

AARON'S INC  
Form 10-Q  
August 04, 2011  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

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

**FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2011**

**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 NUMBER 1-13941**

**AARON S, INC.**

**(Exact name of registrant as specified in its charter)**

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**Georgia**  
(State or other jurisdiction of  
incorporation or organization)

**58-0687630**  
(I. R. S. Employer  
Identification No.)

**309 E. Paces Ferry Road, N.E.**  
**Atlanta, Georgia**  
(Address of principal executive offices)

**30305-2377**  
(Zip Code)

**(404) 231-0011**

(Registrant's telephone number, including area code)

**Not Applicable**

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether registrant (l) 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 Regulations S-T (§232.405 of this chapter) 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 definition 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 ☐ (Do not check if a smaller reporting company) 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.

**Title of Each Class**  
Common Stock, \$.50 Par Value

**Shares Outstanding as of August 1, 2011**  
78,657,646

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**AARON S, INC.**

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**Table of Contents****PART I - FINANCIAL INFORMATION****Item 1 - Financial Statements****AARON S, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(In Thousands, Except Share Data)**

|                                                                                                                                           | September 30,<br>(Unaudited)<br>June 30,<br>2011 | September 30,<br>December 31,<br>2010 |
|-------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------|---------------------------------------|
| <b>ASSETS:</b>                                                                                                                            |                                                  |                                       |
| Cash and Cash Equivalents                                                                                                                 | \$ 176,379                                       | \$ 72,022                             |
| Investment Securities                                                                                                                     | 32,922                                           |                                       |
| Accounts Receivable (net of allowances of \$4,684 in 2011 and \$4,544 in 2010)                                                            | 62,212                                           | 69,662                                |
| Lease Merchandise                                                                                                                         | 1,277,822                                        | 1,280,457                             |
| Less: Accumulated Depreciation                                                                                                            | (474,088)                                        | (465,973)                             |
|                                                                                                                                           | 803,734                                          | 814,484                               |
| Property, Plant and Equipment, Net                                                                                                        | 214,128                                          | 204,912                               |
| Goodwill                                                                                                                                  | 198,806                                          | 202,379                               |
| Other Intangibles, Net                                                                                                                    | 3,083                                            | 3,832                                 |
| Prepaid Expenses and Other Assets                                                                                                         | 52,573                                           | 122,932                               |
| Assets Held For Sale                                                                                                                      | 11,756                                           | 11,849                                |
| Total Assets                                                                                                                              | \$ 1,555,593                                     | \$ 1,502,072                          |
| <b>LIABILITIES &amp; SHAREHOLDERS EQUITY:</b>                                                                                             |                                                  |                                       |
| Accounts Payable and Accrued Expenses                                                                                                     | \$ 177,850                                       | \$ 213,139                            |
| Deferred Income Taxes Payable                                                                                                             | 258,676                                          | 227,513                               |
| Customer Deposits and Advance Payments                                                                                                    | 35,303                                           | 40,213                                |
| Credit Facilities                                                                                                                         | 41,131                                           | 41,790                                |
| Total Liabilities                                                                                                                         | 512,960                                          | 522,655                               |
| Commitments and Contingencies                                                                                                             | 41,500                                           |                                       |
| <b>Shareholders' Equity:</b>                                                                                                              |                                                  |                                       |
| Common Stock, Par Value \$.50 Per Share; Authorized: 225,000,000 Shares; Shares Issued: 90,752,123 at June 30, 2011 and December 31, 2010 | 45,376                                           | 45,376                                |
| Additional Paid-in Capital                                                                                                                | 205,498                                          | 201,752                               |
| Retained Earnings                                                                                                                         | 862,186                                          | 809,084                               |
| Accumulated Other Comprehensive Income                                                                                                    | 1,196                                            | 846                                   |
|                                                                                                                                           | 1,114,256                                        | 1,057,058                             |
| Less: Treasury Shares at Cost,<br>Common Stock, 11,765,396 Shares at June 30, 2011 and 10,664,728 Shares at December 31, 2010             | (113,123)                                        | (77,641)                              |
| Total Shareholders' Equity                                                                                                                | 1,001,133                                        | 979,417                               |

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|                                          |              |              |
|------------------------------------------|--------------|--------------|
| Total Liabilities & Shareholders' Equity | \$ 1,555,593 | \$ 1,502,072 |
|------------------------------------------|--------------|--------------|

The accompanying notes are an integral part of the Consolidated Financial Statements

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**AARON S, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF EARNINGS**

(Unaudited)

|                                      | September 30,<br>Three Months Ended<br>June 30,<br>2011 | September 30,<br>Three Months Ended<br>June 30,<br>2010 | September 30,<br>Six Months Ended<br>June 30,<br>2011 | September 30,<br>Six Months Ended<br>June 30,<br>2010 |
|--------------------------------------|---------------------------------------------------------|---------------------------------------------------------|-------------------------------------------------------|-------------------------------------------------------|
|                                      | (In Thousands, Except Per Share Data)                   |                                                         |                                                       |                                                       |
| REVENUES:                            |                                                         |                                                         |                                                       |                                                       |
| Lease Revenues and Fees              | \$ 371,107                                              | \$ 344,949                                              | \$ 769,331                                            | \$ 711,646                                            |
| Retail Sales                         | 8,187                                                   | 9,330                                                   | 22,193                                                | 24,416                                                |
| Non-Retail Sales                     | 84,607                                                  | 73,564                                                  | 185,054                                               | 169,640                                               |
| Franchise Royalties and Fees         | 15,176                                                  | 14,147                                                  | 31,519                                                | 29,074                                                |
| Other                                | 3,623                                                   | 3,009                                                   | 7,268                                                 | 5,492                                                 |
|                                      | 482,700                                                 | 444,999                                                 | 1,015,365                                             | 940,268                                               |
| COSTS AND EXPENSES:                  |                                                         |                                                         |                                                       |                                                       |
| Retail Cost of Sales                 | 4,805                                                   | 5,651                                                   | 13,285                                                | 14,613                                                |
| Non-Retail Cost of Sales             | 77,121                                                  | 68,157                                                  | 168,210                                               | 155,520                                               |
| Operating Expenses                   | 211,390                                                 | 206,210                                                 | 427,800                                               | 412,669                                               |
| Lawsuit Expense                      | 36,500                                                  |                                                         | 36,500                                                |                                                       |
| Depreciation of Lease Merchandise    | 134,585                                                 | 124,808                                                 | 278,678                                               | 256,888                                               |
| Interest                             | 672                                                     | 844                                                     | 1,346                                                 | 1,687                                                 |
|                                      | 465,073                                                 | 405,670                                                 | 925,819                                               | 841,377                                               |
| EARNINGS BEFORE INCOME TAXES         | 17,627                                                  | 39,329                                                  | 89,546                                                | 98,891                                                |
| INCOME TAXES                         | 6,828                                                   | 14,894                                                  | 34,358                                                | 37,481                                                |
| NET EARNINGS                         | \$ 10,799                                               | \$ 24,435                                               | \$ 55,188                                             | \$ 61,410                                             |
| EARNINGS PER SHARE                   |                                                         |                                                         |                                                       |                                                       |
| Basic                                | \$ .14                                                  | \$ .30                                                  | \$ .69                                                | \$ .75                                                |
| Assuming Dilution                    | .13                                                     | .30                                                     | .68                                                   | .75                                                   |
| CASH DIVIDENDS DECLARED PER SHARE:   |                                                         |                                                         |                                                       |                                                       |
| Common Stock                         | \$ .013                                                 | \$ .012                                                 | \$ .026                                               | \$ .024                                               |
| WEIGHTED AVERAGE SHARES OUTSTANDING: |                                                         |                                                         |                                                       |                                                       |
| Basic                                | 79,686                                                  | 81,479                                                  | 79,887                                                | 81,439                                                |
| Assuming Dilution                    | 80,899                                                  | 82,309                                                  | 81,037                                                | 82,228                                                |

The accompanying notes are an integral part of the Consolidated Financial Statements



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**AARON S, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)

|                                                        | September 30,<br>Six Months Ended<br>June 30,<br>2011<br>(In Thousands) | September 30,<br>Six Months Ended<br>June 30,<br>2010<br>(In Thousands) |
|--------------------------------------------------------|-------------------------------------------------------------------------|-------------------------------------------------------------------------|
| <b>OPERATING ACTIVITIES:</b>                           |                                                                         |                                                                         |
| Net Earnings                                           | \$ 55,188                                                               | \$ 61,410                                                               |
| Depreciation of Lease Merchandise                      | 278,678                                                                 | 256,888                                                                 |
| Other Depreciation and Amortization                    | 26,174                                                                  | 22,236                                                                  |
| Additions to Lease Merchandise                         | (472,752)                                                               | (501,320)                                                               |
| Book Value of Lease Merchandise Sold or Disposed       | 201,400                                                                 | 193,271                                                                 |
| Change in Deferred Income Taxes                        | 31,163                                                                  | (22,214)                                                                |
| Loss on Sale of Property, Plant, and Equipment         | 289                                                                     | 389                                                                     |
| Gain on Asset Dispositions                             | (997)                                                                   | (406)                                                                   |
| Change in Income Tax Receivable                        | 77,425                                                                  | (6,159)                                                                 |
| Change in Accounts Payable and Accrued Expenses        | (35,835)                                                                | (13,594)                                                                |
| Change in Commitments and Contingencies                | 41,500                                                                  |                                                                         |
| Change in Accounts Receivable                          | 7,450                                                                   | 12,143                                                                  |
| Excess Tax Benefits from Stock-Based Compensation      | (693)                                                                   | (229)                                                                   |
| Change in Other Assets                                 | (6,669)                                                                 | (4,699)                                                                 |
| Change in Customer Deposits and Advanced Payments      | (4,910)                                                                 | (6,062)                                                                 |
| Stock-Based Compensation                               | 2,435                                                                   | 2,396                                                                   |
| Other Changes, Net                                     | 1,285                                                                   | (969)                                                                   |
| Cash Provided by (Used in) Operating Activities        | 201,131                                                                 | (6,919)                                                                 |
| <b>INVESTING ACTIVITIES:</b>                           |                                                                         |                                                                         |
| Purchase of Investment Securities                      | (33,079)                                                                |                                                                         |
| Additions to Property, Plant and Equipment             | (36,938)                                                                | (43,390)                                                                |
| Acquisitions of Businesses and Contracts               | (1,730)                                                                 | (12,640)                                                                |
| Proceeds from Sales of Property, Plant, and Equipment  | 5,621                                                                   | 38,660                                                                  |
| Proceeds from Dispositions of Businesses and Contracts | 6,365                                                                   | 1,135                                                                   |
| Cash Used in Investing Activities                      | (59,761)                                                                | (16,235)                                                                |
| <b>FINANCING ACTIVITIES:</b>                           |                                                                         |                                                                         |
| Proceeds from Credit Facilities                        | 2,501                                                                   | 2,429                                                                   |
| Repayments on Credit Facilities                        | (3,160)                                                                 | (3,045)                                                                 |
| Dividends Paid                                         | (2,099)                                                                 | (975)                                                                   |
| Acquisition of Treasury Stock                          | (38,507)                                                                | (968)                                                                   |
| Excess Tax Benefits from Stock-Based Compensation      | 693                                                                     | 229                                                                     |
| Issuance of Stock Under Stock Option Plans             | 3,559                                                                   | 1,136                                                                   |
| Cash Used in Financing Activities                      | (37,013)                                                                | (1,194)                                                                 |

