

AAON INC  
Form 10-Q  
November 03, 2016

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2016  
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: 0-18953

AAON, INC.

(Exact name of registrant as specified in its charter)

Nevada 87-0448736

(State or other jurisdiction (IRS Employer  
of incorporation or organization) Identification No.)

2425 South Yukon, Tulsa, Oklahoma 74107

(Address of principal executive offices)

(Zip Code)

(918) 583-2266

(Registrant's telephone number, including area code)

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

Yes ☒ No ☐

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

Yes ☒ No ☐ Not Applicable ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

Large accelerated filer ☐ Accelerated filer ☒

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Non-accelerated filer      Smaller reporting company

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

Yes      No      a

As of October 28, 2016, registrant had outstanding a total of 52,755,240 shares of its \$.004 par value Common Stock.

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## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements.

## AAON, Inc. and Subsidiaries

## Consolidated Balance Sheets

(Unaudited)

|   | September 30,<br>2016                                 | December 31,<br>2015 |
|---|---|----------------------|
|   | (in thousands, except<br>share and per share<br>data) |                      |
| Assets  |   |                      |
| Current assets:   |   |                      |
| Cash and cash equivalents   | \$ 14,562   | \$ 7,908             |
| Certificates of deposit   | 6,232   | 10,080               |
| Investments held to maturity at amortized cost  | 20,518  | 12,444               |
| Accounts receivable, net  | 53,334  | 50,024               |
| Income tax receivable   | 2,472   | 4,702                |
| Note receivable   | 25  | 23                   |
| Inventories, net  | 43,401  | 38,499               |
| Prepaid expenses and other  | 820   | 533                  |
| Total current assets  | 141,364   | 124,213              |
| Property, plant and equipment:  |   |                      |
| Land  | 2,233   | 2,233                |
| Buildings   | 77,185  | 68,806               |
| Machinery and equipment   | 156,932   | 143,100              |
| Furniture and fixtures  | 12,543  | 11,270               |
| Total property, plant and equipment   | 248,893   | 225,409              |
| Less: Accumulated depreciation  | 133,659   | 124,348              |
| Property, plant and equipment, net  | 115,234   | 101,061              |
| Certificates of deposit   | —   | 1,880                |
| Investments held to maturity at amortized cost  | —   | 5,039                |
| Note receivable   | 679   | 661                  |
| Total assets  | \$ 257,277  | \$ 232,854           |
| Liabilities and Stockholders' Equity  |   |                      |
| Current liabilities:  |   |                      |
| Revolving credit facility   | \$ —  | \$ —                 |
| Accounts payable  | 7,228   | 6,178                |
| Accrued liabilities   | 36,110  | 37,235               |
| Total current liabilities   | 43,338  | 43,413               |
| Deferred revenue  | 1,423   | 698                  |
| Deferred tax liabilities  | 7,187   | 8,706                |
| Donations   | 553   | 1,119                |
| Commitments and contingencies   |   |                      |
| Stockholders' equity:   |   |                      |
| Preferred stock, \$.001 par value, 5,000,000 shares authorized, no shares issued  | —   | —                    |
| Common stock, \$.004 par value, 100,000,000 shares authorized, 52,783,642 and 53,012,363 issued and outstanding at September 30, 2016 and December 31, 2015, respectively | 211   | 212                  |
| Additional paid-in capital  | —   | —                    |

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|   |           |            |
|---|-----------|------------|
| Retained earnings   | 204,565   | 178,706    |
| Total stockholders' equity  | 204,776   | 178,918    |
| Total liabilities and stockholders' equity  | \$257,277 | \$ 232,854 |
| The accompanying notes are an integral part of these consolidated financial statements. |           |            |

