

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the Quarterly Period Ended August 31, 2014

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File No. 1-6263

**AAR CORP.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**36-2334820**

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

**One AAR Place, 1100 N. Wood Dale Road  
Wood Dale, Illinois**

(Address of principal executive offices)

**60191**

(Zip Code)

**(630) 227-2000**

(Registrant's telephone number, including area code)

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 during the preceding 12 months (or for such shorter period that the registrant was required to 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.

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

As of August 31, 2014, there were 39,877,641 shares of the registrant's Common Stock, \$1.00 par value per share, outstanding.

**Part I – FINANCIAL INFORMATION**

**Item 1.**

**[Financial Statements](#)**

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AAR CORP. and Subsidiaries  
Condensed Consolidated Balance Sheets  
As of August 31, 2014 and May 31, 2014  
(In millions, except share data)

**ASSETS**

	<u>August 31, 2014</u> (Unaudited)	<u>May 31, 2014</u>
Current assets:		
Cash and cash equivalents	\$ 81.8	\$ 89.2
Accounts receivable, less allowances of \$6.0 and \$6.2, respectively	294.9	283.1
Inventories	532.0	495.3
Rotable spares and equipment on or available for short-term lease	137.3	137.6
Deposits, prepaids and other	79.3	81.6
Deferred tax assets	30.6	30.1
Total current assets	<u>1,155.9</u>	<u>1,116.9</u>
Property, plant and equipment, net of accumulated depreciation of \$420.6 and \$424.3, respectively	<u>287.9</u>	<u>314.9</u>
Other assets:		
Goodwill	258.0	261.7
Intangible assets, net of accumulated amortization of \$38.4 and \$36.2, respectively	159.7	165.4
Equipment on or available for long-term lease	102.6	98.4
Capitalized program development costs	111.4	112.2
Investment in joint ventures	29.8	29.9
Other	100.1	100.1
	<u>761.6</u>	<u>767.7</u>
	<u>\$ 2,205.4</u>	<u>\$ 2,199.5</u>

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

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AAR CORP. and Subsidiaries  
Condensed Consolidated Balance Sheets  
As of August 31, 2014 and May 31, 2014  
(In millions, except share data)

**LIABILITIES AND EQUITY**

	<u>August 31, 2014</u> (Unaudited)	<u>May 31, 2014</u>
Current liabilities:		
Current maturities of long-term debt	\$ 78.5	\$ 69.7
Accounts and trade notes payable	196.6	171.1
Accrued liabilities	141.2	161.3

Total current liabilities	416.3	402.1
Long-term debt, less current maturities	548.6	564.3
Deferred tax liabilities	163.0	162.2
Other liabilities and deferred income	73.0	70.2
	<u>784.6</u>	<u>796.7</u>
Equity:		
Preferred stock, \$1.00 par value, authorized 250,000 shares; none issued	—	—
Common stock, \$1.00 par value, authorized 100,000,000 shares; issued 44,993,858 and 44,674,186 shares at cost, respectively	45.0	44.7
Capital surplus	438.3	436.4
Retained earnings	657.4	646.0
Treasury stock, 5,116,217 and 5,113,939 shares at cost, respectively	(99.0)	(98.3)
Accumulated other comprehensive loss	(37.9)	(29.3)
Total AAR stockholders' equity	1,003.8	999.5
Noncontrolling interest	0.7	1.2
Total equity	<u>1,004.5</u>	<u>1,000.7</u>
	<u>\$ 2,205.4</u>	<u>\$ 2,199.5</u>

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

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AAR CORP. and Subsidiaries  
Condensed Consolidated Statements of Income  
For the Three Months Ended August 31, 2014 and 2013  
(Unaudited)  
(In millions)

	Three Months Ended August 31,	
	2014	2013
Sales:		
Sales from products	\$ 294.7	\$ 305.5
Sales from services	174.5	209.0
	<u>469.2</u>	<u>514.5</u>
Cost and operating expenses:		
Cost of products	255.1	269.0
Cost of services	138.8	160.8
Selling, general and administrative	44.9	47.7
	<u>438.8</u>	<u>477.5</u>
Earnings from joint ventures	0.6	1.2
Operating income	31.0	38.2
Interest expense	(9.6)	(11.0)
Interest income	0.1	0.3
Income before provision for income taxes	21.5	27.5
Provision for income taxes	7.0	9.5
Net income attributable to AAR and noncontrolling interest	14.5	18.0
Income attributable to noncontrolling interest	(0.1)	(0.1)
Net income attributable to AAR	<u>\$ 14.4</u>	<u>\$ 17.9</u>
Earnings per share — basic	\$ 0.36	\$ 0.45
Earnings per share — diluted	\$ 0.36	\$ 0.45

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

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AAR CORP. and Subsidiaries  
Condensed Consolidated Statements of Comprehensive Income  
For the Three Months Ended August 31, 2014 and 2013  
(Unaudited)  
(In millions)

Three Months Ended August 31,	
2014	2013

Net income attributable to AAR and noncontrolling interest	\$	14.5	\$	18.0
Other comprehensive income (loss), net of tax expense (benefit):				
Currency translation adjustments, net of tax of (\$0.4) and \$0.2		(9.0)		2.8
Unrealized gain on derivative instruments:				
Unrealized gain arising during period, net of tax of \$0.2 and \$0.4		0.3		0.9
Pension and other post-retirement plans:				
Amortization of actuarial loss and prior service cost included in net income, net of tax of \$0.1 and \$0.2		0.1		0.2
Other comprehensive (loss) income, net of tax		(8.6)		3.9
Comprehensive income, net of tax		5.9		21.9
Comprehensive income related to noncontrolling interest		(0.1)		(0.1)
Comprehensive income attributable to AAR	\$	5.8	\$	21.8

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

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AAR CORP. and Subsidiaries  
Condensed Consolidated Statements of Cash Flows  
For the Three Months Ended August 31, 2014 and 2013  
(Unaudited)  
(In millions)

	Three Months Ended August 31,		
	2014	2013	
Cash flows provided from operating activities:			
Net income attributable to AAR and noncontrolling interest	\$	14.5	
Adjustments to reconcile net income attributable to AAR and noncontrolling interest to net cash provided from operating activities:			
Depreciation and amortization	17.1	19.3	
Amortization of stock-based compensation	2.0	1.6	
Amortization of debt discount	0.7	1.5	
Amortization of overhaul costs	6.2	8.7	
Deferred tax provision	0.8	4.1	
Earnings from joint ventures	(0.6)	(1.2)	
Changes in certain assets and liabilities:			
Accounts receivable	(13.4)	12.0	
Inventories	(15.1)	(15.3)	
Rotable spares and equipment on or available for short-term lease	0.2	6.6	
Equipment on or available for long-term lease	(7.0)	(1.9)	
Accounts and trade notes payable	26.2	(1.4)	
Accrued and other liabilities	(18.1)	(29.0)	
Other, primarily program and overhaul costs	1.5	4.5	
Net cash provided from operating activities	15.0	27.5	
Cash flows from investing activities:			
Property, plant and equipment expenditures	(9.0)	(7.2)	
Other	(1.1)	(0.1)	
Net cash used in investing activities	(10.1)	(7.3)	
Cash flows from financing activities:			
Reduction in borrowings	(7.3)	(7.7)	
Reduction in capital lease obligations	(1.5)	—	
Cash dividends	(3.6)	(3.0)	
Purchase of treasury stock	—	—	
Stock option exercises	0.2	5.2	
Tax benefits from exercise of stock options	0.6	0.8	
Net cash used in financing activities	(11.6)	(4.7)	
Effect of exchange rate changes on cash	(0.7)	0.1	
(Decrease) Increase in cash and cash equivalents	(7.4)	15.6	
Cash and cash equivalents, beginning of period	89.2	75.3	
Cash and cash equivalents, end of period	\$	81.8	
		\$	90.9