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|                                                  |            |           |
|--------------------------------------------------|------------|-----------|
| Increase (Decrease) in Cash and Cash Equivalents | 104,357    | (24,348)  |
| Cash and Cash Equivalents at Beginning of Period | 72,022     | 109,685   |
| Cash and Cash Equivalents at End of Period       | \$ 176,379 | \$ 85,337 |

The accompanying notes are an integral part of the Consolidated Financial Statements

**Table of Contents****AARON S, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

**Note A - Basis of Presentation**

The consolidated financial statements include the accounts of Aaron's, Inc. (the Company) and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

The consolidated balance sheet as of June 30, 2011, the consolidated statements of earnings for the three and six months ended June 30, 2011 and 2010, and the consolidated statements of cash flows for the six months ended June 30, 2011 and 2010, are unaudited. The preparation of interim consolidated financial statements requires management to make estimates and assumptions that affect the amounts reported in these financial statements and accompanying notes. Management does not believe these estimates or assumptions will change significantly in the future absent unsurfaced and unforeseen events. Generally, actual experience has been consistent with management's prior estimates and assumptions; however, actual results could differ from those estimates.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted. In the opinion of management, all adjustments (generally consisting of normal recurring accruals) considered necessary for a fair presentation have been included in the accompanying financial statements. We suggest you read these financial statements in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2010. The results of operations for the three and six months ended June 30, 2011 are not necessarily indicative of operating results for the full year.

Certain reclassifications have been made to the prior periods to conform to the current period presentation. Prior period share information has been adjusted to reflect the conversion of the former Nonvoting Common Stock into shares of Class A Common Stock and renaming the Class A Common Stock as Common Stock.

*Accounting Policies and Estimates*

See Note A to the consolidated financial statements in the 2010 Annual Report on Form 10-K.

*Cash and Cash Equivalents*

Cash and cash equivalents include all highly liquid investments with maturity dates of less than three months when purchased.

*Investment Securities*

The amortized cost, gross unrealized gains and losses, and fair value of investment securities held to maturity at June 30, 2011 are as follows. The securities are recorded at amortized cost in the consolidated balance sheets and mature at various dates during 2012 and 2013. There were no investment securities held by the Company at December 31, 2010.

|                 | September 30,<br>Amortized<br>Cost | September 30,<br>Gross<br>Unrealized<br>Gains<br>(In Thousands) | September 30,<br>Gross<br>Unrealized<br>Losses | September 30,<br>Fair<br>Value |
|-----------------|------------------------------------|-----------------------------------------------------------------|------------------------------------------------|--------------------------------|
| Corporate Bonds | \$ 32,922                          | \$ 1                                                            | \$ (106)                                       | \$ 32,817                      |

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### *Lease Merchandise*

Lease merchandise adjustments for the three month periods ended June 30 were \$10.4 million in 2011 and \$13.5 million in 2010. Lease merchandise adjustments for the six month periods ended June 30 were \$19.9 million in 2011 and \$23.1 million in 2010. These adjustments are recorded as a component of operating expenses under the allowance method, which includes losses incurred but not yet identified.

### *Goodwill and Other Intangibles*

During the six months ended June 30, 2011 the Company recorded \$874,000 in goodwill, \$136,000 in customer relationship intangibles, \$82,000 in non-compete intangibles, and \$17,000 in acquired franchise development rights in connection with a series of acquisitions of sales and lease ownership businesses. Customer relationship intangibles are amortized on a straight-line basis over their estimated useful lives of two years. Other intangible assets are amortized using the straight-line method over the life of the asset. Amortization expense was \$476,000 and \$801,000 for the three month periods ended June 30, 2011 and 2010, respectively. Amortization expense was \$976,000 and \$1.7 million for the six month periods ended June 30, 2011 and 2010, respectively. The aggregate purchase price for these asset acquisitions totaled \$1.7 million, with the principal tangible assets acquired consisting of lease merchandise and fixtures and equipment. These purchase price allocations are tentative and preliminary; the Company anticipates finalizing them prior to December 31, 2011. The results of operations of the acquired businesses are included in the Company's results of operations from the dates of acquisition and are not significant.

### *Stock Compensation*

The results of operations for the three months ended June 30, 2011 and 2010 include \$607,000 and \$865,000, respectively, in compensation expense related to unvested stock option grants. The results of operations for the six months ended June 30, 2011 and 2010 include \$1.2 million and \$1.6 million, respectively, in compensation expense related to unvested stock option grants. The results of operations for the three months ended June 30, 2011 and 2010 include \$751,000 and \$361,000, respectively, in compensation expense related to restricted stock unit ( RSUs ) awards and restricted stock awards ( RSAs ). The results of operations for the six months ended June 30, 2011 and 2010 include \$1.2 million and \$815,000, respectively, in compensation expense related to RSUs and RSAs. The Company granted 225,000 RSUs and 6,000 RSAs in the six months ended June 30, 2011. The Company granted 347,250 stock options and 300,000 RSUs in the six months ended June 30, 2010. Approximately 100,000 and 9,000 options were exercised during the three month period ended June 30, 2011 and 2010, respectively. Approximately 261,000 and 29,000 options were exercised during the six month period ended June 30, 2011 and 2010, respectively, and 137,000 and 146,000 RSAs vested on February 28, 2011 and 2010, respectively. The aggregate number of shares of common stock that may be issued or transferred under the Company's incentive stock awards plan is 14,735,112 as of June 30, 2011.

### *Deferred Compensation*

Effective July 1, 2009, the Company implemented the Aaron's, Inc. Deferred Compensation Plan an unfunded, nonqualified deferred compensation plan for a select group of management, highly compensated employees and non-employee directors. On a pre-tax basis, eligible employees can defer receipt of up to 75% of their base compensation and up to 100% of their incentive pay compensation, and eligible non-employee directors can defer receipt of up to 100% of both their cash and stock director fees. In addition, the Company may elect to make restoration matching contributions on behalf of eligible employees to compensate such employees for certain limitations on the amount of matching contributions an employee can receive under the Company's tax-qualified 401(k) plan.

Compensation deferred under the plan is credited to each participant's deferral account and a deferred compensation liability is recorded in accounts payable and accrued expenses in the consolidated balance sheets. The deferred compensation plan liability was \$5.5 million and \$3.5 million as of June 30, 2011 and December 31, 2010, respectively. Liabilities under the plan are recorded at amounts due to participants, based on the fair value of participants' selected investments. The Company has established a Rabbi Trust to fund obligations under the plan with Company-owned life insurance ( COLI ) contracts. The obligations are unsecured general obligations of the Company and the participants have no right, interest or claim in the assets of the Company, except as unsecured general creditors. The cash surrender value of these COLI contracts totaled \$5.3 million and \$3.5 million as of June 30, 2011 and December 31, 2010, respectively, and is included in prepaid expenses and other assets in the consolidated balance sheets.

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Deferred compensation expense charged to operations for the Company's matching contributions totaled \$90,000 and \$44,000 in the three month periods ended June 30, 2011 and 2010, respectively. Deferred compensation expense charged to operations for the Company's matching contributions totaled \$191,000 and \$115,000 in the six month periods ended June 30, 2011 and 2010, respectively. Total benefits of \$27,000 were paid in the first six months of 2011 and no benefits were paid in 2010.

### *Income Taxes*

The Company files a federal consolidated income tax return in the United States, and the parent company and its subsidiaries file in various states and foreign jurisdictions. With few exceptions, the Company is no longer subject to federal, state and local tax examinations by tax authorities for years before 2007.

As of June 30, 2011 and December 31, 2010, the amount of uncertain tax benefits that, if recognized, would affect the effective tax rate is \$1.2 million, including interest and penalties. The Company recognizes potential interest and penalties related to uncertain tax benefits as a component of income tax expense.

### *Fair Value of Financial Instruments*

The fair values of the Company's cash and cash equivalents, accounts receivable and accounts payable approximate their carrying amounts due to their short-term nature. At June 30, 2011 and December 31, 2010, the fair value of fixed rate long-term debt approximated its carrying value. The fair value of debt is estimated using valuation techniques that consider risk-free borrowing rates and credit risk.

### *Earnings Per Share*

Earnings per share is computed by dividing net earnings by the weighted average number of shares of Common Stock outstanding during the period. The computation of earnings per share assuming dilution includes the dilutive effect of stock options, RSUs and RSAs. Such stock options had the effect of increasing the weighted average shares outstanding assuming dilution by approximately 1.1 million and 830,000 for the three months ended at June 30, 2011 and 2010, respectively. Stock options had the effect of increasing the weighted average shares outstanding assuming dilution by approximately 985,000 and 789,000 for the six months ended at June 30, 2011 and 2010, respectively. RSUs had the effect of increasing the weighted average shares outstanding assuming dilution by approximately 160,000 and 165,000 for the three and six months ended at June 30, 2011, respectively. There were no RSAs or RSUs that had the effect of increasing the weighted average shares outstanding assuming dilution for the three and six months ended June 30, 2010.

There were no anti-dilutive stock options excluded from the computation of earnings per share assuming dilution for the three months ended June 30, 2011. Anti-dilutive stock options excluded from the computation of earnings per share assuming dilution were 336,000 for the three months ended June 30, 2010. Anti-dilutive stock options excluded from the computation of earnings per share assuming dilution were 293,000 and 336,000 for the six months ended June 30, 2011 and 2010, respectively. Anti-dilutive RSUs and RSAs excluded from the computation of earnings per share assuming dilution were 6,000 and 438,000 for the three months ended at June 30, 2011 and 2010, respectively. Anti-dilutive RSUs and RSAs excluded from the computation of earnings per share assuming dilution were 6,000 and 438,000 for the six months ended at June 30, 2011 and 2010, respectively.

