However, this procedure under the Bankruptcy Code has been subject to significant litigation, and it is possible that the Company's enforcement rights may be further adversely affected by a bankruptcy filing by a defaulting lessee.

Several of the Company's customers have experienced significant financial difficulties, become insolvent, or have been declared or have filed for bankruptcy. Such an insolvency or bankruptcy usually discharges all unpaid obligations of the customer existing at the time of the filing, resulting in a total loss of those receivables. The Company closely monitors the performance of all of its lessees and its risk exposure to any lessee that may be facing financial difficulties, in order to guide decisions with respect to such lessee that would mitigate losses in the event the lessee is unable to meet or rejects its lease obligations. There can be no assurance that additional customers will not become insolvent or file for bankruptcy or that the Company will be able to mitigate any of the resultant losses.

*Risks Related to Regional Air Carriers.* The Company's continued focus on its customer base of regional air carriers subjects the Company to additional risks. Some of the lessees in the regional air carrier market are companies that are start-up, low-capital, and/or low-margin operators. Often, the success of such carriers depends on contractual arrangements with major trunk carriers or franchises from governmental agencies that provide subsidies for operating essential air routes, both of which may be subject to termination or cancellation on short notice. Regional carriers, even if financially strong, that are owned by, or are a sister corporation of, an established major carrier can also be swept into bankruptcy if the major carrier files for bankruptcy or becomes insolvent. Four of the Company's regional air carrier customers filed for bankruptcy in 2012-2013, and in May 2014, a Thai regional carrier that leased six aircraft and two engines from the Company ceased operations.

*Credit Facility Debt Limitations.* Under the Credit Facility, the amount available to be borrowed is limited to the total amount of asset-specific advance rates. Lessee arrearages or asset off-lease periods may reduce the advance rate for the related assets and, therefore, the permitted borrowing under the facility. Amounts subject to deferral agreements also reduce the borrowing base. The Company believes it will have sufficient cash funds to make any required principal repayment that arises due to any such borrowing base limitations.

*Availability of Financing.* The Company's continued growth will depend on its ability to continue to obtain capital, either through debt or equity financings. The financial markets have experienced significant setbacks that have continued to make access to capital and asset-based debt financing more costly and difficult to obtain. There can be no assurance that the Company's belief regarding the availability of financing under the current Credit Facility will prove to be correct, or that the Company will succeed in finding additional funding, and if such financing is found, it may be on terms less favorable than the Company's current debt financings.

*General Economic Conditions and Lowered Demand for Travel.* The Company's business is dependent upon general economic conditions and the strength of the travel and transportation industry. The industry is continuing to experience financial difficulty due to the slow recovery in the global economy. Passenger volume has fallen significantly for many carriers, and the loss of revenue has affected their financial condition. The current lending environment has made it difficult or impossible for many regional carriers to find the additional debt financing on which they have traditionally relied. The confluence of these economic factors increases the likelihood of failures among the Company's customers. The spread of a disease epidemic, the threat or execution of a terrorist attack against aviation, a worsening financial/bank crisis in Europe, a natural event that interrupts air traffic, political crises or other events that cause a prolonged spike in fuel prices, or other like events could exacerbate an already weakened condition and lead to widespread failures in the air carrier industry. If lessees experience financial difficulties and are unable to meet lease obligations, this will, in turn, negatively affect the Company's financial performance.

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Airline reductions in capacity in response to lower passenger loads have resulted in reduced demand for aircraft and aircraft engines and a corresponding decrease in market lease rental rates and aircraft values for many aircraft types. This reduced market value could affect the Company's results if the market value of an asset or assets in the Company's portfolio falls below carrying value, and the Company determines that a write-down of the value on its balance sheet is appropriate. Furthermore, if older, expiring leases are replaced with leases at decreased lease rates, the lease revenue from the Company's existing

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Economic downturns can affect certain regions of the world more than others. As the Company's portfolio is not entirely globally diversified, a localized downturn in one of the key regions in which the Company leases assets could have a significant adverse impact on the Company. The Company's significant sources of operating lease revenue by region are summarized in "*Outlook - Operating Segments*," above.

Over the last few years, several of the Company's customers have experienced financial difficulties arising from a combination of the weakened air carrier market and their own unique financial circumstances and have requested and been granted deferral of certain overdue and/or future rental or reserve payment obligations. It is possible that the Company may enter into additional deferral agreements if the current weakened air carrier environment continues. When a customer requests a deferral of lease obligations, the Company evaluates the lessee's financial plan, the likelihood that the lessee can remain a viable carrier, and whether the deferral will be repaid according to the agreed schedule. The Company may elect to record the deferred rent and reserve payments from the lessee on a cash basis, which could have a material effect on the Company's financial results in the applicable periods.