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AAON, Inc. and Subsidiaries  
Consolidated Statements of Income  
(Unaudited)

|  | Three Months Ended<br>September 30,             |            | Nine Months Ended<br>September 30, |            |
|--|---|------------|------------------------------------|------------|
|  | 2016  | 2015       | 2016                               | 2015       |
|  | (in thousands, except share and per share data) |            |                                    |            |
| Net sales                                    | \$104,568                                       | \$94,360   | \$292,309                          | \$261,403  |
| Cost of sales                                | 71,476  | 64,175     | 200,739                            | 182,303    |
| Gross profit                                 | 33,092  | 30,185     | 91,570                             | 79,100     |
| Selling, general and administrative expenses | 10,400  | 10,062     | 29,874                             | 27,579     |
| Gain on disposal of assets                   | —   | (34)       | (20)                               | (59)       |
| Income from operations                       | 22,692  | 20,157     | 61,716                             | 51,580     |
| Interest income, net                         | 82  | 14         | 223                                | 87         |
| Other (expense) income, net                  | (12)  | (58)       | 115                                | (106)      |
| Income before taxes                          | 22,762  | 20,113     | 62,054                             | 51,561     |
| Income tax provision                         | 7,080   | 6,862      | 20,098                             | 18,781     |
| Net income                                   | \$15,682  | \$13,251   | \$41,956                           | \$32,780   |
| Earnings per share:                          |   |            |                                    |            |
| Basic  | \$0.30  | \$0.24     | \$0.79                             | \$0.61     |
| Diluted                                      | \$0.29  | \$0.24     | \$0.78                             | \$0.60     |
| Cash dividends declared per common share:    | \$—   | \$—        | \$0.11                             | \$0.11     |
| Weighted average shares outstanding:         |   |            |                                    |            |
| Basic  | 52,891,879                                      | 54,209,942 | 52,942,571                         | 54,160,649 |
| Diluted                                      | 53,394,331                                      | 54,579,590 | 53,467,023                         | 54,623,163 |

The accompanying notes are an integral part of these consolidated financial statements.

AAON, Inc. and Subsidiaries  
Consolidated Statements of Stockholders' Equity  
(Unaudited)

|   | Common Stock<br>Shares | Amount | Paid-in<br>Capital | Retained<br>Earnings | Total     |
|---|------------------------|--------|--------------------|----------------------|-----------|
|   | (in thousands)         |        |                    |                      |           |
| Balances at December 31, 2015   | 53,012                 | \$ 212 | \$ —               | \$178,706            | \$178,918 |
| Net income  | —                      | —      | —                  | 41,956               | 41,956    |
| Stock options exercised and restricted<br>stock awards vested, including tax benefits | 347                    | 1      | 1,680              | —                    | 1,681     |
| Share-based compensation  | —                      | —      | 3,172              | —                    | 3,172     |
| Stock repurchased and retired   | (575 )                 | (2 )   | (4,852 )           | (10,277 )            | (15,131 ) |
| Dividends   | —                      | —      | —                  | (5,820 )             | (5,820 )  |
| Balances at September 30, 2016  | 52,784                 | \$ 211 | \$ —               | \$204,565            | \$204,776 |

The accompanying notes are an integral part of these consolidated financial statements.

AAON, Inc. and Subsidiaries  
Consolidated Statements of Cash Flows  
(Unaudited)

|   | Nine Months<br>Ended<br>September 30, |           |
|---|---------------------------------------|-----------|
|   | 2016                                  | 2015      |
|   | (in thousands)                        |           |
| Operating Activities  |                                       |           |
| Net income  | \$41,956                              | \$32,780  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                       |           |
| Depreciation  | 9,547                                 | 8,587     |
| Amortization of bond premiums   | 216                                   | 168       |
| Provision for losses on accounts receivable, net of adjustments                   | 30                                    | (48 )     |
| Provision for excess and obsolete inventories                                     | 420                                   | (111 )    |
| Share-based compensation  | 3,172                                 | 2,076     |
| Gain on disposition of assets   | (20 )                                 | (59 )     |
| Foreign currency transaction (gain) loss  | (38 )                                 | 114       |
| Interest income on note receivable  | (21 )                                 | (23 )     |
| Deferred income taxes   | (1,519 )                              | (1,000 )  |
| Changes in assets and liabilities:  |                                       |           |
| Accounts receivable   | (3,340 )                              | (1,685 )  |
| Income taxes  | 2,230                                 | 2,614     |
| Inventories   | (5,322 )                              | (3,323 )  |
| Prepaid expenses and other  | (287 )                                | (154 )    |
| Accounts payable  | 949                                   | (3,801 )  |
| Deferred revenue  | 334                                   | 138       |
| Accrued liabilities and donations   | (1,300 )                              | 2,130     |
| Net cash provided by operating activities   | 47,007                                | 38,403    |
| Investing Activities  |                                       |           |
| Capital expenditures  | (23,627 )                             | (12,775 ) |
| Proceeds from sale of property, plant and equipment                               | 28                                    | 63        |
| Investment in certificates of deposits  | (4,112 )                              | (6,200 )  |
| Maturities of certificates of deposits  | 9,840                                 | 4,658     |
| Purchases of investments held to maturity   | (10,384 )                             | (14,183 ) |
| Maturities of investments   | 5,622                                 | 9,907     |
| Proceeds from called investments  | 1,511                                 | 757       |
| Principal payments from note receivable   | 39                                    | 42        |
| Net cash used in investing activities   | (21,083 )                             | (17,731 ) |
| Financing Activities  |                                       |           |
| Borrowings under revolving credit facility  | 761                                   | —         |
| Payments under revolving credit facility  | (761 )                                | —         |
| Stock options exercised   | 1,681                                 | 2,640     |
| Repurchase of stock   | (14,572 )                             | (9,074 )  |
| Employee taxes paid by withholding shares   | (559 )                                | (362 )    |
| Cash dividends paid to stockholders   | (5,820 )                              | (5,965 )  |
| Net cash used in financing activities   | (19,270 )                             | (12,761 ) |
| Net increase in cash and cash equivalents   | 6,654                                 | 7,911     |
| Cash and cash equivalents, beginning of period                                    | 7,908                                 | 21,952    |
| Cash and cash equivalents, end of period  | \$14,562                              | \$29,863  |