### *Derivative Financial Instruments*

The Company utilizes derivative financial instruments to mitigate its exposure to certain market risks associated with its ongoing operations. The primary risk it seeks to manage through the use of derivative financial instruments is commodity price risk, including the risk of increases in the market price of diesel fuel used in the Company's delivery vehicles. All derivative financial instruments are recorded at fair value on the consolidated balance sheets. The Company does not use derivative financial instruments for trading or speculative purposes. The Company is exposed to counterparty credit risk on all its derivative financial instruments. The counterparties to these contracts are high credit quality commercial banks, which the Company believes largely minimize the risk of counterparty default. The Company's fuel hedges expired during the six months ended June 30, 2011. The fair value of the hedges as of December 31, 2010, and the changes in their fair values during the six months ended June 30, 2011 and 2010 were immaterial.

**Table of Contents***Assets Held for Sale*

Certain properties, primarily consisting of parcels of land, met the held for sale classification criteria at June 30, 2011 and December 31, 2010. After adjustment to fair value, the \$11.8 million carrying value of these properties has been classified as assets held for sale in the consolidated balance sheets as of June 30, 2011 and December 31, 2010. The Company estimated the fair values of these properties using the market values for similar properties and these are considered Level 2 assets as defined in FASB ASC Topic 820, Fair Value Measurements.

*Disposal Activities*

During the second quarter of 2010 the Company closed eight of its Aaron's Office Furniture stores and plans to have the remaining four stores closed by September 30, 2010. As a result, the Company recorded \$2.0 million in closed store reserves, \$4.7 million in lease merchandise write-downs and other miscellaneous expenses. The charges, totaling \$7.1 million, were recorded within operating expenses on the consolidated statement of earnings and are included in the Other segment category.

*Concentration of Credit Risk*

The Company maintained its cash and cash equivalents in a limited number of banks. Bank balances typically exceed coverage provided by the Federal Deposit Insurance Corporation. However due to the size and strength of the banks where the balances are held, such exposure to loss is considered minimal.

**Note B Credit Facilities**

On May 18, 2011, the Company entered into the second amendment to its revolving credit agreement, dated May 23, 2008, as amended, and on July 1, 2011, the Company entered into a third amendment. The amendments to the revolving credit agreement (i) add the defined terms

Institutional Investor and Private Placement Debt to further clarify the circumstances under which the Company may incur indebtedness and still remain in compliance with applicable negative covenants and (ii) modified the negative covenant restricting debt applicable to us by, among other things, increasing the amount of indebtedness the Company may incur with respect to certain privately placed debt from an aggregate principal amount of up to \$60.0 million to an aggregate principal amount of up to \$150.0 million. The Company entered into the amendments in order to permit the issuance of the 3.75% senior notes issued to a consortium of insurance companies as described in Note G.

**Note C Comprehensive Income**

Comprehensive income is comprised of the net earnings of the Company, foreign currency translation adjustments and unrealized loss from fuel hedges, as summarized below:

|                                         | September 30,<br>Three Months Ended<br>June 30,<br>2011 | September 30,<br>Three Months Ended<br>June 30,<br>2010 | September 30,<br>Six Months Ended<br>June 30,<br>2011 | September 30,<br>Six Months Ended<br>June 30,<br>2010 |
|-----------------------------------------|---------------------------------------------------------|---------------------------------------------------------|-------------------------------------------------------|-------------------------------------------------------|
| (In Thousands)                          |                                                         |                                                         |                                                       |                                                       |
| Net Earnings                            | \$ 10,799                                               | \$ 24,435                                               | \$ 55,188                                             | \$ 61,410                                             |
| Other Comprehensive Income:             |                                                         |                                                         |                                                       |                                                       |
| Foreign Currency Translation Adjustment | 64                                                      | (382)                                                   | 362                                                   | (66)                                                  |
| Fuel Hedges, Net of Tax                 | 20                                                      | (5)                                                     | (12)                                                  | (12)                                                  |
| Comprehensive Income                    | \$ 10,883                                               | \$ 24,048                                               | \$ 55,538                                             | \$ 61,332                                             |

**Note D Segment Information**

| September 30,<br>Three Months Ended<br>June 30, | September 30,<br>Three Months Ended<br>June 30, | September 30,<br>Six Months Ended<br>June 30, | September 30,<br>Six Months Ended<br>June 30, |
|-------------------------------------------------|-------------------------------------------------|-----------------------------------------------|-----------------------------------------------|
|-------------------------------------------------|-------------------------------------------------|-----------------------------------------------|-----------------------------------------------|

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| (In Thousands)                                       | 2011       | 2010       | 2011         | 2010       |
|------------------------------------------------------|------------|------------|--------------|------------|
| <b>Revenues From External Customers:</b>             |            |            |              |            |
| Sales and Lease Ownership                            | \$ 459,796 | \$ 422,564 | \$ 972,794   | \$ 896,062 |
| Franchise                                            | 15,176     | 14,147     | 31,519       | 29,074     |
| Other                                                | 3,019      | 4,508      | 5,969        | 9,403      |
| Manufacturing                                        | 20,713     | 14,199     | 49,122       | 39,219     |
| Revenues of Reportable Segments                      | 498,704    | 455,418    | 1,059,404    | 973,758    |
| Elimination of Intersegment Revenues                 | (20,905)   | (14,390)   | (49,496)     | (39,600)   |
| Cash to Accrual Adjustments                          | 4,901      | 3,971      | 5,457        | 6,110      |
| Total Revenues from External Customers               | \$ 482,700 | \$ 444,999 | \$ 1,015,365 | \$ 940,268 |
| <b>Earnings (Loss) Before Income Taxes:</b>          |            |            |              |            |
| Sales and Lease Ownership                            | \$ 2,234   | \$ 35,076  | \$ 59,451    | \$ 80,819  |
| Franchise                                            | 11,846     | 11,013     | 24,762       | 22,543     |
| Other                                                | (467)      | (7,262)    | 857          | (8,075)    |
| Manufacturing                                        | (73)       | 355        | 1,318        | 1,552      |
| Earnings Before Income Taxes for Reportable Segments | 13,540     | 39,182     | 86,388       | 96,839     |
| Elimination of Intersegment Loss (Profit)            | 73         | (355)      | (1,318)      | (1,554)    |
| Cash to Accrual and Other Adjustments                | 4,014      | 502        | 4,476        | 3,606      |
| Total Earnings Before Income Taxes                   | \$ 17,627  | \$ 39,329  | \$ 89,546    | \$ 98,891  |

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Earnings before income taxes for each reportable segment are determined in accordance with accounting principles generally accepted in the United States with the following adjustments:

Sales and lease ownership revenues are reported on a cash basis for management reporting purposes.

A predetermined amount of each reportable segment's revenues is charged to the reportable segment as an allocation of corporate overhead. This allocation was approximately 2% in 2011 and 2010.

Accruals related to store closures are not recorded on the reportable segment's financial statements, as they are maintained and controlled by corporate headquarters.

The capitalization and amortization of manufacturing and distribution variances are recorded in the consolidated financial statements as part of Cash to Accrual and Other Adjustments and are not allocated to the segment that holds the related lease merchandise.

Advertising expense in the sales and lease ownership division is estimated at the beginning of each year and then allocated to the division ratably over the year for management reporting purposes. For financial reporting purposes, advertising expense is recognized when the related advertising activities occur. The difference between these two methods is recorded as part of Cash to Accrual and Other Adjustments.

Sales and lease ownership lease merchandise write-offs are recorded using the direct write-off method for management reporting purposes. For financial reporting purposes, the allowance method is used and is recorded as part of Cash to Accrual and Other Adjustments.

Interest on borrowings is estimated at the beginning of each year. Interest is then allocated to operating segments on the basis of relative total assets.

Revenues in the Other category are primarily revenues of the Aaron's Office Furniture division, from leasing space to unrelated third parties in the corporate headquarters building and revenues from several minor unrelated activities. The pre-tax losses or earnings in the Other category are the result of the activity mentioned above, net of the portion of corporate overhead not allocated to the reportable segments for management purposes. Included in the Earnings Before Income Taxes results above for the Sales and lease Ownership segment is a \$36.5 million accrual for the lawsuit expense described in Note E.

## **Note E Commitments**

The Company leases warehouse and retail store space for substantially all of its operations under operating leases expiring at various times through 2028. Most of the leases contain renewal options for additional periods ranging from one to 15 years or provide for options to purchase the related property at predetermined purchase prices that do not represent bargain purchase options. The Company also leases transportation and computer equipment under operating leases expiring during the next five years. The Company expects that most leases will be renewed or replaced by other leases in the normal course of business.

On May 18, 2011, the Company entered into a second amendment to its second amended and restated loan facility and guaranty, dated June 18, 2010, as amended, and on July 1, 2011, the Company entered into a third amendment. The amendments to the franchisee loan facility, among other things, (i) extend the maturity date until May 16, 2012, (ii) increase the maximum Canadian subfacility commitment amount for loans to franchisees that operate stores in Canada (other than in the Province of Quebec) from Cdn \$25.0 million to Cdn \$35.0 million, (iii) add the defined terms Institutional Investor and Private Placement Debt to further clarify the circumstances under which the Company may incur indebtedness and still remain in compliance with applicable negative covenants, (iv) modify the negative covenant restricting debt applicable to the Company by, among other things, increasing the amount of indebtedness the Company may incur with respect to certain privately placed debt from an aggregate principal amount of up to \$60 million to an aggregate principal amount of up to \$150.0 million, and (v) replace the pricing grid schedule to the franchisee loan facility to reduce the applicable margins and participant unused commitment fee percentages with respect to the funded participations.

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The Company has guaranteed the borrowings of certain independent franchisees under the franchisee loan program with several banks. In the event these franchisees are unable to meet their debt service payments or otherwise experience an event of default, the Company would be unconditionally liable for the outstanding balance of the franchisees' debt obligations under the franchisee loan program, which would be due in full within 90 days of the event of default. At June 30, 2011, the portion that the Company will be obligated to repay in the event franchisees defaulted was \$131.4 million. Of this amount, approximately \$114.1 million represents franchise borrowings outstanding under the franchisee loan program and approximately \$17.3 million represents franchise borrowings under other debt facilities. Due to franchisee borrowing limits, management believes any losses associated with any defaults would be mitigated through recovery of lease merchandise as well as the associated lease agreements and other assets. Since its inception in 1994, the Company has had no significant losses associated with the franchise loan and guaranty program.

The Company has no long-term commitments to purchase merchandise. At June 30, 2011, the Company had non-cancelable commitments primarily related to certain advertising and marketing programs of \$34.6 million.