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

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AAR CORP. and Subsidiaries  
Condensed Consolidated Statements of Changes in Equity  
For the Three Months Ended August 31, 2014  
(Unaudited)  
(In millions)

	Common Stock	Capital Surplus	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total AAR Stockholders' Equity	Noncontrolling Interest	Total Equity
Balance, May 31, 2014	\$ 44.7	\$ 436.4	\$ 646.0	\$ (98.3)	\$ (29.3)	\$ 999.5	\$ 1.2	\$ 1,000.7
Net income	—	—	14.4	—	—	14.4	0.1	14.5
Cash dividends	—	—	(3.0)	—	—	(3.0)	(0.6)	(3.6)
Stock option activity	—	0.6	—	0.2	—	0.8	—	0.8
Restricted stock activity	0.3	1.3	—	(0.9)	—	0.7	—	0.7
Other comprehensive loss, net of tax	—	—	—	—	(8.6)	(8.6)	—	(8.6)
Balance, August 31, 2014	<u>\$ 45.0</u>	<u>\$ 438.3</u>	<u>\$ 657.4</u>	<u>\$ (99.0)</u>	<u>\$ (37.9)</u>	<u>\$ 1,003.8</u>	<u>\$ 0.7</u>	<u>\$ 1,004.5</u>

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these statements.

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AAR CORP. and Subsidiaries  
Notes to Condensed Consolidated Financial Statements  
August 31, 2014  
(Unaudited)  
(Dollars in millions, except per share amounts)

**Note 1 — Basis of Presentation**

AAR CORP. and its subsidiaries are referred to herein collectively as “AAR,” “Company,” “we,” “us,” and “our,” unless the context indicates otherwise. The accompanying Condensed Consolidated Financial Statements include the accounts of AAR and its subsidiaries after elimination of intercompany accounts and transactions.

We have prepared these statements without audit, pursuant to the rules and regulations of the United States Securities and Exchange Commission (“SEC”). The Condensed Consolidated Balance Sheet as of May 31, 2014 has been derived from audited financial statements. To prepare the financial statements in conformity with U.S. generally accepted accounting principles (“GAAP”), management has made a number of estimates and assumptions relating to the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities. Actual results could differ from those estimates. Certain information and note disclosures, normally included in comprehensive financial statements prepared in accordance with GAAP, have been condensed or omitted pursuant to such rules and regulations of the SEC. These Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and notes thereto included in our latest annual report on Form 10-K.

In the opinion of management, the condensed consolidated financial statements reflect all adjustments (which consist only of normal recurring adjustments) necessary to present fairly the condensed consolidated financial position of AAR CORP. and its subsidiaries as of August 31, 2014, the Condensed Consolidated Statements of Income and the Condensed Consolidated Statements of Comprehensive Income for the three-month periods ended August 31, 2014 and 2013, the Condensed Consolidated Statements of Cash Flows for the three-month periods ended August 31, 2014 and 2013, and the Condensed Consolidated Statement of Changes in Equity for the three-month period ended August 31, 2014. The results of operations for such interim periods are not necessarily indicative of the results for the full year.

**Note 2 — Revenue Recognition**

Sales and related cost of sales for product sales are recognized upon shipment of the product to the customer. Our standard terms and conditions provide that title passes to the customer when the product is shipped to the customer. Sales of certain defense products are recognized upon customer acceptance, which includes transfer of title. Under the majority of our expeditionary airlift services contracts, we are paid and record as revenue a fixed daily amount per aircraft for each day an aircraft is available to perform airlift services. In addition, we are paid and record as revenue an amount which is based on number of hours flown. Sales from services and the related cost of services are generally recognized when customer-owned material is shipped back to the customer. We have adopted this accounting policy because at the time the customer-owned material is shipped back to the customer, all services related to that material are complete as our service agreements generally do not require us to provide services at customer sites. Furthermore, serviced units are typically shipped to the customer immediately upon completion of the related services. Sales and related cost of sales for certain long-term manufacturing contracts, certain large airframe maintenance contracts, and performance-based logistics programs are recognized by the percentage of completion method, either based on the relationship of costs incurred to date to the estimated total costs or the units of delivery method. Lease revenues are recognized as earned. Income from monthly or quarterly rental payments is recorded in the pertinent period according to the lease agreement. However, for leases that provide variable rents, we recognize lease income on a straight-line basis. In addition to a monthly lease rate, some engine leases require an additional rental amount based on the number of hours the engine is used in a particular month. Lease income associated with these contingent rentals is recorded in the period in which actual usage is reported to us by the lessee, which is normally the month following the actual usage.

Certain supply chain management programs we provide to our customers contain multiple elements or deliverables, such as program and warehouse management, parts distribution, and maintenance and repair services. We recognize revenue for each element or deliverable that can be identified as a separate unit of accounting at the time of delivery based upon the relative fair value of the products and services.

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(Unaudited)  
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Included in accounts receivable as of August 31, 2014 and May 31, 2014, are \$19.1 million and \$19.7 million, respectively, of unbilled accounts receivable related to the KC10 supply agreement. These unbilled accounts receivable relate to costs we have incurred on parts that were requested and accepted by our customer to support the program. These costs have not been billed by us because the customer has not issued the final paperwork necessary to allow for billing.

In addition to the unbilled accounts receivable, included in *Other* non-current assets on the Condensed Consolidated Balance Sheet as of August 31, 2014 and May 31, 2014, are \$8.6 million and \$9.9 million, respectively, of costs in excess of amounts billed for the flight-hour portion of the same KC10 supply agreement. These amounts represent the difference between the amount of revenue recognized by us driven by costs incurred under the flight hour portion of the program, compared to what was billed.

*New Accounting Pronouncements*

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update (“ASU”) No. 2014-09, *Revenue from Contracts with Customers*, which provides guidance for revenue recognition. This ASU affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of non-financial assets. This ASU will supersede the revenue recognition requirements in ASC 605, Revenue Recognition, and most industry-specific guidance. This ASU also supersedes certain cost guidance included in Subtopic 605-35, Revenue Recognition-Construction-Type and Production-Type Contracts. This new standard will be effective for us beginning June 1, 2017. We are currently evaluating the impact of the adoption of this new standard on our consolidated financial statements.

**Note 3 — Accounting for Stock-Based Compensation**

*Restricted Stock*

In July 2014, as part of our annual long-term stock incentive compensation, we granted 192,250 shares of performance-based restricted stock and 95,956 shares of time-based restricted stock to eligible employees. The grant date fair value per share for both grants was \$26.08. In June 2014, we also granted 45,000 shares of time-based restricted stock to members of the Board of Directors with a grant date fair value per share of \$24.50. Expense charged to operations for restricted stock during the three-month periods ended August 31, 2014 and 2013 was \$1.3 million and \$1.1 million, respectively.