The accompanying notes are an integral part of these consolidated financial statements.

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AAON, Inc. and Subsidiaries  
Notes to the Consolidated Financial Statements  
(Unaudited)

1. General

Basis of Presentation

The accompanying unaudited consolidated financial statements of AAON, Inc., a Nevada corporation, and our operating subsidiaries, all of which are wholly-owned, (collectively, the “Company”) have been prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”) for interim financial information and with the rules and regulations of the Securities and Exchange Commission (“SEC”). These financial statements have not been audited by the Company's independent registered public accounting firm, except that the consolidated balance sheet at December 31, 2015 is derived from audited consolidated financial statements. Accordingly, they do not include all of the information and notes required by U.S. GAAP for complete financial statements. The financial statements reflect all adjustments (all of which are of a normal recurring nature) which are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented. Interim results are not necessarily indicative of the results that may be expected for a full year. Certain disclosures have been condensed in or omitted from these consolidated financial statements. The accompanying unaudited financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015. All intercompany balances and transactions have been eliminated in consolidation.

We are engaged in the engineering, manufacturing, marketing and sale of air conditioning and heating equipment consisting of standard, semi-custom and custom rooftop units, chillers, packaged outdoor mechanical rooms, air handling units, makeup air units, energy recovery units, condensing units, geothermal/water-source heat pumps and coils.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Because these estimates and assumptions require significant judgment, actual results could differ from those estimates and could have a significant impact on our results of operations, financial position and cash flows. We reevaluate our estimates and assumptions as needed, but at a minimum on a quarterly basis. The most significant estimates include, but are not limited to, the allowance for doubtful accounts, inventory reserves, warranty accrual, worker's compensation accrual, medical insurance accrual, income taxes and share-based compensation. Actual results could differ materially from those estimates.

Accounting Policies

A comprehensive discussion of our critical accounting policies and management estimates is included in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2015. There have been no significant changes in our critical accounting policies other than our early adoption of ASU 2016-09, Improvements to Employee Share-Based Payment Accounting as discussed in Notes 10, 11 and 12.

Recent Accounting Pronouncements

Changes to U.S. GAAP are established by the Financial Accounting Standards Board ("FASB") in the form of Accounting Standards Updates ("ASUs") to the FASB's Accounting Standards Codification.

We consider the applicability and impact of all ASUs. ASUs not listed below were assessed and determined to be either not applicable or are expected to have minimal impact on our consolidated financial statements and notes thereto.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. In August 2015, with the issuance of ASU 2015-14, the FASB amended the effective date for us to January 1, 2018. The Company plans to adopt using the retrospective transition method. We are currently assessing how ASU 2014-09 will impact our consolidated financial statements and notes thereto.

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In January 2016, the FASB issued ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities, which will address certain aspects of recognition, measurement, presentation and disclosure of financial instruments. The ASU becomes effective in the annual reporting period beginning after December 31, 2017, including interim reporting periods. We do not expect ASU 2016-01 will have a material effect on our consolidated financial statements and notes thereto.