*International Risks.* The Company leases assets primarily in overseas markets. Leases with foreign lessees, however, may present different risks than those with domestic lessees. Most of the Company's expected growth is outside of the United States.

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. An economic downturn in a particular country or region may impact a foreign lessee's ability to make lease payments, even if the U.S. and other foreign economies remain stable.

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. In addition, if the Company undertakes certain obligations under a lease to contribute to a repair or improvement and if the work is performed in a foreign jurisdiction and paid for in foreign currency, currency fluctuations resulting in a weaker dollar between the time such agreement is made and the time payment for the work is made may result in an unanticipated increase in U.S. dollar-denominated cost for the Company.

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 payments, increasing the risk of default of that lessee, particularly if its revenue is primarily derived in the local currency.

Foreign lessees that operate internationally may also face restrictions on repatriating foreign revenue to their home country. This could create a cash flow crisis for an otherwise profitable carrier, affecting its ability to meet its lease obligations.

Non-U.S. lessees are not subject to U.S. bankruptcy laws, although there may be debtor protection similar to U.S. bankruptcy laws available in some jurisdictions. 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 lessee. In any event, collection and enforcement may be more difficult and complicated in foreign countries.

Finally, ownership of a leased asset operating in a foreign country and/or by a foreign carrier may subject the Company to additional tax liabilities that are not present with aircraft operated in the United States. Depending on the jurisdiction, laws governing such tax liabilities may be complex, not well formed or not uniformly enforced. In such jurisdictions, the Company may decide to take an uncertain tax position based on the best advice of the local tax experts it engages, which position may be challenged by the taxing authority. If the taxing authority later assesses a liability, the Company may be required to pay penalties and interest on the assessed amount, which penalties and interest would not give rise to a corresponding foreign tax credit on the Company's U.S. tax return.

*Concentration of Lessees and Aircraft Type.* For the month ended July 31, 2014, based on monthly operating lease revenue and interest income from finance leases, the Company's five largest customers accounted for a total of approximately 83% of the Company's monthly lease revenue. A lease default by or collection problem with one or a combination of any of these significant customers could have a disproportionate negative impact on the Company's financial results and borrowing base under the Credit Facility, 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. In addition, if the Company's revenues become overly concentrated in a small number of lessees, the Company could fail to comply with certain financial covenants in its Credit Facility related to customer concentration. In the event of any such failure to be in compliance, the Company will need to seek waivers or amendment of the applicable covenants from its lenders if such compliance failure is not timely cured. Any default under the Credit Facility, if not cured in the time permitted under the Credit Facility or waived by the lenders, could result in foreclosure upon any or all of the assets of the Company.

The dominant types of aircraft in the Company's portfolio are summarized in "*Outlook - Operating Segments*," above. A change in the desirability and availability of any of these types of aircraft, which would in turn affect valuations of such aircraft, would have a disproportionately significant impact on the

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*Investment in New Aircraft Types and Engines.* The Company intends to continue to focus solely on regional aircraft and engines. Although the Company has traditionally invested in a limited number of types of turboprop aircraft and engines, the Company has also acquired several types of regional jet aircraft, as well as regional jet aircraft engines, and may continue to seek acquisition opportunities for new types and models of aircraft and engines used in the Company's targeted customer base of regional air carriers. Acquisition of aircraft types and engines not previously acquired by the Company entails greater ownership risk due to the Company's lack of experience managing those assets. The Company believes, however, that the overall industry experience of JMC's personnel and its technical resources should permit the Company to effectively manage such new aircraft types and engines. Further, the broadening of the asset types in the aircraft portfolio may have a benefit of diversifying the Company's portfolio (see "*Factors That May Affect Future Results - Concentration of Lessees and Aircraft Type*," above).

*Engine Leasing Risk.* The Company currently has five engines in its portfolio, making up 5% of the Company's total net book value of aircraft and aircraft engines held for lease. The Company may from time to time lease one or more of these engines under industry standard short-term engine leases, which place the risk of an engine failure not caused by lessee negligence or foreign object damage upon the lessor. It is not economically practicable for an engine lessor to insure against that risk. If an engine failure occurs and is not covered by a manufacturer's warranty or is not otherwise caused by circumstances that the lessee is required to cover, the Company's investment in the engine could be a significant loss or the Company might incur a significant maintenance expense.