*Stock Options*

The total intrinsic value of stock options exercised during the three-month periods ended August 31, 2014 and 2013 was \$1.0 million and \$2.6 million, respectively. Expense charged to operations for stock options during the three-month periods ended August 31, 2014 and 2013 was \$0.7 million and \$0.5 million, respectively. No stock options were granted during the three-month period ended August 31, 2014.

**Note 4 — Inventory**

The summary of inventories is as follows:

	August 31, 2014	May 31, 2014
Raw materials and parts	\$ 100.5	\$ 114.1
Work-in-process	51.9	57.5
Aircraft and engine parts, components and finished goods	329.8	297.3
Aircraft held for sale and related support parts	49.8	26.4
	<u>\$ 532.0</u>	<u>\$ 495.3</u>

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We classify certain aircraft from our expeditionary airlift business as assets held for sale at the time management commits to a plan to sell the aircraft, changes to the planned sale are not likely, the aircraft are actively marketed and available for immediate sale, and the sale is expected to be completed within one year. Upon designation of an aircraft as held for sale, we record the aircraft’s value at the lower of its carrying value or its estimated fair value, less estimated costs to sell. Assets held for sale are not depreciated.

Aircraft may be classified as assets held for sale for more than one year as we continue to actively market the aircraft at reasonable prices. Certain aircraft types we currently have available for sale are specifically designed for particular functions which limits the marketability of those assets. At August 31, 2014, we had fifteen aircraft held for sale comprised of eight rotary-wing and seven fixed-wing aircraft. At May 31, 2014, we had nine aircraft held for sale comprised of five fixed-wing and four rotary-wing aircraft.

**Note 5 — Supplemental Cash Flow Information**

	2014	2013
Interest paid	\$ 13.9	\$ 14.0
Income taxes paid	2.6	2.5
Income tax refunds received	1.3	6.5

## Note 6 — Financing Arrangements

A summary of the carrying amount of our debt is as follows:

	August 31, 2014	May 31, 2014
Revolving credit facility expiring April 24, 2018 with interest payable monthly	\$ 130.0	\$ 130.0
Secured credit facility (secured by aircraft and related engines and components) due April 23, 2015 with floating interest rate, payable monthly	27.6	29.9
Note payable due March 9, 2017 with floating interest rate, payable semi-annually on June 1 and December 1	25.0	30.0
Notes payable due January 15, 2022 with interest at 7.25% payable semi-annually on January 15 and July 15	332.4	332.6
Convertible notes payable due March 1, 2016 with interest at 2.25% payable semi-annually on March 1 and September 1	46.2	45.7
Other(1)	65.9	65.8
<b>Total debt</b>	<b>627.1</b>	<b>634.0</b>
Current maturities of debt	(78.5)	(69.7)
<b>Long-term debt</b>	<b>\$ 548.6</b>	<b>\$ 564.3</b>

(1) Included in Other is a mortgage loan (secured by Wood Dale, Illinois facility) due August 1, 2015 of \$11.0 million and \$11.0 million, 1.75% convertible notes due February 1, 2015 of \$29.9 and \$29.8 million, and an industrial revenue bond (secured by property, plant, and equipment) due August 1, 2018 of \$25.0 million and \$25.0 million at August 31, 2014 and May 31, 2014, respectively.

We have exercised our right to redeem all of the currently outstanding 1.75% convertible notes due February 1, 2015 at a redemption price of 103.358% of the principal amount plus accrued and unpaid interest to, but not including, the redemption date of October 1, 2014.

At August 31, 2014, the carrying value of our 7.25% bonds, 1.75% convertible notes and 2.25% convertible notes was \$408.5 million and the estimated fair value was approximately \$435.4 million. These debt issuances are classified as Level 2 in the fair value hierarchy. This classification is defined as a fair value determined using market-based inputs other than quoted prices that are observable for the liability, either directly or indirectly.

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At August 31, 2014, the remaining variable rate and fixed rate debt had a fair value that approximates the carrying value of \$218.6 million. These debt instruments are classified as Level 3 in the fair value hierarchy which is defined as a fair value determined based upon one or more significant unobservable inputs.

We are subject to a number of covenants under our financing arrangements, including restrictions that relate to the payment of cash dividends, maintenance of minimum net working capital and tangible net worth levels, fixed charge coverage ratio, sales of assets, additional financing, purchase of our shares and other matters. We are in compliance with all financial and other covenants under our financing arrangements.

### Convertible Notes

As of August 31, 2014 and May 31, 2014, the long-term debt and equity component (recorded in capital surplus, net of income tax benefit) consisted of the following:

	August 31, 2014	May 31, 2014
<b>Long-term debt:</b>		
Principal amount	\$ 79.8	\$ 79.8
Unamortized discount	(3.7)	(4.4)
Net carrying amount	\$ 76.1	\$ 75.4
Equity component, net of tax	\$ 75.3	\$ 75.3

The discount on the liability component of long-term debt is being amortized using the effective interest method based on an effective rate of 5.00% for our 1.75% convertible notes and 7.41% for our 2.25% convertible notes.

As of August 31, 2014 and 2013, for each of our convertible note issuances, the “if converted” value does not exceed its principal amount.

The interest expense associated with the convertible notes was as follows:

	August 31,	
	2014	2013
Coupon interest	\$ 0.5	\$ 0.8
Amortization of deferred financing fees	0.1	0.1
Amortization of discount	0.7	1.4
Interest expense related to convertible notes	<u>\$ 1.3</u>	<u>\$ 2.3</u>

## Note 7 — Derivative Instruments and Hedging Activities

We are exposed to interest rate risk associated with fluctuations in interest rates on our variable rate debt. We utilize two derivative financial instruments to manage our variable interest rate exposure over a medium- to long-term period. We have a floating-to-fixed interest rate swap and an interest rate cap agreement, each hedging \$50.0 million of notional principal interest under our revolving credit facility.

We do not hold or issue derivative instruments for trading purposes and are not a party to any instruments with leverage or prepayment features. In connection with derivative financial instruments, there exists the risk of the possible inability of counterparties to meet the terms of their contracts. We mitigate this risk by performing financial reviews before the contract is entered into, as well as on-going periodic evaluations. We do not expect any significant losses from counterparty defaults.

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We classify the derivatives as assets or liabilities on the balance sheet. Accounting for the change in fair value of the derivatives is a function of whether the instrument qualifies for, and has been designated as, a hedging relationship, and the type of hedging relationship. As of August 31, 2014, all of our derivative instruments were classified as cash flow hedges. The fair value of the interest rate swap and interest rate cap agreements represents the difference in the present values of cash flows calculated at the contracted interest rates and at current market interest rates at the end of the reporting period.

We record the fair value of assets and liabilities in accordance with the hierarchy established by ASC 820, *Fair Value Measurement*. The fair value of our interest rate derivatives are classified as Level 2, which refers to fair values estimated using significant other observable inputs including quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active. The following table summarizes the classification and fair values of our interest rate derivative instruments reported in the Condensed Consolidated Balance Sheets at August 31, 2014 and May 31, 2014.