In *Alford v. Aaron Rents, Inc. et al* originally filed in the U.S. District Court for the Southern District of Illinois on October 2, 2008, plaintiff alleged, among other claims, that she was sexually harassed and subjected to retaliation, in violation of Title VII of the Civil Rights Act of 1964, by a general manager of a Company store. After trial, the jury returned a defense verdict solely on the claim of retaliation. On June 14, 2011, the jury awarded plaintiff compensatory damages in the amount of \$13.5 million and punitive damages in the amount of \$80.0 million. Of the total damages awarded, \$53.7 million exceeded the maximum award permitted by law. Consequently, the court reduced the judgment to \$39.8 million.

The Company is appealing the verdict. It is likely that the Company will need to post a bond while judgment is stayed pending the appeal process. Although the Company believes it has meritorious arguments, due to the inherent uncertainty of litigation, there can be no guarantee that the Company will ultimately be successful in its appeal.

The Company has accrued \$41.5 million, which represents the judgment, as reduced, and associated legal fees and expenses and has insurance coverage of \$5.0 million. Additional positive or negative developments in the lawsuit could affect the assumptions, and therefore, the accrual.

The Company is also a party to various claims and legal proceedings arising in the ordinary course of business. The Company regularly assesses its insurance deductibles, analyzes litigation information with its attorneys and evaluates its loss experience. The Company also enters into various contracts in the normal course of business that may subject it to risk of financial loss if counterparties fail to perform their contractual obligations. The Company does not believe its exposure to loss under any of these claims is probable nor can the Company estimate a range of amounts of loss that are reasonably possible. The Company's requirement to record or disclose potential losses under generally accepted accounting principles could change in the near term depending upon changes in facts and circumstances.

See Note F to the consolidated financial statements in the 2010 Annual Report on Form 10-K for further information.

### **Note F Related Party Transactions**

The Company leases certain properties under capital leases from certain related parties that are described in Note D to the consolidated financial statements in the 2010 Annual Report on Form 10-K.

### **Note G Subsequent Event**

On July 5, 2011, the Company entered into a note purchase agreement with several insurance companies. Pursuant to this agreement, the Company and its subsidiary, Aaron Investment Company, as co-obligors issued \$125.0 million in senior unsecured notes to the purchasers in a private placement. The notes bear interest at the rate of 3.75% per year and mature on April 27, 2018. Payments of interest are due quarterly, commencing July 27, 2011, with principal payments of \$25.0 million each due annually commencing April 27, 2014.

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The new note purchase agreement contains financial maintenance covenants, negative covenants regarding the Company's other indebtedness, its guarantees and investments, and other customary covenants substantially similar to the covenants in the Company's existing note purchase agreement, revolving credit facility and franchisee loan and guaranty facility, as modified.

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**Report of Independent Registered Public Accounting Firm**

The Board of Directors of Aaron's, Inc. and subsidiaries

We have reviewed the consolidated balance sheet of Aaron's, Inc. and subsidiaries as of June 30, 2011, and the related consolidated statements of earnings for the three- and six-month periods ended June 30, 2011 and 2010, and the consolidated statements of cash flows for the six-month periods ended June 30, 2011 and 2010. These financial statements are the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the consolidated financial statements referred to above for them to be in conformity with U.S. generally accepted accounting principles.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Aaron's, Inc. and subsidiaries as of December 31, 2010, and the related consolidated statements of earnings, shareholders' equity, and cash flows for the year then ended not presented herein, and in our report dated February 25, 2011, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2010, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Ernst & Young LLP

Atlanta, Georgia

August 4, 2011

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### **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*Special Note Regarding Forward-Looking Information: Except for historical information contained herein, the matters set forth in this Form 10-Q are forward-looking statements. Forward-looking statements involve a number of risks and uncertainties that could cause actual results to differ materially from any such statements, including risks and uncertainties associated with our growth strategy, competition, trends in corporate spending, the Company's franchise program, government regulation and the risks and uncertainties discussed under Item 1A, Risk Factors, in the Company's Annual Report on Form 10-K for the Year Ended December 31, 2010, filed with the Securities and Exchange Commission, and in the Company's other public filings.*

The following discussion should be read in conjunction with the consolidated financial statements as of and for the three and six months ended June 30, 2011, including the notes to those statements, appearing elsewhere in this report. We also suggest that management's discussion and analysis appearing in this report be read in conjunction with the management's discussion and analysis and consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2010.

#### **Overview**

Aaron's, Inc. is a leading specialty retailer of residential furniture, consumer electronics, computers, household appliances and accessories. Our major operating divisions are the Aaron's Sales & Lease Ownership Division and the Woodhaven Furniture Industries Division, which manufactures and supplies nearly one-half of the furniture and bedding leased and sold in our stores.

Aaron's has demonstrated strong revenue growth over the last three years. Total revenues have increased from \$1.593 billion in 2008 to \$1.877 billion in 2010, representing a compound annual growth rate of 8.5%. Total revenues from operations for the three months ended June 30, 2011, were \$482.7 million, an increase of \$37.7 million, or 8.5%, over the comparable period in 2010. Total revenues from operations for the six months ended June 30, 2011, were \$1.015 billion, an increase of \$75.1 million, or 8.0%, over the comparable period in 2010.

Most of our growth comes from the opening of new sales and lease ownership stores and increases in same store revenues from previously opened stores. We spend on average approximately \$600,000 to \$700,000 in the first year of operation of a new store, which includes purchases of lease merchandise, investments in leasehold improvements and financing first year start-up costs. Our new sales and lease ownership stores typically achieve revenues of approximately \$1.1 million in their third year of operation. Our comparable stores open more than three years normally achieve approximately \$1.4 million in revenues per store, which we believe represents a higher per store revenue volume than the typical rent-to-own store. Most of our stores are cash flow positive in the second year of operations following their opening.

We believe that the decline in the number of furniture stores, the limited number of retailers that focus on credit installment sales to lower and middle income consumers and increased consumer credit constraints during the current economic downturn have created a market opportunity for our unique sales and lease ownership concept. The traditional retail consumer durable goods market is much larger than the lease market, leaving substantial potential for growth for our sales and lease ownership division. We believe that the segment of the population targeted by our sales and lease ownership division comprises approximately 50% of all households in the United States and that the needs of these consumers are generally underserved. However, although we believe our business is recession-resistant, with those who are no longer able to access consumer credit becoming new customers of Aaron's, there can be no guarantee that if the current economic climate continues for an extensive period of time or there is another economic downturn that our customer base will not curtail spending on household merchandise.

We also use our franchise program to help us expand our sales and lease ownership concept more quickly and into more areas than we otherwise would by opening only Company-operated stores. Franchise royalties and other related fees represent a growing source of high margin revenue for us, accounting for approximately \$59.1 million of revenues in 2010, up from \$45.0 million in 2008, representing a compound annual growth rate of 14.6%. Total revenues from franchise royalties and fees for the three months ended June 30, 2011, were \$15.2 million, an increase of \$1.0 million, or 7.3%, over the comparable period in 2010. Total revenues from franchise royalties and fees for the six months ended June 30, 2011, were \$31.5 million, an increase of \$2.4 million, or 8.4%, over the comparable period in 2010.

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*Aaron's Office Furniture Closure.* In November 2008, we completed the sale of substantially all of the assets and the transfer of certain liabilities of our legacy residential rent-to-rent business, Aaron's Corporate Furnishings division, to CORT Business Services Corporation. When we sold our legacy rent-to-rent business, it decided to keep the 13 Aaron's Office Furniture stores, a rent-to-rent concept aimed at the office market. However, after disappointing results in a difficult environment, in June 2010 we announced our plans to close all of the then 12 remaining Aaron's Office Furniture stores and focus solely on the our sales and lease ownership business. In 2010, we closed eleven of its Aaron's Office Furniture stores and have one remaining store open to liquidate merchandise.

*Same Store Revenues.* We believe the changes in same store revenues are a key performance indicator. For the three months ended June 30, 2011, we calculated this amount by comparing revenues for the three months ended June 30, 2011 to revenues for the comparable period in 2010 for all stores open for the entire 15-month period ended June 30, 2011, excluding stores that received lease agreements from other acquired, closed, or merged stores. For the six months ended June 30, 2011, we calculated this amount by comparing revenues for the six months ended June 30, 2011 to revenues for the comparable period in 2009 for all stores open for the entire 24-month period ended June 30, 2011, excluding stores that received lease agreements from other acquired, closed or merged stores.

## **Key Components of Earnings**

In this management's discussion and analysis section, we review the Company's consolidated results.

*Revenues.* We separate our total revenues into five components: lease revenues and fees, retail sales, non-retail sales, franchise royalties and fees, and other. Lease revenues and fees includes all revenues derived from lease agreements from our sales and lease ownership stores, including agreements that result in our customers acquiring ownership at the end of the term. Retail sales represent sales of both new and lease return merchandise from our Company-operated stores. Non-retail sales mainly represent new merchandise sales to our sales and lease ownership division franchisees. Franchise royalties and fees represent fees from the sale of franchise rights and royalty payments from franchisees, as well as other related income from our franchised stores. Other revenues include, at times, income from gains on sales of sales and lease ownership stores and other miscellaneous revenues.

*Cost of Sales.* We separate our cost of sales into two components: retail and non-retail. Retail cost of sales represents the original or depreciated cost of merchandise sold through our Company-operated stores. Non-retail cost of sales primarily represents the cost of merchandise sold to our franchisees.

*Operating Expenses.* Operating expenses include personnel costs, selling costs, occupancy costs, and delivery costs, among other expenses.

*Depreciation of Lease Merchandise.* Depreciation of lease merchandise reflects the expense associated with depreciating merchandise leased to customers and held for lease by our Company-operated sales and lease ownership stores.

## **Critical Accounting Policies**

*Revenue Recognition.* Lease revenues are recognized in the month they are due on the accrual basis of accounting. For internal management reporting purposes, lease revenues from the sales and lease ownership division are recognized as revenue in the month the cash is collected. On a monthly basis, we record a deferral of revenue for lease payments received prior to the month due and an accrual for lease revenues due but not yet received, net of allowances. Our revenue recognition accounting policy matches the lease revenue with the corresponding costs, mainly depreciation, associated with the lease merchandise. As of June 30, 2011 and December 31, 2010, we had a revenue deferral representing cash collected in advance of being due or otherwise earned totaling \$34.7 million and \$39.5 million, respectively, and accounts revenue receivable, net of allowance for doubtful accounts based on historical collection rates, of \$5.3 million and \$4.9 million, respectively. Revenues from the sale of merchandise to franchisees are recognized at the time of receipt by the franchisee, and revenues from such sales to other customers are recognized at the time of shipment.