In March 2016, the FASB issued ASU 2016-08, Principal versus Agent Considerations (Reporting Revenue Gross versus Net), which provides implementation guidance for Topic 606 on principal versus agent considerations. The effective date and transition requirements for the ASU are the same as ASU 2014-09. We are currently assessing how ASU 2016-08 will impact our consolidated financial statements and notes thereto.

In April 2016, the FASB issued ASU 2016-10, Identifying Performance Obligations and Licensing, which provides clarification for two aspects of Topic 606: identifying performance obligations and the licensing implementation guidance. The effective date and transition requirements for the ASU are the same as ASU 2014-09. We are currently assessing how ASU 2016-10 will impact our consolidated financial statements and notes thereto.

In May 2016, the FASB issued ASU 2016-12, Revenue from Contracts with Customers, which further amends Topic 606. The effective date and transition requirements for the ASU are the same as ASU 2014-09. We are currently assessing how ASU 2016-12 will impact our consolidated financial statements and notes thereto.

## 2. Revenue Recognition

We recognize revenues from sales of products when the title and risk of ownership pass to the customer. Final sales prices are fixed based on purchase orders. Sales allowances and customer incentives are treated as reductions to sales and are provided for based on historical experiences and current estimates. Sales of our products are moderately seasonal with the peak period being July - November of each year.

In addition, the Company presents revenues net of sales tax and net of certain payments to our independent manufacturer representatives (“Representatives”). Representatives are national companies that are in the business of providing HVAC units and other related products and services to customers. The end user customer orders a bundled group of products and services from the Representative and expects the Representative to fulfill the order. Only after the specifications are agreed to by the Representative and the customer, and the decision is made to use an AAON HVAC unit, will we receive notice of the order. We establish the amount we must receive for our HVAC unit (“minimum sales price”), but do not control the total order price that is negotiated by the Representative with the end user customer.

We are responsible for billings and collections resulting from all sales transactions, including those initiated by our Representatives. The Representatives submit the total order price to us for invoicing and collection. The total order price includes our minimum sales price and an additional amount which may include both the Representatives’ fee and amounts due for additional products and services required by the customer. These additional products and services may include controls purchased from another manufacturer to operate the unit, start-up services, and curbs for supporting the unit (“Third Party Products”). All are associated with the purchase of a HVAC unit but may be provided by the Representative or another third party. The Company is under no obligation related to Third Party Products.

The Representatives’ fee and Third Party Products amounts (“Due to Representatives”) are paid only after all amounts associated with the order are collected from the customer. The amount of payments to our Representatives were \$15.8 million and \$14.4 million for the three months ended September 30, 2016 and 2015, respectively. The amounts of payments to our Representatives were \$43.5 million and \$42.5 million for the nine months ended September 30, 2016 and 2015, respectively.

The Company also sells extended warranties on parts for various lengths of time ranging from 6 months to 10 years. Revenue for these separately priced warranties is deferred and recognized on a straight-line basis over the separately priced warranty period.

### 3. Investments

**Certificates of Deposit** – We held \$6.2 million and \$12.0 million in certificates of deposit at September 30, 2016 and December 31, 2015, respectively. At September 30, 2016, the certificates of deposit bear interest ranging from 0.45% to 0.90% per annum and have various maturities ranging from less than one month to approximately 10 months.

**Investments Held to Maturity** – Our investments held to maturity are comprised of \$20.5 million of corporate notes and bonds with original maturities ranging from less than one month to approximately 9 months. The investments have moderate risk with S&P ratings ranging from AA to BBB-.

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We record the amortized cost basis and accrued interest of the corporate notes and bonds in the Consolidated Balance Sheets. We record the interest and amortization of bond premium to interest income in the Consolidated Statements of Income.