Derivatives designated as hedging instruments	Balance Sheet Classification	August 31, 2014	May 31, 2014
Interest rate cap	Long-term assets	\$ 0.1	\$ 0.1
Interest rate swap	Long-term liabilities	(2.4)	(2.8)

We include gains and losses on the derivative instruments in other comprehensive income. We recognize the gains and losses on our derivative instruments as an adjustment to interest expense in the period the hedged interest payment affects earnings. The impact of the interest rate swap and interest cap agreement on the Condensed Consolidated Statement of Comprehensive Income for the three-month periods ended August 31, 2014 and 2013 was unrealized gains of \$0.3 million and \$0.9 million, respectively. We expect minimal gain or loss to be reclassified into earnings within the next 12 months.

## Note 8 — Earnings per Share

The computation of basic earnings per share is based on the weighted average number of common shares outstanding during each period. The computation of diluted earnings per share is based on the weighted average number of common shares outstanding during the period plus, when their effect is dilutive, incremental shares consisting of shares subject to stock options, shares issuable upon vesting of restricted stock awards, and shares to be issued upon conversion of convertible debt.

We used the “if-converted” method in calculating the diluted earnings per share effect of the assumed conversion of our contingently convertible debt issued in fiscal 2006 because the principal for that issuance can be settled in stock, cash, or a combination thereof. Under the “if converted” method, the after-tax effect of interest expense related to the convertible securities is added back to net income, and the convertible debt is assumed to have been converted into common shares at the beginning of the period.

In accordance with ASC 260-10-45, *Share-Based Payment Arrangements and Participating Securities and the Two-Class Method*, our unvested restricted stock awards are deemed participating securities since these shares are entitled to participate in dividends declared on common shares. During periods of net income, the calculation of earnings per share for common stock excludes income attributable to unvested restricted stock awards from the numerator and excludes the dilutive impact of those shares from the denominator. During periods of net loss, no effect is given to the participating securities because they do not share in the losses of the Company.

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AAR CORP. and Subsidiaries  
Notes to Condensed Consolidated Financial Statements  
August 31, 2014



The following table provides a reconciliation of the computations of basic and diluted earnings per share information for the three-month periods ended August 31, 2014 and 2013.

	Three Months Ended August 31,	
	2014	2013
<b>Basic EPS:</b>		
Net income attributable to AAR and noncontrolling interest	\$ 14.5	\$ 18.0
Less income attributable to participating shares	(0.3)	(0.4)
Less income attributable to noncontrolling interest	(0.1)	(0.1)
Net income attributable to AAR available to common shareholders	<u>\$ 14.1</u>	<u>\$ 17.5</u>
<b>Basic shares:</b>		
Weighted average common shares outstanding	<u>38.8</u>	<u>38.6</u>
Earnings per share — basic	<u>\$ 0.36</u>	<u>\$ 0.45</u>
<b>Diluted EPS:</b>		
Net income attributable to AAR and noncontrolling interest	\$ 14.5	\$ 18.0
Less income attributable to participating shares	(0.3)	(0.4)
Less income attributable to noncontrolling interest	(0.1)	(0.1)
Net income attributable to AAR available to common shareholders	<u>\$ 14.1</u>	<u>\$ 17.5</u>
<b>Diluted shares:</b>		
Weighted average common shares outstanding	38.8	38.6
Additional shares from the assumed exercise of stock options	0.4	0.4
Weighted average common shares outstanding — diluted	<u>39.2</u>	<u>39.0</u>
Earnings per share — diluted	<u>\$ 0.36</u>	<u>\$ 0.45</u>

At August 31, 2014 and 2013, respectively, stock options to purchase 180,163 shares and 1,211,672 shares of common stock were outstanding, but were not included in the computation of diluted earnings per share because the exercise price of each of these options was greater than the average market price of the common shares during the interim periods then ended.

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**Note 9 — Accumulated Other Comprehensive Loss**

Changes in our accumulated other comprehensive loss (“AOCL”) by component for the three-month periods ended August 31, 2014 and 2013 were as follows:

	Currency Translation Adjustments	Pensions Plans	Derivative Instruments	Total
Balance at June 1, 2014	\$ 8.7	\$ (35.4)	\$ (2.6)	\$ (29.3)
Other comprehensive income (loss) before reclassifications	(9.0)	—	0.3	(8.7)
Amounts reclassified from AOCL	—	0.1	—	0.1
Total other comprehensive income (loss)	(9.0)	0.1	0.3	(8.6)
Balance at August 31, 2014	<u>\$ (0.3)</u>	<u>\$ (35.3)</u>	<u>\$ (2.3)</u>	<u>\$ (37.9)</u>
Balance at June 1, 2013	\$ (5.4)	\$ (33.8)	\$ (3.3)	\$ (42.5)
Other comprehensive income before reclassifications	2.8	—	0.9	3.7
Amounts reclassified from AOCL	—	0.2	—	0.2
Total other comprehensive income	2.8	0.2	0.9	3.9
Balance at August 31, 2013	<u>\$ (2.6)</u>	<u>\$ (33.6)</u>	<u>\$ (2.4)</u>	<u>\$ (38.6)</u>

**Note 10 — Program Development Costs**

Our Cargo Systems unit was selected in June 2005 to provide cargo loading systems for the Airbus A400M Military Transport Aircraft (“A400M”). During fiscal 2013, we delivered initial production units to Airbus and began delivering revenue-producing units in fiscal 2014. As of August 31, 2014 and May 31, 2014, we have capitalized, net of reimbursements, \$141.2 million and \$139.8 million, respectively, of costs associated with the engineering and development of the cargo system. Capitalized costs are classified between current and non-current assets on the Condensed Consolidated Balance Sheets. Current assets include \$29.8 million and \$27.6 million in *Deposits, prepaids and other* at August 31, 2014 and May 31, 2014, respectively, and non-current assets include \$111.4 million and \$112.2 million in *Capitalized program development costs* at August 31, 2014 and May 31, 2014, respectively. Sales and

related cost of sales are recognized on the units of delivery method. In determining the recoverability of the capitalized program development costs, we have made certain judgments and estimates concerning expected revenues and the cost to manufacture the A400M cargo system. Differences between actual results and our assumptions may result in our not fully recovering our program development costs, which could adversely affect our operating results and financial condition.

## Note 11 — Business Segment Information

Consistent with how our chief operating decision making officer (Chief Executive Officer) evaluates performance and the way we are organized internally, we report our activities in two business segments: Aviation Services and Technology Products.

Sales in the Aviation Services segment are derived from the sale and lease of a wide variety of new, overhauled and repaired engine and airframe parts and components to the commercial aviation and government and defense markets. We provide customized inventory supply chain management, performance based logistics programs, aircraft component repair management services, and aircraft modifications. The segment also includes

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repair, maintenance and overhaul of aircraft and landing gear and expeditionary airlift services. Cost of sales consists principally of the cost of product, direct labor, overhead, and aircraft maintenance costs.

Sales in the Technology Products segment are derived from the manufacture of heavy-duty pallets and lightweight cargo containers for the commercial market, in-plane cargo loading and handling systems for commercial and military applications, and steel and composite machined and fabricated parts, components and sub-systems for various aerospace and defense programs. The segment also engineers, designs and manufactures containers, pallets and shelters used to support the U.S. military's requirements for a mobile and agile force and provides system integration services for specialized command and control systems. Cost of sales consists principally of the cost of material to manufacture products, direct labor and overhead.