*Lease Merchandise.* Our sales and lease ownership division depreciates merchandise over the applicable agreement period, generally 12 to 24 months when leased, and 36 months when not leased, to 0% salvage value. Our office furniture division depreciates merchandise over its estimated useful life, which ranges from 24 months to 48 months, net of salvage value, which ranges from 0% to 30%. Sales and lease ownership merchandise is generally depreciated at a faster rate than our office furniture merchandise. Our policies require routine lease merchandise counts by store managers, annual audits by our internal auditors and write-offs for unsalable, damaged, or missing

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merchandise inventories. Full physical inventories are generally taken at our fulfillment and manufacturing facilities two to four times a year with appropriate provisions made for missing, damaged and unsalable merchandise. In addition, we monitor lease merchandise levels and mix by division, store and fulfillment center, as well as the average age of merchandise on hand. If unsalable lease merchandise cannot be returned to vendors, its carrying value is adjusted to net realizable value or written off. All lease merchandise is available for lease and sale, excluding merchandise determined to be missing, damaged or unsalable.

We record lease merchandise carrying value adjustments on the allowance method, which estimates the merchandise losses incurred but not yet identified by management as of the end of the accounting period. Lease merchandise adjustments for the three month periods ended June 30 were \$10.4 million in 2011 and \$13.5 million in 2010. Lease merchandise adjustments for the six month periods ended June 30 were \$19.9 million in 2011 and \$23.1 million in 2010.

*Leases and Closed Store Reserves.* The majority of our Company-operated stores are operated from leased facilities under operating lease agreements. The majority of the leases are for periods that do not exceed five years, although lease terms range in length up to 15 years. Leasehold improvements related to these leases are generally amortized over periods that do not exceed the lesser of the lease term or useful life. While some of our leases do not require escalating payments, for the leases which do contain such provisions we record the related lease expense on a straight-line basis over the lease term. We do not generally obtain significant amounts of lease incentives or allowances from landlords. Any incentive or allowance amounts we receive are recognized ratably over the lease term.

From time to time, we close or consolidate stores. Our primary costs associated with closing stores are the future lease payments and related commitments. We record an estimate of the future obligation related to closed stores based upon the present value of the future lease payments and related commitments, net of estimated sublease income based upon historical experience. As of June 30, 2011 and December 31, 2010, our reserve for closed stores was \$3.6 million and \$6.4 million, respectively. Due to changes in the market conditions, our estimates related to sublease income may change and as a result, our actual liability may be more or less than the liability recorded at June 30, 2011.

*Insurance Programs.* We maintain insurance contracts to fund workers compensation, vehicle liability, general liability and group health insurance claims. Using actuarial analysis and projections, we estimate the liabilities associated with open and incurred but not reported workers compensation, vehicle liability and general liability claims. This analysis is based upon an assessment of the likely outcome or historical experience, net of any stop loss or other supplementary coverage. We also calculate the projected outstanding plan liability for our group health insurance program using historical claims runoff data. Our gross estimated liability for workers compensation insurance claims, vehicle liability, general liability and group health insurance was \$30.0 million and \$27.6 million at June 30, 2011 and December 31, 2010, respectively. In addition, we have prefunding balances on deposit with the insurance carriers of \$25.6 million and \$23.8 million at June 30, 2011 and December 31, 2010, respectively.

If we resolve insurance claims for amounts that are in excess of our current estimates and within policy stop loss limits, we will be required to pay additional amounts beyond those accrued at June 30, 2011.

The assumptions and conditions described above reflect management's best assumptions and estimates, but these items involve inherent uncertainties as described above, which may or may not be controllable by management. As a result, the accounting for such items could result in different amounts if management used different assumptions or if different conditions occur in future periods.

*Legal Reserves.* We are subject to various legal claims arising in the ordinary course of business. We establish reserve for legal claims, pursuant to the provisions of ASC 450, Contingencies, when the associated costs with the claims become probable and can be reasonably estimated. We expense legal fees and expenses incurred in connection with the defense of all of our litigation at the time such amounts are invoiced or otherwise made known to us.

Based on information currently available, it is the opinion of management that the ultimate resolution of pending and threatened legal proceedings will not have a material adverse effect on the results of operations, financial position, or cash flows of the Company. However, in the event of unexpected future developments, it is possible that the ultimate resolution of such matters, if unfavorable, could have such effect in future periods.

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*Income Taxes.* The calculation of our income tax expense requires significant judgment and the use of estimates. We periodically assess tax positions based on current tax developments, including enacted statutory, judicial and regulatory guidance. In analyzing our overall tax position, consideration is given to the amount and timing of recognizing income tax liabilities and benefits. In applying the tax and accounting guidance to the facts and circumstances, income tax balances are adjusted appropriately through the income tax provision. Reserves for income tax uncertainties are maintained at levels we believe are adequate to absorb probable payments. Actual amounts paid, if any, could differ significantly from these estimates.

We use the liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Valuation allowances are established, when necessary, to reduce deferred tax assets when we expect the amount of tax benefit to be realized is less than the carrying value of the deferred tax asset.

**Results of Operations****Three months ended June 30, 2011 compared with three months ended June 30, 2010**

The following table shows key selected financial data for the three month periods ended June 30, 2011 and 2010, and the changes in dollars and as a percentage to 2011 from 2010:

| (In Thousands)                      | September 30,<br>Three Months Ended<br>June 30, 2011 | September 30,<br>Three Months Ended<br>June 30, 2010 | September 30,<br>Dollar Increase/<br>(Decrease) to<br>2011 from 2010 | September 30,<br>% Increase/<br>(Decrease) to<br>2011 from 2010 |
|-------------------------------------|------------------------------------------------------|------------------------------------------------------|----------------------------------------------------------------------|-----------------------------------------------------------------|
| <b>REVENUES:</b>                    |                                                      |                                                      |                                                                      |                                                                 |
| Lease Revenues and Fees             | \$ 371,107                                           | \$ 344,949                                           | \$ 26,158                                                            | 7.6%                                                            |
| Retail Sales                        | 8,187                                                | 9,330                                                | (1,143)                                                              | (12.3)                                                          |
| Non-Retail Sales                    | 84,607                                               | 73,564                                               | 11,043                                                               | 15.0                                                            |
| Franchise Royalties and Fees        | 15,176                                               | 14,147                                               | 1,029                                                                | 7.3                                                             |
| Other                               | 3,623                                                | 3,009                                                | 614                                                                  | 20.4                                                            |
|                                     | 482,700                                              | 444,999                                              | 37,701                                                               | 8.5                                                             |
| <b>COSTS AND EXPENSES:</b>          |                                                      |                                                      |                                                                      |                                                                 |
| Retail Cost of Sales                | 4,805                                                | 5,651                                                | (846)                                                                | (15.0)                                                          |
| Non-Retail Cost of Sales            | 77,121                                               | 68,157                                               | 8,964                                                                | 13.2                                                            |
| Operating Expenses                  | 211,390                                              | 206,210                                              | 5,180                                                                | 2.5                                                             |
| Lawsuit Expense                     | 36,500                                               |                                                      | 36,500                                                               |                                                                 |
| Depreciation of Lease Merchandise   | 134,585                                              | 124,808                                              | 9,777                                                                | 7.8                                                             |
| Interest                            | 672                                                  | 844                                                  | (172)                                                                | (20.4)                                                          |
|                                     | 465,073                                              | 405,670                                              | 59,403                                                               | 14.6                                                            |
| <b>EARNINGS BEFORE INCOME TAXES</b> | 17,627                                               | 39,329                                               | (21,702)                                                             | (55.2)                                                          |
| <b>INCOME TAXES</b>                 | 6,828                                                | 14,894                                               | (8,066)                                                              | (54.2)                                                          |
| <b>NET EARNINGS</b>                 | \$ 10,799                                            | \$ 24,435                                            | \$ (13,636)                                                          | (55.8)%                                                         |

*Revenues.* The 8.5% increase in total revenues, to \$482.7 million for the three months ended June 30, 2011, from \$445.0 million for the comparable period in 2010, was due mainly to a \$26.2 million, or 7.6%, increase in lease revenues and fees. The increase in lease revenues and fees was attributable to our sales and lease ownership division, which had a 5.0% increase in same store revenues during the second quarter of

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2011 and added a net of 57 Company-operated stores since June 30, 2010.

The 12.3% decrease in revenues from retail sales, to \$8.2 million for the three months ended June 30, 2011, from \$9.3 million for the comparable period in 2010, was due to decreased sales as a result of the closure of the Aaron's Office Furniture stores.

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The 15.0% increase in non-retail sales (which mainly represents merchandise sold to our franchisees), to \$84.6 million for the three months ended June 30, 2011, from \$73.6 million for the comparable period in 2010, was due to the growth of our franchise operations. The total number of franchised sales and lease ownership stores at June 30, 2011 was 687, reflecting a net addition of 69 stores since June 30, 2010.

The 7.3% increase in franchise royalties and fees, to \$15.2 million for the three months ended June 30, 2011, from \$14.1 million for the comparable period in 2010, primarily reflects an increase in royalty income from franchisees, increasing 8.8% to \$12.4 million for the three months ended June 30, 2011, compared to \$11.4 million for the three months ended June 30, 2010. The increase in royalty income is due primarily to the growth in the number of franchised stores and same store growth in the revenues of existing franchise stores.

Other revenues increased 20.4% to \$3.6 million for the three months ended June 30, 2011, from \$3.0 million for the comparable period in 2010. Included in other revenues for the three months ended June 30, 2011 and 2010 are gains of \$517,000 and \$406,000, respectively, on sales of Company-operated stores.

*Cost of Sales.* Retail cost of sales decreased 15.0% to \$4.8 million for the three months ended June 30, 2011, compared to \$5.7 million for the comparable period in 2010, and as a percentage of retail sales, decreased to 58.7% in 2011 from 60.6% in 2010 as a result of the decline in the volume of lower margin office furniture retail sales.

Non-retail cost of sales increased 13.2% to \$77.1 million for the three months ended June 30, 2011, from \$68.2 million for the comparable period in 2010, and as a percentage of non-retail sales, decreased to 91.2% from 92.6% as a result of improved pricing and lower product cost.

*Expenses.* Operating expenses for the three months ended June 30, 2011, increased \$5.2 million or 2.5%, to \$211.4 million from \$206.2 million for the comparable period in 2010. As a percentage of total revenues, operating expenses were 43.8% for the three months ended June 30, 2011, and 46.3% for the comparable period in 2010.

We recorded \$36.5 million in lawsuit expense in the three months ended June 30, 2011.

Depreciation of lease merchandise increased \$9.8 million to \$134.6 million for the three months ended June 30, 2011, from \$124.8 million during the comparable period in 2010, a 7.8% increase. As a percentage of total lease revenues and fees, depreciation of lease merchandise was 36.3% and 36.2%, for the three months ended June 30, 2011 and 2010, respectively.