*Interest Rate Risk.* The Credit Facility carries a floating interest rate based upon short-term interest rate indices. Lease rates typically, but not always, move over time with interest rates, but market demand and numerous other asset-specific factors also affect lease rates. Because the Company's typical lease rates are fixed at lease origination, interest rate changes during the lease term have no effect on existing lease rental 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 decreased net income as additional interest expense outpaces revenue growth. Further, even if significant lease origination occurs following such rate increases, other contemporaneous aircraft market forces may result in lower or flat rental rates, thereby decreasing net income.

*Reliance on JMC.* All management of the Company is performed by JMC under the twenty-year Management Agreement between the Company and JMC that expires in April of 2018 and provides for an asset-based management fee. JMC is not a fiduciary of the Company or its stockholders. The Company's Board of Directors (the "Board") has ultimate control and supervisory responsibility over all aspects of the Company and owes fiduciary duties to the Company and its stockholders. The Board has no control over the internal operations of JMC, but the Board does have the ability and responsibility to manage the Company's relationship with JMC and the performance of JMC's obligations to the Company under the Management Agreement, as it would have for any third party service provider to the Company. While JMC may not owe any fiduciary duties to the Company by virtue of the Management Agreement, all of the officers of JMC are also officers of the Company, and in that capacity owe fiduciary duties to the Company and its stockholders. In addition, certain officers of the Company hold significant ownership positions in the Company and JHC, the parent company of JMC.

The 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. Certain directors of the Company are also directors of JMC and, as discussed above, the officers of the Company are also officers of JMC and certain officers hold significant ownership positions in both the Company and JHC, the holding company for 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.

*Management Fee Structure.* All decisions regarding acquisitions and disposal of aircraft from the Company's portfolio are made by JMC. JMC is paid a management fee based on the net asset value of the Company's portfolio. It may also receive a one-time asset acquisition fee upon purchase of an asset by the Company, and a one-time remarketing fee in connection with the sale or re-lease of an asset. Optimization of the results of the Company depends on timing of the acquisition, lease yield on the acquired assets, and re-lease or sale of its portfolio assets. Under the current management fee structure, a larger volume of acquisitions generates acquisition fees and also increases the periodic management fee by increasing the size of the aircraft portfolio. Since the Company's current business strategy involves continued growth of its portfolio and a "buy and hold" strategy, a compensation structure that results in greater compensation with an increased portfolio size is consistent with that strategy. The compensation structure does, nonetheless, create a situation where a decision by JMC for the Company to forego an asset transaction deemed to be an unacceptable business risk due to the lessee or the aircraft type is in conflict with JMC's own pecuniary interest. As a result, the compensation structure could act to incent greater risk-taking by JMC in asset acquisition decision-making. The Company has established objective target guidelines for yields on acquired assets. Further, the Company's Board, including a majority of the outside independent directors, must approve any acquisition that involves a new asset type. While the Company currently believes the foregoing are effective mitigating factors against undue compensation-incented risk-taking by JMC, there is no assurance that such mechanisms can entirely and effectively eliminate such risk.

*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, maximum aircraft age, 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 aircraft 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. Nevertheless, 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 in many cases customers that are private companies without well-established third party credit ratings, is not well served by the Company's larger competitors. JMC has developed a reputation as a global participant in this segment of the market, and the Company believes that JMC's reputation benefits the Company. There is, however, no assurance that competition from larger aircraft leasing companies will not increase significantly or that JMC's reputation 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. A "triple net lease" is a lease under which, in addition to monthly rental payments, the lessee is generally responsible for the taxes, insurance and maintenance and repair of the aircraft arising from the use and operation of the aircraft during the term of the lease. Although the United States Aviation Act may provide some protection with respect to the Company's aircraft assets, it is unclear to what extent such statutory protection would be available to the Company with respect to most of the Company's assets, which are operated in foreign countries where such provisions of the United States Aviation Act may not apply.

The Company's leases generally require a lessee to insure against likely risks of loss or damage to the leased asset, and liability to passengers and third parties pursuant to industry standard insurance policies and require lessees to provide insurance certificates documenting the policy periods and coverage amounts. The Company tracks receipt of the certificates and calendars their expiration dates. Prior to the expiration of an insurance certificate, if a replacement certificate has not been received, the Company reminds the lessee of its obligation to provide current insurance certificates to avoid a default under the lease.

Despite these requirements and procedures, there may be certain cases where the loss is not entirely covered by the lessee or its insurance. The possibility of such an event is remote, but any such uninsured loss with respect to the equipment or insured loss for which insurance proceeds are inadequate might result in a loss of invested capital in and any profits anticipated from, such equipment, as well as a potential claim directly against the Company.