The accounting policies for the segments are the same as those described in Note 1 of Notes to Consolidated Financial Statements included in our annual report on Form 10-K for the year ended May 31, 2014. Our Chief Executive Officer evaluates performance based on the reportable segments and utilizes gross profit as a primary profitability measure. The assets and certain expenses related to corporate activities are not allocated to the segments. Our reportable segments are aligned principally around differences in products and services.

Gross profit is calculated by subtracting cost of sales from sales. Selected financial information for each segment is as follows:

	Three Months Ended August 31,	
	2014	2013
<b>Net sales:</b>		
Aviation Services	\$ 363.7	\$ 393.7
Technology Products	105.5	120.8
	<u>\$ 469.2</u>	<u>\$ 514.5</u>
<b>Gross profit:</b>		
Aviation Services	\$ 59.1	\$ 65.5
Technology Products	16.2	19.2
	<u>\$ 75.3</u>	<u>\$ 84.7</u>

The following table reconciles segment gross profit to consolidated income before provision for income taxes.

	Three Months Ended August 31,	
	2014	2013
Segment gross profit	\$ 75.3	\$ 84.7
Selling, general and administrative	(44.9)	(47.7)
Earnings from joint ventures	0.6	1.2
Interest expense	(9.6)	(11.0)
Interest income	0.1	0.3
Income before provision for income taxes	<u>\$ 21.5</u>	<u>\$ 27.5</u>

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## Item 2 — Management's Discussion and Analysis of Financial Condition and Results of Operations (Dollars in millions)

## General Overview

We report our activities in two business segments: Aviation Services and Technology Products.

The Aviation Services segment provides aftermarket support and services and includes the sale and lease of a wide variety of new, overhauled and repaired engine and airframe parts and components to the commercial aviation and government and defense markets. We provide customized inventory supply chain management, performance based logistics programs, aircraft component repair management services, and aircraft modifications. The segment also includes repair, maintenance and overhaul of aircraft and landing gear and expeditionary airlift services. Cost of sales consists principally of the cost of product, direct labor, overhead, and aircraft maintenance costs.

Sales in the Technology Products segment are derived from the manufacture of heavy-duty pallets and lightweight cargo containers for the commercial market, in-plane cargo loading and handling systems for commercial and military applications, and steel and composite machined and fabricated parts, components and sub-systems for various aerospace and defense programs. The segment also engineers, designs and manufactures containers, pallets and shelters used to support the U.S. military's requirements for a mobile and agile force and provides system integration services for specialized command and control systems. Cost of sales consists principally of the cost of material to manufacture products, direct labor and overhead.

The accounting policies for the segments are the same as those described in Note 1 of Notes to Consolidated Financial Statements included in our annual report on Form 10-K for the year ended May 31, 2014. Our chief operating decision making officer (Chief Executive Officer) evaluates performance based on the reportable segments and utilizes gross profit as a primary profitability measure. Gross profit is calculated by subtracting costs of sales from sales. The assets and certain expenses related to corporate activities are not allocated to the segments. Our reportable segments are aligned principally around differences in products and services.

Consolidated sales for the first quarter ended August 31, 2014 decreased \$45.3 million or 8.8% compared to the prior year period. During the first quarter, sales to commercial customers increased \$7.2 million or 2.4% compared to the prior year's quarter. The increase in sales to commercial customers was driven primarily by higher supply chain volumes partially offset by a significant engineering services program that ended in the second quarter of fiscal 2014 and lower sales of commercial cargo products.

During the first quarter, sales to government and defense customers decreased \$52.5 million or 24.1% compared to the prior year's quarter. The decline in sales to government and defense customers was driven primarily by lower demand by the U.S. Department of Defense ("DoD") for expeditionary airlift services in Afghanistan and the delivery of an aircraft to a foreign defense customer in the first quarter of fiscal 2014 with no deliveries in the first quarter of fiscal 2015.

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## Results of Operations

### Three-Month Period Ended August 31, 2014

Sales and gross profit for our two business segments for the quarters ended August 31, 2014 and 2013 were as follows:

	Three Months Ended August 31,		
	2014	2013	% Change
<b>Sales:</b>			
Aviation Services			
Commercial	\$ 237.0	\$ 221.4	7.0%
Defense	126.7	172.3	(26.5)%
	<u>\$ 363.7</u>	<u>\$ 393.7</u>	(7.6)%
Technology Products			
Commercial	\$ 66.0	\$ 74.4	(11.3)%
Defense	39.5	46.4	(14.9)%
	<u>\$ 105.5</u>	<u>\$ 120.8</u>	(12.7)%
<b>Gross Profit:</b>			
Aviation Services			
Commercial	\$ 36.7	\$ 35.3	4.0%
Defense	22.4	30.2	(25.8)%
	<u>\$ 59.1</u>	<u>\$ 65.5</u>	(9.8)%
Technology Products			
Commercial	\$ 14.2	\$ 14.8	(4.1)%
Defense	2.0	4.4	(54.5)%
	<u>\$ 16.2</u>	<u>\$ 19.2</u>	(15.6)%

### Aviation Services Segment

Sales in the Aviation Services segment decreased \$30.0 million or 7.6% from the prior year. The decrease in sales was due to a \$45.6 million or 26.5% decrease in sales to government and defense customers primarily attributable to lower demand for expeditionary airlift services in Afghanistan due to a reduced number of aircraft positions, and the delivery of an aircraft to a foreign defense customer in the first quarter of fiscal 2014 with no deliveries in the first quarter of fiscal 2015. The decrease was partially offset by increased by higher supply chain volumes.

Sales in this segment to commercial customers increased \$15.6 million or 7.0% over the prior year primarily due to higher supply chain volumes due principally to new contract wins announced in the second half of fiscal 2014 and higher demand for aftermarket parts support. These increases were partially

offset by a significant engineering services program that ended in the second quarter of fiscal 2014.

Our reduced role in Afghanistan has had an impact on our expeditionary fleet operations. The following summarizes the status of various contracts and new business wins at our expeditionary airlift operation:

- In May 2014, the DoD exercised the final renewal option on our fixed-wing contract valued at approximately \$50 million for airlift support in Afghanistan through May 31, 2015.
- In early November 2013, the DoD exercised a renewal option on our rotary-wing contract valued at approximately \$180 million for airlift support in Afghanistan through October 31, 2014. The DoD has one additional option year remaining after October 31, 2014.
- On December 2, 2013, the Company was awarded a new contract to provide fixed-wing support to the U.S. Africa Command. The contract is valued at \$23 million and includes a base seven-month period plus five three-month renewal options. After months of delay from four protests by the incumbent operator, the initial period of performance began on June 1, 2014.

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- On November 30, 2013, the Company was awarded an Indefinite Delivery Indefinite Quantity (IDIQ) contract to provide fixed- and rotary-wing support for the Afghan National Security Forces under the NATO Training Mission and Combined Security Transition Command. The contract has a maximum value of \$134 million. The Company is waiting to receive task orders under the contract.
- On May 16, 2014, the Company was awarded a new contract valued at \$34 million to provide rotary-wing support to U.S. Africa Command. The incumbent operator filed two protests that were overturned and on September 10, 2014, the Company received a Notice to Proceed and a contract modification of the performance period which will now begin October 24, 2014 and end September 2016.
- On May 23, 2014, the Company was awarded a new contract to provide rotary-wing support to the U.S. Navy through Vertical Replenishment services in the Mediterranean primarily for the 5th Fleet. The contract is valued at \$34 million and includes a base one-year period beginning October 1, 2014 with four one-year options.
- On August 27, 2014, the Company was awarded a new contract to provide fixed- and rotary-wing CASEVAC, MEDEVAC and personnel recovery services to US Africa Command. The contract is valued at \$49 million and includes a base six-month period and two one-year options. Performance on the contract begins on December 1, 2014.