The following summarizes the amortized cost and estimated fair value of our investments held to maturity as of September 30, 2016 and December 31, 2015:

|                              | Amortized<br>Cost | Gross<br>Unrealized<br>Gain | Gross<br>Unrealized<br>(Loss) | Fair<br>Value |
|------------------------------|-------------------|-----------------------------|-------------------------------|---------------|
| September 30, 2016:          | (in thousands)    |                             |                               |               |
| Current assets:              |                   |                             |                               |               |
| Investments held to maturity | \$20,518          | \$                          | —\$ (16 )                     | \$20,502      |
| Non current assets:          |                   |                             |                               |               |
| Investments held to maturity | —                 | —                           | —                             | —             |
| Total                        | \$20,518          | \$                          | —\$ (16 )                     | \$20,502      |

December 31, 2015:

|                              |          |    |           |          |
|------------------------------|----------|----|-----------|----------|
| Current assets:              |          |    |           |          |
| Investments held to maturity | \$12,444 | \$ | —\$ (16 ) | \$12,428 |
| Non current assets:          |          |    |           |          |
| Investments held to maturity | 5,039    | —  | (17 )     | 5,022    |
| Total                        | \$17,483 | \$ | —\$ (33 ) | \$17,450 |

#### 4. Accounts Receivable

Accounts receivable and the related allowance for doubtful accounts are as follows:

|                                       | September 30,<br>2016 | December 31,<br>2015 |
|---------------------------------------|-----------------------|----------------------|
|                                       | (in thousands)        |                      |
| Accounts receivable                   | \$53,479              | \$ 50,139            |
| Less: Allowance for doubtful accounts | (145 )                | (115 )               |
| Total, net                            | \$53,334              | \$ 50,024            |

|  | Three months ended<br>September 30,<br>2016 |    | September 30,<br>2015 |  | Nine months ended<br>September 30,<br>2016 |     | September 30,<br>2015 |  |
|--|---|----|-----------------------|--|--|-----|-----------------------|--|
| Allowance for doubtful accounts:                                 | (in thousands)                              |    |                       |  |  |     |                       |  |
| Balance, beginning of period                                     | \$73  | \$ | 69                    |  | \$ 115                                     | \$  | 171                   |  |
| Provisions for losses on accounts receivables, net of recoveries | 72  |    | 54                    |  | 30   | (40 | )                     |  |
| Accounts receivable written off                                  | —   |    | —                     |  | —  | (8  | )                     |  |
| Balance, end of period   | \$145                                       | \$ | 123                   |  | \$ 145                                     | \$  | 123                   |  |

## 5. Inventories

Inventories are valued at the lower of cost or market. Cost is determined by the first-in, first-out (“FIFO”) method. We establish an allowance for excess and obsolete inventories based on product line changes, the feasibility of substituting parts and the need for supply and replacement parts.

|   | September 30, 2016 | December 31, 2015 |
|---|--------------------|-------------------|
|   | (in thousands)     |                   |
| Raw materials                                       | \$39,713           | \$ 33,853         |
| Work in process                                     | 2,169              | 2,522             |
| Finished goods                                      | 2,696              | 2,881             |
|   | 44,578             | 39,256            |
| Less: Allowance for excess and obsolete inventories | (1,177 )           | (757 )            |
| Total, net  | \$43,401           | \$ 38,499         |

The related changes in the allowance for excess and obsolete inventories account are as follows:

|  | Three months ended<br>September 30, 2016 |        | September 30, 2015 |  | Nine months ended<br>September 30, 2016 |        | September 30, 2015 |  |
|--|--|--------|--------------------|--|---|--------|--------------------|--|
|  |  |        |                    |  |   |        |                    |  |
|  |  |        |                    |  |   |        |                    |  |
| Allowance for excess and obsolete inventories: |  |        |                    |  |   |        |                    |  |
| Balance, beginning of period                   | \$1,065                                  | \$ 773 |                    |  | \$757                                   | \$ 714 |                    |  |
| Provisions for excess and obsolete inventories | 112                                      | (35 )  |                    |  | 420                                     | 24     |                    |  |
| Inventories written off                        | —  | (135 ) |                    |  | —                                       | (135 ) |                    |  |
| Balance, end of period                         | \$1,177                                  | \$ 603 |                    |  | \$1,177                                 | \$ 603 |                    |  |