Interest expense decreased to \$672,000 for the three months ended June 30, 2011, compared with \$844,000 for the comparable period in 2010, a 20.4% decrease. The decrease in interest expense was due to lower debt levels during the second quarter of 2011.

Income tax expense decreased \$8.1 million to \$6.8 million for the three months ended June 30, 2011, compared to \$14.9 million for the comparable period in 2010, representing a 54.2% decrease. Our effective tax rate increased to 38.7% in 2011 from 37.9% in 2010 primarily related to the loss of the Section 199 manufacturing deduction due to the Net Operating Loss created by bonus depreciation and various other state items.

*Net Earnings.* Net earnings decreased \$13.6 million to \$10.8 million for the three months ended June 30, 2011, compared with \$24.4 million for the comparable period in 2010, representing a 55.8% decrease. As a percentage of total revenues, net earnings were 2.2% and 5.5% for the three months ended June 30, 2011 and 2010, respectively. The decrease in net earnings was primarily a result of \$36.5 million in lawsuit expense recorded in the second quarter of 2011. The decrease was offset by the maturing of new Company-operated sales and lease ownership stores added over the past several years, contributing to a 5.0% increase in same store revenues and a 7.3% increase in franchise royalties and fees.

**Table of Contents****Six months ended June 30, 2011 compared with six months ended June 30, 2010**

The following table shows key selected financial data for the six month periods ended June 30, 2011 and 2010, and the changes in dollars and as a percentage to 2011 from 2010:

| (In Thousands)                      | September 30,<br>Six Months Ended<br>June 30, 2011 | September 30,<br>Six Months Ended<br>June 30, 2010 | September 30,<br>Dollar Increase/<br>(Decrease) to<br>2011 from 2010 | September 30,<br>% Increase/<br>(Decrease) to<br>2011 from 2010 |
|-------------------------------------|----------------------------------------------------|----------------------------------------------------|----------------------------------------------------------------------|-----------------------------------------------------------------|
| <b>REVENUES:</b>                    |                                                    |                                                    |                                                                      |                                                                 |
| Lease Revenues and Fees             | \$ 769,331                                         | \$ 711,646                                         | \$ 57,685                                                            | 8.1%                                                            |
| Retail Sales                        | 22,193                                             | 24,416                                             | (2,223)                                                              | (9.1)                                                           |
| Non-Retail Sales                    | 185,054                                            | 169,640                                            | 15,414                                                               | 9.1                                                             |
| Franchise Royalties and Fees        | 31,519                                             | 29,074                                             | 2,445                                                                | 8.4                                                             |
| Other                               | 7,268                                              | 5,492                                              | 1,776                                                                | 32.3                                                            |
|                                     | 1,015,365                                          | 940,268                                            | 75,097                                                               | 8.0                                                             |
| <b>COSTS AND EXPENSES:</b>          |                                                    |                                                    |                                                                      |                                                                 |
| Retail Cost of Sales                | 13,285                                             | 14,613                                             | (1,328)                                                              | (9.1)                                                           |
| Non-Retail Cost of Sales            | 168,210                                            | 155,520                                            | 12,690                                                               | 8.2                                                             |
| Operating Expenses                  | 427,800                                            | 412,669                                            | 15,131                                                               | 3.7                                                             |
| Lawsuit Expense                     | 36,500                                             |                                                    | 36,500                                                               |                                                                 |
| Depreciation of Lease Merchandise   | 278,678                                            | 256,888                                            | 21,790                                                               | 8.5                                                             |
| Interest                            | 1,346                                              | 1,687                                              | (341)                                                                | (20.2)                                                          |
|                                     | 925,819                                            | 841,377                                            | 84,442                                                               | 10.0                                                            |
| <b>EARNINGS BEFORE INCOME TAXES</b> | 89,546                                             | 98,891                                             | (9,345)                                                              | (9.4)                                                           |
| <b>INCOME TAXES</b>                 | 34,358                                             | 37,481                                             | (3,123)                                                              | (8.3)                                                           |
| <b>NET EARNINGS</b>                 | \$ 55,188                                          | \$ 61,410                                          | \$ (6,222)                                                           | (10.1)%                                                         |

*Revenues.* The 8.0% increase in total revenues, to \$1.015 billion for the six months ended June 30, 2011, from \$940.3 million in the comparable period in 2010, was due mainly to a \$57.7 million, or 8.1%, increase in lease revenues and fees, plus a \$15.4 million, or 9.1%, increase in non-retail sales. The increase in lease revenues and fees was attributable to our sales and lease ownership division, which had a 3.2% increase in same store revenues for the six months ended June 30, 2011 from the comparable period in 2010 and added 57 Company-operated stores since the end of June 30, 2010.

The 9.1% decrease in revenues from retail sales, to \$22.2 million for the six months ended June 30, 2011 from \$24.4 million for the comparable period in 2010, was due to decreased sales as a result of the closure of the Aaron's Office Furniture stores.

The 9.1% increase in non-retail sales (which mainly represents merchandise sold to our franchisees), to \$185.1 million for the six months ended June 30, 2011, from \$169.6 million for the comparable period in 2010, was due to the growth of our franchise operations. The total number of franchised sales and lease ownership stores at June 30, 2011 was 687, reflecting a net addition of 69 stores since June 30, 2010.

The 8.4% increase in franchise royalties and fees, to \$31.5 million for the six months ended June 30, 2011, from \$29.1 million for the comparable period in 2010, primarily reflects an increase in royalty income from franchisees, increasing 10.0% to \$26.3 million for the six months ended June 30, 2011, compared to \$23.9 million for the six months ended June 30, 2010. The increase is due primarily to the growth in the number of franchised stores and same store growth in the revenues of existing franchised stores.

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Other revenues increased 32.3% to \$7.3 million for the six months ended June 30, 2011, from \$5.5 million for the comparable period in 2010. Included in other revenues for the six months ended June 30, 2011 and 2010, are gains of \$997,000 and \$406,000, respectively, on sales of Company-operated stores.

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*Cost of Sales.* Retail cost of sales decreased 9.1% to \$13.3 million for the six months ended June 30, 2011, compared to \$14.6 million for the comparable period in 2010, and as a percentage of retail sales, remained constant at 59.9% in both 2011 and 2010.

Non-retail cost of sales increased 8.2%, to \$168.2 million for the six months ended June 30, 2011, from \$155.5 million for the comparable period in 2010, and as a percentage of non-retail sales, decreased to 90.9% from 91.7% as a result of improved pricing and lower product cost.

*Expenses.* Operating expenses for the six months ended June 30, 2011, increased \$15.1 million to \$427.8 million from \$412.7 million for the comparable period in 2010, a 3.7% increase. As a percentage of total revenues, operating expenses were 42.1% for the six months ended June 30, 2011 and 43.9% for the comparable period in 2010.

We recorded \$36.5 million in lawsuit expense in the six months ended June 30, 2011.

Depreciation of lease merchandise increased \$21.8 million to \$278.7 million for the six months ended June 30, 2011, from \$256.9 million during the comparable period in 2010, an 8.5% increase, and as a percentage of total lease revenues and fees, increased slightly to 36.2% in 2011 from 36.1% in 2010.

Interest expense decreased \$341,000 to \$1.3 million for the six months ended June 30, 2011, compared with \$1.7 million for the comparable period in 2010, a 20.2% decrease. The decrease in interest expense was due to lower debt levels during the first six months of 2011.

Income tax expense decreased \$3.1 million to \$34.4 million for the six months ended June 30, 2011, compared to \$37.5 million for the comparable period in 2010, representing a 8.3% decrease. Our effective tax rate increased to 38.4% in 2011 from 37.9% in 2010 primarily related to the loss of the Section 199 manufacturing deduction due to the Net Operating Loss created by bonus depreciation and various other state items.

*Net Earnings.* Net earnings decreased \$6.2 million to \$55.2 million for the six months ended June 30, 2011, compared with \$61.4 million for the comparable period in 2010, representing a 10.1% decrease. As a percentage of total revenues, net earnings were 5.4% for the six months ended June 30, 2011, and 6.5% for the six months ended June 30, 2010. The decrease in net earnings was primarily a result of \$36.5 million in lawsuit expense recorded in the second quarter of 2011, offset by the maturing new Company-operated sales and lease ownership stores added over the past several years, contributing to a 3.2% increase in same store revenues, and an 8.4% increase in franchise royalties and fees.

## **Balance Sheet**

*Cash and Cash Equivalents.* Our cash and cash equivalents balance increased to \$176.4 million at June 30, 2011, from \$72.0 million at December 31, 2010. The increase in our cash balance is primarily due to an \$80.9 million income tax refund received in February 2011 and an increase in cash from operations. For additional information, refer to the Liquidity and Capital Resources and Commitments sections below.

*Investment Securities.* Our investment securities balance increased to \$32.9 million at June 30, 2011 primarily as a result of purchases of corporate bonds in the second quarter of 2011. The securities are recorded at amortized cost in the consolidated balance sheets and mature at various dates in the period July 2012 to May 2013. We did not hold any investment securities at December 31, 2010.

*Prepaid Expenses and Other Assets.* Prepaid expenses and other assets decreased \$70.4 million to \$52.6 million at June 30, 2011, from \$122.9 million at December 31, 2010, primarily as a result of the receipt of the income tax refund in February 2011.

*Accounts Payable and Accrued Expenses.* The decrease of \$35.2 million in accounts payable and accrued expenses, to \$177.9 million at June 30, 2011 from \$213.1 million at December 31, 2010, is primarily the result of fluctuations in the timing of payments.

*Deferred Income Taxes Payable.* The increase of \$31.2 million in deferred income taxes payable to \$258.7 million at June 30, 2011, from \$227.5 million at December 31, 2010, is primarily related to bonus depreciation deductions on leased merchandise under the Small Business Jobs Act of 2010 and the Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010. The additional bonus depreciation deductions are partially offset by the reversals of the bonus depreciation deductions under the Economic Stimulus Act of 2008, the American Recovery and Reinvestment Act of 2009, and the Small Business Jobs Act of 2010.

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### **Liquidity and Capital Resources**

#### ***General***

Cash flows from operating activities for the six months ended June 30, 2011 and 2010 were \$201.1 million in cash inflows and \$6.9 million in cash outflows, respectively. The increase in cash flows from operating activities is primarily related to lower 2011 tax payments, tax refunds, income from operations and lower additions to lease merchandise.

Purchases of sales and lease ownership stores had a positive impact on operating cash flows in each period presented. The positive impact on operating cash flows from purchasing stores occurs as the result of lease merchandise, other assets and intangibles acquired in these purchases being treated as an investing cash outflow. As such, the operating cash flows attributable to the newly purchased stores usually have an initial positive effect on operating cash flows that may not be indicative of the extent of their contributions in future periods. The amount of lease merchandise purchased in these acquisitions and shown under investing activities was \$616,000 for the first six months of 2011 and \$4.5 million for the comparable 2010 period. Our cash flows from operations include profits on the sale of lease merchandise. Sales of sales and lease ownership stores are an additional source of investing cash flows. Proceeds from such sales were \$6.4 million and \$1.1 million for the first six months of 2011 and 2010, respectively.