We are also bidding on other expeditionary airlift contracts supporting both DoD and non-DoD customers, although there can be no assurance we will be awarded any of these contracts. At the beginning of fiscal year 2014, we had 40 aircraft in revenue service compared to 19 aircraft in revenue service as of August 31, 2014. We are actively marketing 15 aircraft for sale comprised of 8 rotary-wing and 7 fixed-wing aircraft. Additional aircraft may be available for sale should contracted positions in Afghanistan be further reduced and not replaced with new contract awards.

Gross profit in the Aviation Services segment decreased \$6.4 million or 9.8%. Gross profit on sales to commercial customers increased \$1.4 million or 4.0% over the prior year with the gross profit margin down slightly to 15.5% compared to 15.9% in the prior year. The increase in gross profit on sales to commercial customers is primarily attributable to higher supply chain volumes and higher demand for aftermarket parts support. This increase was partially offset by a slight decline in gross profit margins in our maintenance, repair and overhaul businesses.

Gross profit in this segment on sales to government and defense customers decreased \$7.8 million or 25.8% from the prior year which was in line with the sales decrease as the gross profit margin percentage increased slightly from 17.5% to 17.7%.

*Technology Products Segment*

Sales in the Technology Products segment decreased \$15.3 million or 12.7% from the prior year. The decrease in sales was due to an \$8.4 million or 11.3% decline in sales to our commercial customers primarily attributable to lower demand for our commercial cargo systems and precision-machined parts.

Sales in this segment to government and defense customers decreased \$6.9 million or 14.9% from the prior year. Sales to government and defense customers declined due to lower demand for mobility products from the DoD as they reduced spending for these products.

Gross profit in the Technology Products segment decreased \$3.0 million or 15.6%. Gross profit on sales to commercial customers decreased \$0.6 million or 4.1% from the prior year with the gross profit margin increasing to 21.5% in fiscal 2015 from 19.9% in the prior year.

Gross profit in this segment on sales to government and defense customers decreased \$2.4 million or 54.5% from the prior year with the gross profit margin decreasing to 5.1% in fiscal 2015 from 9.5% in the prior year. The decreased gross profit margin on sales to government and defense customers is primarily attributable to lower sales volumes at our mobility products business and sales of the low-margin A400M system.

*Selling, General and Administrative Expenses and Earnings from Aircraft Joint Ventures*

Selling, general and administrative expenses decreased \$2.8 million in fiscal 2015 reflecting the realization of benefits from the cost control measures implemented by the Company during fiscal 2014, including the elimination of certain positions and favorable procurement actions.

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Earnings from aircraft joint ventures decreased \$0.6 million reflecting lower lease revenue from our joint ventures.

*Operating and Net Income*

Operating income decreased \$7.2 million or 18.8% from the prior year primarily due to lower sales in our Aviation Services and Technology Products segments.

Our effective income tax rate was 32.6% for the three-month period ended August 31, 2014 compared to 34.5% in the prior year. This lower effective tax rate reflects the expected increase in manufacturing incentives in fiscal 2015, which had previously been limited as a result of tax losses and the utilization of tax losses.

Net income was \$14.4 million compared to \$17.9 million in the prior year due to the factors discussed above.

## **Liquidity, Capital Resources and Financial Position**

Our operating activities are funded and commitments met principally through the generation of cash from operations. Periodically, we may raise capital through the issuance of common stock and debt financing in the public and private markets. In addition to these cash sources, our current capital resources include an unsecured credit facility, as well as a separate secured credit facility. We continually evaluate various financing arrangements, including the issuance of common stock or debt, which would allow us to improve our liquidity position and finance future growth on commercially reasonable terms. Our continuing ability to borrow from our lenders and issue debt and equity securities to the public and private markets in the future may be negatively affected by a number of factors, including the overall health of the credit markets, general economic conditions, airline industry conditions, geo-political events, and our operating performance. Our ability to generate cash from operations is influenced primarily by our operating performance and changes in working capital. Under our universal shelf registration statement filed with the Securities and Exchange Commission that became effective May 4, 2012, we registered an indeterminate number of principal amount or shares of common stock, shares of preferred stock, debt securities, warrants, stock purchase contracts and stock purchase units which may be sold from time to time, subject to market conditions.

At August 31, 2014, our liquidity and capital resources included cash of \$81.8 million and working capital of \$739.6 million. We have an agreement with various financial institutions, as lenders, and Bank of America, N.A., as administrative agent for the lenders (as amended, the "Credit Agreement") providing for an unsecured revolving credit facility of \$475.0 million that we can draw upon for general corporate purposes. The Credit Agreement expires on April 24, 2018. Borrowings under the Credit Agreement bear interest at the offered Eurodollar Rate (defined as the British Bankers Association LIBOR Rate) plus 125 to 225 basis points based on certain financial measurements if a Eurodollar Rate loan, or at the offered fluctuating Base Rate plus 25 to 125 basis points based on certain financial measurements if a Base Rate loan. Borrowings outstanding under this facility at August 31, 2014 were \$130.0 million and there were approximately \$14.8 million of outstanding letters of credit, which reduced the availability of this facility to \$330.2 million. There are no other terms or covenants limiting the availability of this facility. We also have \$5.2 million available under a foreign line of credit.

In addition to our unsecured Credit Agreement, we have a \$40.0 million secured term credit facility with The Huntington National Bank (the "Huntington Loan Agreement"). Borrowings under the Huntington Loan Agreement are secured by aircraft and related engines and components owned by us. The Huntington Loan Agreement expires on April 23, 2015. Borrowings bear interest at LIBOR plus 175 basis points. As of August 31, 2014, \$27.6 million was outstanding under this agreement.

We intend to retire maturities due within the next 12 months through a combination of cash on hand and borrowings under our Credit Agreement.

We are in compliance with all financial and other covenants under each of our financing arrangements.

### *Cash Flows from Operating Activities*

During the three-month period ended August 31, 2014, our cash flow from operations was \$15.0 million primarily as a result of net income attributable to AAR and noncontrolling interest, depreciation and amortization,

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and an increase in accounts payable. These positive impacts were partially offset by increases in accounts receivable and inventory as well as a reduction in accrued liabilities.

Cash flow from operations decreased \$12.5 million from the three-month period ended August 31, 2013 due to increased accounts receivable and decreased accrued liabilities partially offset by an increase in accounts payable.

### *Cash Flows from Investing Activities*

During the three-month period ended August 31, 2014, our investing activities used \$10.1 million of cash principally due to property, plant and equipment expenditures.

Cash flows used in investing activities increased \$2.8 million over the three-month period ended August 31, 2013 due to increased spend on property, plant and equipment expenditures in fiscal 2015.

### *Cash Flows from Financing Activities*

During the three-month period ended August 31, 2014, our financing activities used \$11.6 million of cash primarily due to a net reduction in borrowings and payment of dividends.