*Compliance with Future Environmental Regulations.* Compliance with future environmental regulations may harm the Company's business. Many aspects of aircraft operations are subject to increasingly stringent environmental regulations, and growing concerns about climate change may result in the imposition by the U.S and foreign governments of additional regulation of carbon emissions, aimed at either requiring adoption of technology to reduce the amount of carbon emissions or putting in place a fee or tax system on carbon emitters. It is likely that any such regulation will be directed at the Company's customers, as operators of aircraft, or at the Company, as owners of aircraft. Under the Company's triple-net lease arrangements, the Company would likely shift responsibility for compliance to its lessees, but there might be some costs of regulation that the Company could not shift and would itself have to bear. Although it is not expected that the costs of complying with current environmental regulations will have a material adverse effect on the Company's financial position, results of operations, or cash flows, no assurance can be given that the costs of complying with environmental regulations adopted in the future will not have such an effect.

*Cyber-Security Risks.* The Company believes that it has sufficient cyber-security measures in place commensurate with the risks to the Company of a successful cyber-attack or breach of security. The Company's main vulnerability to a cyber-attack would be interruption of the Company's email communications internally and with third parties, and loss of document sharing between the Company's offices and remote workers. Such an attack could temporarily impede the efficiency of the Company's operations; however, the Company believes that sufficient replacement mechanisms exist in the event of such an interruption that there would not be a material adverse financial impact on the Company's business.

*Warrants.* As part of a subordinated debt financing, which was fully repaid in December of 2011, the Company issued warrants to purchase up to 81,224 shares of the Company's common stock that are currently exercisable (and expire on December 31, 2015) and represent approximately 5% of the post-exercise fully diluted capitalization of the Company. The exercise price of the warrants is \$8.75 per share. If the warrants to purchase shares are exercised at a time when the exercise price is less than the market price of the Company's common stock, there will be dilution to the existing holders of common stock. This dilution of the Company's common stock could depress its trading price.

*Possible Volatility of Stock Price.* The market price of the Company's common stock may be subject to fluctuations following developments relating 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, or arising from other investor

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### Item 3. Quantitative and Qualitative Disclosures About Market Risk.

This report does not include information described under Item 305 of Regulation S-K pursuant to the rules of the Securities and Exchange Commission that permit "smaller reporting companies" to omit such information.

### Item 4. Controls and Procedures.

**CEO and CFO Certifications.** Attached as exhibits to this Quarterly Report on Form 10-Q (the "Report") are certifications of the Company's Chief Executive Officer (the "CEO") and the Company's Chief Financial Officer (the "CFO"), which are required pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (the "Section 302 Certifications"). This section of the Report includes information concerning the evaluation of disclosure controls and procedures referred to in the Section 302 Certifications and this should be read in conjunction with the Section 302 Certifications for a more complete understanding of the topics presented.

**Evaluation of the Company's Disclosure Controls and Procedures.** Disclosure controls and procedures ("Disclosure Controls") are controls and other procedures that are designed to ensure that information required to be disclosed in the Company's reports filed under the Securities Exchange Act of 1934, such as this Report, is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission and 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.

The Company's management, with the participation of the CEO and CFO, evaluated the effectiveness of the design and operation of the Company's Disclosure Controls and concluded that the Company's Disclosure Controls were effective as of June 30, 2014.

**Changes in Internal Control Over Financial Reporting.** No change in the Company's internal control over financial reporting occurred during the fiscal quarter ended June 30, 2014 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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## PART II OTHER INFORMATION

### Item 6. Exhibits

Exhibit Number	Description
10.19	Form of Second Amended and Restated Credit Agreement, dated May 30, 2014, between the Company and Union Bank, N.A., California Bank and Trust, U.S. Bank National Association, Umpqua Bank, First Bank, and Cathay Bank (portions of this exhibit have been omitted pursuant to a request for confidential treatment).
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.
101.INS	XBRL Instance Document
101.SCH	XBRL Schema Document
101.CAL	XBRL Calculation Linkbase Document
101.LAB	XBRL Label Linkbase Document
101.PRE	XBRL Presentation Linkbase Document
101.DEF	XBRL Definition Linkbase Document

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

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Date: August 13, 2014

AEROCENTURY CORP.

By: /s/ Toni M. Perazzo

Name: Toni M. Perazzo

Title: Senior Vice President-Finance and  
Chief Financial Officer

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