Our primary capital requirements consist of buying lease merchandise for sales and lease ownership stores. As we continue to grow, the need for additional lease merchandise is expected to remain our major capital requirement. Other capital requirements include purchases of property, plant and equipment and expenditures for acquisitions. These capital requirements historically have been financed through:

- cash flows from operations;
- bank credit;
- trade credit with vendors;
- proceeds from the sale of lease return merchandise;
- private debt offerings; and
- stock offerings.

At June 30, 2011, we did not have any amounts outstanding under our revolving credit agreement. The credit facilities balance decreased by \$659,000 in 2011. Our current revolving credit facility expires May 23, 2013 and the total available credit on the facility is \$140.0 million. On May 18, 2011, we entered into a second amendment to our revolving credit agreement, dated May 23, 2008, as amended, and on July 1, 2011, we entered into a third amendment. The amendments to the revolving credit agreement added the defined terms Institutional Investor and Private Placement Debt, to further clarify the circumstances under which we may incur indebtedness and still remain in compliance with applicable negative covenants, modified the negative covenant restricting debt by, among other things, increasing the amount of indebtedness we may incur with respect to certain privately placed debt from an aggregate principal amount of up to \$60.0 million to an aggregate principal amount of up to \$150.0 million and permitted the issuance of our 3.75% senior notes issued to several insurance companies as described below.

We have \$24.0 million currently outstanding in aggregate principal amount of 5.03% senior unsecured notes due July 2012, principal repayments of which were made in 2008, 2009 and 2010, and are due in \$12.0 million annual installments until maturity.

In connection with the entry into the note purchase agreement described below, we entered into a letter amendment, dated July 5, 2011, to our existing note purchase agreement to permit the issuance of our 3.75% senior notes issued to several insurance companies.

On July 5, 2011, we entered into a note purchase agreement with several insurance companies. Pursuant to this agreement, the Company and its subsidiary, Aaron Investment Company, as co-obligors issued \$125.0 million in senior unsecured notes to the purchasers in a private placement. The notes bear interest at the rate of 3.75% per year and mature on April 27, 2018. Payments of interest are due quarterly, commencing July 27, 2011, with principal

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payments of \$25.0 million each due annually commencing April 27, 2014. The new note purchase agreement contains financial maintenance covenants, negative covenants regarding our other indebtedness, its guarantees and investments, and other customary covenants substantially similar to the covenants in the our existing note purchase agreement, revolving credit facility and franchisee loan guaranty facility, as modified.

Our revolving credit agreement, 5.03% senior unsecured notes, 3.75% senior unsecured notes and our franchisee loan facility agreement and guaranty discussed below, contain certain financial covenants. These covenants include requirements that we maintain ratios of: (1) EBITDA plus lease expense to fixed charges of no less than 2:1; (2) total debt to EBITDA of no greater than 3:1; and (3) total debt to total capitalization of no greater than 0.6:1. EBITDA in each case, means consolidated net income before interest and tax expense, depreciation (other than lease merchandise depreciation) and amortization expense, and other non-cash charges. We are also required to maintain a minimum amount of shareholders' equity. See the full text of the covenants themselves in our credit and guarantee agreements, which we have filed as exhibits to our Securities and Exchange Commission reports, for the details of these covenants and other terms. If we fail to comply with these covenants, we will be in default under these agreements, and all amounts would become due immediately. We were in compliance with all of these covenants at June 30, 2011 and believe that we will continue to be in compliance in the future.

We purchase our Common Stock in the market from time to time as authorized by our board of directors. In May 2011, the Board of Directors approved and authorized the repurchase of an additional 5,955,204 shares of Common Stock over the previously authorized repurchase amount of 4,044,796 shares, increasing the total number of our shares of Common Stock authorized for repurchase to 10,000,000. We repurchased 1,454,112 shares in the first six months of 2011 for a cash outlay of \$37.5 million. We have the authority to purchase 8,902,907 additional shares as of June 30, 2011. We repurchased 1,478,805 shares in 2010 for a cash outlay of \$28.0 million.

We have a consistent history of paying dividends, having paid dividends for 24 consecutive years. A \$.012 per share dividend on our former non-voting Common Stock and Common Stock (formerly our Class A Common Stock) was paid in January 2010, April 2010, July 2010, and October 2010 for a total cash outlay of \$3.9 million. Our board of directors increased the dividend 8.3% for the third quarter of 2010 on November 3, 2010 to \$.013 per share and the dividend was paid to holders of Common Stock in January 2011. A \$.013 per share dividend on Common Stock was paid in April 2011 and July 2011 for a total cash outlay of \$2.1 million. Subject to sufficient operating profits, any future capital needs and other contingencies, we currently expect to continue our policy of paying dividends.

If we achieve our expected level of growth in our operations, we anticipate we will be able to fund our growth using expected cash flows from operations, existing cash and cash equivalents, existing credit facilities, vendor credits and proceeds from the sale of lease merchandise returned for at least the next 24 months.

## **Commitments**

*Income Taxes.* During the six months ended June 30, 2011, we made \$8.8 million in income tax payments. Within the next six months, we anticipate that we will make cash payments for state income taxes of approximately \$2.4 million. The Small Business Jobs Act of 2010 was enacted after we paid our third quarter 2010 estimated federal tax. In December, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 was enacted. As a result of the bonus depreciation provisions in these acts we had paid more than our anticipated 2010 federal tax liability. We filed for a refund of overpaid federal tax of approximately \$80.9 million in January 2011 and received that refund in February 2011.

The Economic Stimulus Act of 2008, the American Recovery and Reinvestment Act of 2009, and the Small Business Jobs Act of 2010 provided for accelerated depreciation by allowing a bonus first-year depreciation deduction of 50% of the adjusted basis of qualified property, such as our lease merchandise, placed in service during those years. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 allowed for deduction of 100% of the adjusted basis of qualified property for assets placed in service after September 8, 2010 and before December 31, 2011. Accordingly, our cash flow benefited from having a lower cash tax obligation which, in turn, provided additional cash flow from operations. Because of our sales and lease ownership model where we remain the owner of merchandise on lease, we benefit more from bonus depreciation, relatively, than traditional furniture, electronics and appliance retailers. In future years we anticipate having to make increased tax payments on our earnings as a result of expected profitability and the reversal of the accelerated depreciation

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deductions that were taken in 2010 and prior periods. We estimate that at December 31, 2010 the remaining tax deferral associated with the acts described above is approximately \$150.0 million, of which approximately 76% will reverse in 2011 and most of the remainder will reverse between 2012 and 2013.

*Leases.* We lease warehouse and retail store space for most of our operations under operating leases expiring at various times through 2028. Most of the leases contain renewal options for additional periods ranging from one to 15 years or provide for options to purchase the related property at predetermined purchase prices that do not represent bargain purchase options. We also lease transportation and computer equipment under operating leases expiring during the next five years. We expect that most leases will be renewed or replaced by other leases in the normal course of business. Approximate future minimum rental payments required under operating leases that have initial or remaining non-cancelable terms in excess of one year as of June 30, 2011 are shown in the below table under Contractual Obligations and Commitments.

We have 20 capital leases, 19 of which are with a limited liability company ( LLC ) whose managers and owners are 11 Aaron's executive officers, with no individual owning more than 13.33% of the LLC. Nine of these related party leases relate to properties purchased from us in October and November of 2004 by the LLC for a total purchase price of \$6.8 million. The LLC is leasing back these properties to us for a 15-year term, with a five-year renewal at our option, at an aggregate annual lease amount of \$716,000. Another ten of these related party leases relate to properties purchased from us in December 2002 by the LLC for a total purchase price of approximately \$5.0 million. The LLC is leasing back these properties to us for a 15-year term at an aggregate annual lease amount of \$556,000. We do not currently plan to enter into any similar related party lease transactions in the future.

We finance a portion of our store expansion through sale-leaseback transactions. The properties are generally sold at net book value and the resulting leases qualify and are accounted for as operating leases. We do not have any retained or contingent interests in the stores nor do we provide any guarantees, other than a corporate level guarantee of lease payments, in connection with the sale-leasebacks. The operating leases that resulted from these transactions are included in the table below under Contractual Obligations and Commitments.

*Franchisee Loan Guaranty.* We have guaranteed the borrowings of certain independent franchisees under a franchisee loan program with several banks, and we also guarantee franchisee borrowings under certain other debt facilities. On May 18, 2011, we entered into a second amendment to our second amended and restated loan facility and guaranty, dated June 18, 2010, as amended, and on July 1, 2011, we entered into a third amendment. The amendments to the franchisee loan facility extended the maturity date until May 16, 2012, increased the maximum Canadian subfacility commitment amount for loans to franchisees that operate stores in Canada (other than in the Province of Quebec) from Cdn \$25.0 million to Cdn \$35.0 million, and added the defined terms Institutional Investor and Private Placement Debt to further clarify the circumstances under which we may incur indebtedness and still remain in compliance with applicable negative covenants, modified the negative covenant restricting debt applicable to us by, among other things, increasing the amount of indebtedness we may incur with respect to certain privately placed debt from an aggregate principal amount of up to \$60.0 million to an aggregate principal amount of up to \$150 million, replaced the pricing grid schedule to the franchisee loan facility, to reduce the applicable margins and participant unused commitment fee percentages with respect to the funded participations, and permitted the issuance of our 3.75% senior notes issued to several insurance companies as described above under the heading Liquidity and Capital Resources General. We remain subject to the financial covenants under the franchisee loan facility.

At June 30, 2011, the debt amount that we might be obligated to repay in the event franchisees defaulted was \$131.4 million. Of this amount, approximately \$114.1 million represents franchisee borrowings outstanding under the franchisee loan program, and approximately \$17.3 million represents franchisee borrowings that we guarantee under other debt facilities. However, due to franchisee borrowing limits, we believe any losses associated with any defaults would be mitigated through recovery of lease merchandise and other assets. Since its inception in 1994, we have had no significant losses associated with the franchisee loan and guaranty program. We believe the likelihood of any significant amounts being funded in connection with these commitments to be remote.