Cash flows used in financing activities increased \$6.9 million over the three-month period ended August 31, 2013 as the proceeds received from stock option exercises were higher in the prior year.

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

We make a number of significant estimates, assumptions and judgments in the preparation of our financial statements. See *Management's Discussion and Analysis of Financial Condition and Results of Operations* in our 2014 Form 10-K for a discussion of our critical accounting policies. There have been no significant changes to the application of our critical accounting policies during the first quarter for fiscal 2015.

## **Forward-Looking Statements**

This report contains certain forward-looking statements as that term is defined in the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on beliefs of our management, as well as assumptions and estimates based on information available to us as of the dates such assumptions and estimates are made, and are subject to certain risks and uncertainties that could cause actual results to differ materially from historical results or those anticipated, depending on a variety of factors, including those factors discussed under Part II, Item 1A under the heading “Risk Factors” and to those set forth under Part I, Item 1A in our Annual Report on Form 10-K for the year ended May 31, 2014. Should one or more of those risks or uncertainties materialize adversely, or should underlying assumptions or estimates prove incorrect, actual results may vary materially from those described. Those events and uncertainties are difficult or impossible to predict accurately and many are beyond our control. We assume no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

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

Our exposure to market risk includes fluctuating interest rates under our credit agreements and changes in foreign exchange rates.

*Foreign Currency Risk.* Revenues and expenses of our foreign operations are translated at average exchange rates during the period, and balance sheet accounts are translated at period-end exchange rates. Balance sheet translation adjustments are excluded from the results of operations and are recorded in stockholders’ equity as a component of accumulated other comprehensive loss. A hypothetical 10 percent devaluation of the U.S. dollar against foreign currencies would have decreased pre-tax income by approximately \$3 million during the three-month period ended August 31, 2014.

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*Interest Rate Risk.* Refer to the section Quantitative and Qualitative Disclosures about Market Risk in our Annual Report on Form 10-K for the year ended May 31, 2014. There were no significant changes during the quarter ended August 31, 2014.

### Item 4 — Controls and Procedures

As required by Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as of August 31, 2014. This evaluation was carried out under the supervision and with participation of our Chief Executive Officer and Chief Financial Officer. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures. Therefore, effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon our evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective as of August 31, 2014, ensuring that information required to be disclosed in the reports that are filed under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported in a timely manner.

There were no changes in our internal control over financial reporting during the first quarter ended August 31, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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## PART II — OTHER INFORMATION

### Item 1A — Risk Factors

There have been no material changes to our risk factors as set forth in our Annual Report on Form 10-K for the year ended May 31, 2014, except as follows:

#### ***Significant cost issues may develop in connection with the A400M cargo system.***

Our Cargo Systems unit was selected in June 2005 to provide cargo loading systems for the Airbus A400M Military Transport Aircraft (“A400M”). We have incurred significant engineering and development costs in connection with this program (see Note 10 in Notes to Condensed Consolidated Financial Statements), and we expect to incur additional development costs until our system is certified. In July 2013, we and Airbus amended the A400M contract to make changes to the Company’s role and responsibilities under the program, establish a fixed price per shipset, set applicable weight parameters and make certain other changes. We and Airbus are currently negotiating further changes to the Company’s role and responsibilities and the overall pricing structure for the program.

We may not be able to recover some of our engineering and development costs, which could adversely affect our operating results and financial condition, under certain circumstances, including the following: (i) we are not able to obtain certification of our system ; (ii) the A400M program experiences significant additional delivery delays or order cancellations; (iii) we fail to achieve our expected production cost reductions; (iv) we fail to deliver the items that we are now responsible for in accordance with the terms of the amended contract; (v) we fail to reach an agreement on the anticipated further changes to the Company’s role and responsibilities under the program; or (vi) the contract is further amended to change our role and responsibilities and unfavorably modify the overall pricing structure.

#### ***We incur risks associated with new or expanded aviation services and programs.***

The range of aviation services we currently provide and expect to offer in the future have been expanding across both our commercial and defense customers. These offerings have included expansion into wide-body aircraft in our maintenance, repair, and overhaul business as well as a variety of new supply chain programs which are tailored to the specific needs of our customers.

New or expanded services and programs, including wide-body aircraft maintenance, carry risks associated with the development of new processes, increased capital commitments, ability to meet customer demands and requirements including delivery schedules for inventory or aircraft, and ability to accurately estimate costs associated with such services and programs. Failure to successfully fulfill customer requirements and execute new programs and services could have an adverse effect on our business, results of operations, and financial condition.

## Item 6 — Exhibits

The exhibits to this report are listed on the Exhibit Index included elsewhere herein. Management contracts and compensatory arrangements, if any, have been marked with an asterisk (\*) on the Exhibit Index.

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#### SIGNATURE

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

AAR CORP.

(Registrant)

Date: September 24, 2014

/s/ JOHN C. FORTSON

John C. Fortson  
Vice President, Chief Financial Officer and Treasurer  
(Principal Financial Officer and officer duly  
authorized to sign on behalf of registrant)

/s/ MICHAEL J. SHARP

Michael J. Sharp  
Vice President, Controller and Chief Accounting Officer  
(Principal Accounting Officer)

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#### EXHIBIT INDEX

<u>Exhibit No.</u>	<u>Description</u>	<u>Exhibits</u>
10.	Material Contracts	10.1* AAR CORP. Fiscal 2015 Short-Term Incentive Plan (filed herewith).
31.	Rule 13a-14(a)/15(d)-14(a) Certifications	31.1 Section 302 Certification dated September 24, 2014 of David P. Storch, Chairman and Chief Executive Officer of Registrant (filed herewith). 31.2 Section 302 Certification dated September 24, 2014 of John C. Fortson, Vice President, Chief Financial Officer and Treasurer of Registrant (filed herewith).
32.	Section 1350 Certifications	32.1 Section 906 Certification dated September 24, 2014 of David P. Storch, Chairman and Chief Executive Officer of Registrant (filed herewith). 32.2 Section 906 Certification dated September 24, 2014 of John C. Fortson, Vice President, Chief Financial Officer and Treasurer of Registrant (filed herewith).
101.	Interactive Data File	101 The following materials from the Registrant's Quarterly Report on Form 10-Q for the quarter ended August 31, 2014, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets at August 31, 2014 and May 31, 2014, (ii) Condensed Consolidated Statements of Income for the three months ended August 31, 2014 and 2013, (iii) Condensed Consolidated Statements of Comprehensive Income for the three months ended August 31, 2014 and 2013, (iv) Condensed Consolidated Statements of Cash Flows for the three months ended August 31, 2014 and 2013, (v) Condensed Consolidated Statement of Changes in Equity for the three months ended August 31, 2014 and (vi) Notes to Condensed Consolidated Financial Statements.**

\*\* Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.





**AAR CORP. Fiscal 2015 Short-Term Incentive Plan**1. Purpose.

The purpose of the AAR CORP. 2015 Short-Term Incentive Plan ("STIP") is to provide an incentive for selected senior executives of AAR CORP. (the "Company") and its subsidiaries to achieve the Company's short-term performance goals by providing them with an annual cash incentive payment based on the financial and operating success of the Company.