*Legal Reserves.* In *Alford v. Aaron Rents, Inc. et al* originally filed in the U.S. District Court for the Southern District of Illinois on October 2, 2008, plaintiff alleged, among other claims, that she was sexually harassed and subjected to retaliation, in violation of Title VII of the Civil Rights Act of 1964, by a general manager of our store. After trial, the jury returned a defense verdict solely on the claim of retaliation. On June 14, 2011, the jury awarded plaintiff compensatory damages in the amount of \$13.5 million and punitive damages in the amount of \$80 million. Of the total damages awarded, \$53.7 million exceeded the maximum award permitted by law. Consequently, the court reduced the judgment to \$39.8 million.

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We are appealing the verdict. It is likely that we will need to post a bond while judgment is stayed pending the appeal process. Although we believe we have meritorious arguments, due to the inherent uncertainty of litigation, there can be no guarantee that we will ultimately be successful in its appeal.

We have accrued \$41.5 million, which represents the judgment, as reduced, and associated legal fees and expenses and have insurance coverage of \$5.0 million. Additional positive or negative developments in the lawsuit could affect the assumptions, and therefore, the accruals.

*Contractual Obligations and Commitments.* We have no long-term commitments to purchase merchandise. The following table shows the approximate amounts of our contractual obligations, including interest, and commitments to make future payments as of June 30, 2011:

| (In Thousands)                              | September 30,<br>Total | September 30,<br>Period Less<br>Than 1 Year | September 30,<br>Period 1-3<br>Years | September 30,<br>Period 3-5<br>Years | September 30,<br>Period Over<br>5 Years |
|---------------------------------------------|------------------------|---------------------------------------------|--------------------------------------|--------------------------------------|-----------------------------------------|
| Credit Facilities, Excluding Capital Leases | \$ 27,301              | \$ 12,000                                   | \$ 12,000                            | \$ 3,301                             | \$                                      |
| Capital Leases                              | 13,830                 | 1,321                                       | 2,821                                | 3,428                                | 6,260                                   |
| Operating Leases                            | 523,813                | 94,241                                      | 149,595                              | 95,662                               | 184,315                                 |
| Purchase Obligations                        | 34,553                 | 24,698                                      | 9,772                                | 83                                   |                                         |
| <b>Total Contractual Cash Obligations</b>   | <b>\$ 599,497</b>      | <b>\$ 132,260</b>                           | <b>\$ 174,188</b>                    | <b>\$ 102,474</b>                    | <b>\$ 190,575</b>                       |

The following table shows the approximate amounts of our commercial commitments as of June 30, 2011:

| (In Thousands)                       | September 30,<br>Total<br>Amounts<br>Committed | September 30,<br>Period Less<br>Than 1 Year | September 30,<br>Period 1-3<br>Years | September 30,<br>Period 3-5<br>Years | September 30,<br>Period Over<br>5 Years |
|--------------------------------------|------------------------------------------------|---------------------------------------------|--------------------------------------|--------------------------------------|-----------------------------------------|
| Guaranteed Borrowings of Franchisees | \$ 131,382                                     | \$ 130,556                                  | \$ 826                               | \$                                   | \$                                      |

Purchase obligations are primarily related to certain advertising and marketing programs. Purchase orders or contracts for the purchase of lease merchandise and other goods and services are not included in the tables above. We are not able to determine the aggregate amount of those purchase orders that represent contractual obligations, as some purchase orders represent authorizations to purchase rather than binding agreements. Our purchase orders are based on our current distribution needs and are fulfilled by our vendors within short time horizons. We do not have a significant number of agreements for the purchase of lease merchandise or other goods that specify minimum quantities or set prices that exceed our expected requirements for twelve months.

Deferred income tax liabilities as of June 30, 2011 were approximately \$258.7 million. This amount is not included in the total contractual obligations table because we believe this presentation would not be meaningful. Deferred income tax liabilities are calculated based on temporary differences between the tax basis of assets and liabilities and their respective book basis, which will result in taxable amounts in future years when the liabilities are settled at their reported financial statement amounts. The results of these calculations do not have a direct connection with the amount of cash taxes to be paid in any future periods. As a result, scheduling deferred income tax liabilities as payments due by period could be misleading because this scheduling would not relate to liquidity needs.

**Market Risk**

Occasionally, we manage our exposure to changes in short-term interest rates, particularly to reduce the impact on our floating-rate borrowings, by entering into interest rate swap agreements. At June 30, 2011, we did not have any swap agreements. We do not use any significant market risk sensitive instruments to hedge foreign currency or other risks and hold no market risk sensitive instruments for trading or speculative purposes.

**Interest Rate Risk**

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We occasionally hold long-term debt with variable interest rates indexed to LIBOR or the prime rate that exposes us to the risk of increased interest costs if interest rates rise. Based on our overall interest rate exposure at June 30, 2011, a hypothetical 1.0% increase or decrease in interest rates would not be material.

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### **New Accounting Pronouncements**

The pronouncements that the Company adopted in the first six months of 2011 did not have a material impact on the consolidated financial statements.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The information called for by this item is provided under Item 7A in the Company's Annual Report on Form 10-K for the year ended December 31, 2010 and Part I, Item 2 of this Quarterly Report above under the headings "Market Risk" and "Interest Rate Risk."

### **ITEM 4. CONTROLS AND PROCEDURES**

#### **Disclosure Controls and Procedures.**

An evaluation of the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, was carried out by management, with the participation of the Chief Executive Officer ( "CEO" ) and Chief Financial Officer ( "CFO" ), as of the end of the period covered by this Quarterly Report on Form 10-Q.

No system of controls, no matter how well designed and operated, can provide absolute assurance that the objectives of the system of controls are met, and no evaluation of controls can provide absolute assurance that the system of controls has operated effectively in all cases. Our disclosure controls and procedures, however, are designed to provide reasonable assurance that the objectives of disclosure controls and procedures are met.

Based on management's evaluation, the CEO and CFO concluded that the Company's disclosure controls and procedures were effective as of the date of the evaluation to provide reasonable assurance that the objectives of disclosure controls and procedures are met.

#### **Internal Control Over Financial Reporting.**

There were no changes in the Company's internal control over financial reporting, as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934, during the Company's second quarter of 2011 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Table of Contents****PART II OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

From time to time, we are party to various legal proceedings arising in the ordinary course of business. Although the Company does not presently believe that any of the legal proceedings to which it is currently a party will ultimately have a material adverse impact upon its business, financial position or results of operations, it is currently a party to the proceeding described below:

In *Alford v. Aaron Rents, Inc. et al.*, originally filed in the U.S. District Court for the Southern District of Illinois on October 2, 2008, plaintiff alleged, among other claims, that she was sexually harassed and subjected to retaliation, in violation of Title VII of the Civil Rights Act of 1964, by a general manager of a Company store. After trial, the jury returned a defense verdict solely on the claim of retaliation. On June 14, 2011, the jury awarded plaintiff compensatory damages in the amount of \$13.5 million and punitive damages in the amount of \$80 million. Of the total damages awarded, \$53.7 million exceeded the maximum award permitted by law. Consequently, the court reduced the judgment to \$39.8 million.

The Company believes it has meritorious arguments, and intends to vigorously pursue its appeal. However, this proceeding is still developing, and due to inherent uncertainty in litigation and similar adversarial proceedings, there can be no guarantee that the Company will ultimately be successful in its appeal, or in others to which it is currently a party. Substantial losses from legal proceedings could have a material adverse impact upon the Company's business, financial position or results of operations.

**ITEM 1A. RISK FACTORS**

The Company does not have any updates to its risk factors disclosure from that previously reported in its Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

**ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The Company made repurchases of its Common Stock during the second quarter of 2011. On May 3, 2011, the Board of Directors approved and authorized the repurchase of an additional 5,955,204 shares of its Common Stock over the previously authorized repurchase amount of 4,044,796 shares, increasing the total number of shares of Common Stock authorized for repurchase to 10,000,000. As of June 30, 2011, the Company's Board of Directors had authorized the repurchase of up to an additional 8,902,907 shares of Common Stock pursuant to repurchase authority publicly announced from time-to-time.

| Period                                      | September 30,<br>(a) Total Number<br>of Shares<br>Purchased | September 30,<br>(b) Average<br>Price Paid per<br>Share | September 30,<br>(c) Total Number of<br>Shares Purchased as<br>Part of Publicly<br>Announced Plans<br>or<br>Programs | September 30,<br>(d) Maximum Number of<br>Shares that May Yet<br>Be<br>Purchased Under the Plans or<br>Programs |
|---------------------------------------------|-------------------------------------------------------------|---------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------|
| <b>April 1, 2011 through April 30, 2011</b> | 0                                                           | \$ 0                                                    | 0                                                                                                                    | 4,044,796                                                                                                       |
| <b>May 1, 2011 through May 31, 2011</b>     | 600,000                                                     | 27.32                                                   | 600,000                                                                                                              | 9,400,000                                                                                                       |
| <b>June 1, 2011 through June 30, 2011</b>   | 497,093                                                     | 26.06                                                   | 1,097,093                                                                                                            | 8,902,907                                                                                                       |
| <b>Total</b>                                | 1,097,093                                                   | \$ 26.75                                                | 1,097,093                                                                                                            | 8,902,907                                                                                                       |

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**ITEM 6. EXHIBITS**

The following exhibits are furnished herewith:

- 10.1 Second Amendment to Revolving Credit Agreement, by and among Aaron's, Inc., as borrower, SunTrust Bank, as administrative agent, and each of the other financial institutions party thereto as lenders, dated as of May 18, 2011, filed as Exhibit 10.1 to the Company's Current Report on Form 8-K, filed with the Commission on May 24, 2011, which exhibit is by this reference incorporated herein.
- 10.2 Second Amendment to Second Amended and Restated Loan Facility Agreement and Guaranty, by and among Aaron's, Inc., as sponsor, SunTrust Bank, as servicer, and each of the other financial institutions party thereto as participants, dated as of May 18, 2011, filed as Exhibit 10.2 to the Company's Current Report on Form 8-K, filed with the Commission on May 24, 2011, which exhibit is by this reference incorporated herein.
- 15 Letter re: Unaudited interim financial information.
- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended.
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended.
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101 The following financial information from Aaron's, Inc. Quarterly Report on Form 10-Q for the quarter ended June 30, 2011, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Balance Sheets as of June 30, 2011 and December 31, 2010, (ii) Consolidated Statements of Earnings for the three and six months ended June 30, 2011 and 2010, (iii) Consolidated Statements of Cash Flows for the six months ended June 30, 2011 and 2010, and (iv) the Notes to Consolidated Financial Statements.

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**SIGNATURES**

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.

AARON S, INC.  
(Registrant)

Date August 4, 2011

By: /s/ Gilbert L. Danielson  
Gilbert L. Danielson  
Executive Vice President,  
Chief Financial Officer

Date August 4, 2011

/s/ Robert P. Sinclair, Jr.  
Robert P. Sinclair, Jr.  
Vice President,  
Corporate Controller