2. Definitions.

- (a) "Board" means the Board of Directors of the Company.
- (b) "Bonus" means the annual cash incentive paid to a Participant under this STIP for a fiscal year of the Company.
- (c) "Cash Flow from Operations" means cash flow from operations as disclosed by the Company in periodic reports filed with the Securities and Exchange Commission, excluding working capital investments in the Eaton, SRT and Mesa programs (or similar programs), special charges or unusual or infrequent items incurred during the performance period, and as adjusted for changes in generally accepted accounting principles.
- (d) "Cause" means the Participant's unsatisfactory performance or conduct detrimental to the Company and its subsidiaries, as solely determined by the Company.
- (e) "Code" means the Internal Revenue Code of 1986, as amended.
- (f) "Committee" means the Compensation Committee of the Board, or if the Committee is not comprised of "outside directors" as defined in Section 162(m) of the Code, then by a subset of the Committee comprised of at least two "outside directors" (the "Committee").
- (g) "Company" means AAR CORP.
- (h) "Disability" means the inability of the Participant to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months.
- (i) "Earnings Per Share" means diluted earnings per share as disclosed by the Company in its periodic reports filed with the Securities and Exchange Commission, excluding special charges or unusual or infrequent items incurred during the performance period, and as adjusted for changes in generally accepted accounting principles.
- (j) "Participant" means any active executive of the Company or subsidiary who has been selected by the Committee as eligible to earn a Bonus under the STIP.
- (k) "Retirement" means the Participant's voluntary termination of his employment, or his termination of employment by the Company or a subsidiary without Cause, when he has

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(i) attained age 65 or (ii) attained age 55 and his age plus the number of his consecutive years of service with the Company and subsidiaries is at least 75.

- (l) "Salary" means a Participant's base annual salary earned during a fiscal year of the Company while a Participant.
- (m) "STIP" means this AAR CORP. 2015 Short-Term Incentive Plan.

3. Administration.

The STIP shall be administered by the Committee. The Committee has full authority to select the senior executives eligible to participate in the STIP and determine when the senior executive's participation in the STIP will begin and end. Subject to the express provisions of the STIP, the Committee shall be authorized to interpret the STIP and to establish, amend and rescind any rules and regulations relating to the STIP and to make all other determinations deemed necessary or advisable for the proper administration of the STIP. The determinations of the Committee in the proper administration of the STIP shall be conclusive and binding.

4. Eligibility and Participation.

Participation in the STIP is limited to those senior executives of the Company or a subsidiary who the Committee designates as Participants. When the Committee selects an executive to become a Participant under the STIP, it shall designate the date as of which the executive's participation shall begin.

5. Annual Bonus Awards.

- (a) Determination of Participants, Performance Goals and Target Bonus Amounts. On or before the 90<sup>th</sup> day of each fiscal year of the Company, the Committee shall (i) determine the Participants for such fiscal year, (ii) establish threshold, target and maximum Earnings Per Share and Cash Flow from Operations goals for such fiscal year, and (iii) approve the target Bonus payment for each Participant expressed as a percentage of the Participant's Salary.

- (b) **Bonus Payment.** As soon as reasonably practicable after the end of the applicable fiscal year, the Committee shall determine the extent to which each of the Earnings Per Share and Cash Flow from Operations targets were attained for such fiscal year. The Bonus payable to each Participant will be equal to the sum of (i) 75% of the Participant's target Bonus multiplied by the applicable Earnings Per Share Multiplier Percentage and (ii) 25% of the Participant's target Bonus multiplied by the Cash Flow from Operations Multiplier Percentage:

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Earnings Per Share (75%)		Cash Flow from Operations (25%)	
Performance Achievement Level	Multiplier Percentage	Performance Achievement Level	Multiplier Percentage
Threshold	50%	Threshold	50%
Target	100%	Target	100%
Maximum	200%	Maximum	200%

For achievement of Earnings Per Share and Cash Flow from Operations **targets** between established performance achievement levels, the Multiplier Percentage will be interpolated on a straight-line basis.

6. **STIP Limitations.**

Notwithstanding Section 5, (a) the Committee retains full discretion to determine whether any Bonus will be payable for a fiscal year and (b) no Bonus shall be paid under the STIP for a fiscal year to a Participant whose employment with the Company and all subsidiaries terminates during such fiscal year unless the termination is due to death, Disability or Retirement, or as otherwise approved by the Committee. If the Participant terminates during the fiscal year due to death, Disability or Retirement, the Participant shall be entitled to a pro rata portion of the Bonus the Participant would have earned under the STIP had the Participant remained employed through the end of the fiscal year. Such Bonus will be paid at the same time Bonuses are paid to active Participants.

Notwithstanding Section 5, (a) the Committee retains full discretion to determine whether any Bonus shall be payable in a given fiscal year, regardless of performance results and (b) no Bonus will be payable for a fiscal year if net income (as determined in accordance with generally accepted accounting principles) for such fiscal year is not positive.

7. **Payment of Bonuses.**

A Participant's Bonus for a fiscal year shall be paid in cash to the Participant, or to the Participant's beneficiary (or beneficiaries) in the event of the Participant's death, within three months after the end of such fiscal year, unless the Participant has previously elected to have all or a portion of the Bonus deferred in accordance with the AAR CORP. Supplemental Executive Retirement Plan. The Company shall deduct all taxes required by law to be withheld from all Bonus payments.

8. **No Assignment.**

Except in the event of a Participant's death, the rights and interests of a Participant under the STIP shall not be assigned, encumbered or transferred.

9. **Termination of Participation.**

The Committee reserves the right to cancel a Participant's participation in the STIP at any time.

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10. **Employment Rights.**

Nothing contained in the STIP shall be construed as conferring a right upon any employee to continue in the employment of the Company or any subsidiary.

11. **Amendment/Termination.**

The Board may either amend or terminate the STIP at any time, without the consent of the Participants and without the approval of the stockholders of the Company; provided, that such modification or elimination shall not affect the obligation of the Company to pay any Bonus after it has been earned under the STIP.

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SECTION 302  
CERTIFICATION

I, David P. Storch, certify that:

1. I have reviewed this quarterly report on Form 10-Q of AAR CORP. (the "Registrant") for the quarterly period ending August 31, 2014;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;
4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter (the Registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of the Registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

DATE: September 24, 2014

/s/ DAVID P. STORCH

David P. Storch

*Chairman and Chief Executive Officer*

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SECTION 302  
CERTIFICATION

I, John C. Fortson, certify that:

1. I have reviewed this quarterly report on Form 10-Q of AAR CORP. (the "Registrant") for the quarterly period ending August 31, 2014;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;
4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter (the Registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of the Registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

DATE: September 24, 2014

/s/ JOHN C. FORTSON

John C. Fortson

*Vice President, Chief Financial Officer and Treasurer*

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**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the AAR CORP. (the "Company") quarterly report on Form 10-Q for the period ending August 31, 2014 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, David P. Storch, Chairman and Chief Executive Officer of the Company, certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my knowledge:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: September 24, 2014

/s/ DAVID P. STORCH

David P. Storch

*Chairman and Chief Executive Officer*

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**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the AAR CORP. (the "Company") quarterly report on Form 10-Q for the period ending August 31, 2014 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, John C. Fortson, Vice President, Chief Financial Officer and Treasurer of the Company, certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of my knowledge:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: September 24, 2014

/s/ JOHN C. FORTSON

John C. Fortson

*Vice President, Chief Financial Officer and Treasurer*

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