## 6. Supplemental Cash Flow Information

|  | Three months ended<br>September 30, 2016 |          | September 30, 2015 |  | Nine months ended<br>September 30, 2016 |           | September 30, 2015 |  |
|--|--|----------|--------------------|--|---|-----------|--------------------|--|
|  |  |          |                    |  |   |           |                    |  |
| Supplemental disclosures:                    |  |          |                    |  |   |           |                    |  |
| Interest paid                                | \$—                                      | \$ —     |                    |  | \$—                                     | \$ —      |                    |  |
| Income taxes paid                            | \$8,551                                  | \$ 6,321 |                    |  | \$19,398                                | \$ 17,167 |                    |  |
| Non-cash investing and financing activities: |  |          |                    |  |   |           |                    |  |
| Non-cash capital expenditures                | \$(1,211)                                | \$ (17 ) |                    |  | \$101                                   | \$ (190 ) |                    |  |

## 7. Warranties

The Company has warranties with various terms ranging from 18 months for parts to 25 years for certain heat exchangers. The Company has an obligation to replace parts or service its products if conditions under the warranty are met. A provision is made for estimated warranty costs at the time the related products are sold based upon the warranty period, historical trends, new products and any known identifiable warranty issues.

Changes in the warranty accrual are as follows:

|                              | Three months ended<br>September 30,<br>2016 2015 |          | Nine months ended<br>September 30,<br>2016 2015 |          |
|------------------------------|--|----------|---|----------|
|                              | (in thousands)                                   |          |   |          |
| Warranty accrual:            |  |          |   |          |
| Balance, beginning of period | \$8,454  | \$ 8,092 | \$8,469   | \$ 8,130 |
| Payments made                | (1,331 )   | (1,130 ) | (2,988 )  | (3,133 ) |
| Provisions                   | 1,012  | 1,289    | 2,654   | 3,254    |
| Balance, end of period       | \$8,135  | \$ 8,251 | \$8,135   | \$ 8,251 |
| Warranty expense:            | \$1,012  | \$ 1,289 | \$2,654   | \$ 3,254 |

## 8. Accrued Liabilities

Accrued liabilities are as follows:

|                             | September 30,<br>2016 2015 |           |
|-----------------------------|----------------------------|-----------|
|                             | (in thousands)             |           |
| Warranty                    | \$8,135                    | \$ 8,469  |
| Due to representatives      | 10,076                     | 10,597    |
| Payroll                     | 6,082                      | 3,954     |
| 401(k) Contributions        | 1,879                      | 3,054     |
| Profit sharing              | 2,574                      | 2,220     |
| Worker's compensation       | 386                        | 366       |
| Medical self-insurance      | 652                        | 676       |
| Customer prepayments        | 1,069                      | 2,895     |
| Donations                   | 600                        | 600       |
| Employee benefits and other | 4,657                      | 4,404     |
| Total                       | \$36,110                   | \$ 37,235 |

## 9. Revolving Credit Facility

Our revolving credit facility, which is provided by BOKF, NA dba Bank of Oklahoma, formerly known as Bank of Oklahoma, N.A. ("Bank of Oklahoma"), provides for maximum borrowings of \$30.0 million. Under the line of credit, there is one standby letter of credit totaling \$0.8 million. Borrowings available under the revolving credit facility at September 30, 2016 were \$29.2 million. Interest on borrowings is payable monthly at LIBOR plus 2.5%. No fees are associated with the unused portion of the committed amount. We had no outstanding balance under the revolving credit facility at September 30, 2016 and December 31, 2015. The termination date of the revolving credit facility is July 27, 2018.

As of September 30, 2016, we were in compliance with our financial covenants. These covenants require that we meet certain parameters related to our tangible net worth and total liabilities to tangible net worth ratio. At September 30, 2016, our tangible net worth was \$204.8 million and met the requirement of being at or above \$125.0 million. Our total liabilities to tangible net worth ratio was 0.26 to 1, and met the requirement of not being above 2 to 1.

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## 10. Income Taxes

The provision (benefit) for income taxes consists of the following:

|          | Three months ended<br>September 30, |          | Nine months ended<br>September 30, |           |
|----------|-------------------------------------|----------|------------------------------------|-----------|
|          | 2016                                | 2015     | 2016                               | 2015      |
|          | (in thousands)                      |          |                                    |           |
| Current  | \$6,748                             | \$ 7,299 | \$21,617                           | \$ 19,781 |
| Deferred | 332                                 | (437)    | (1,519)                            | (1,000)   |
|          | \$7,080                             | \$ 6,862 | \$20,098                           | \$ 18,781 |

The reconciliation of the Federal statutory income tax rate to the effective income tax rate is as follows:

|  | Three months ended<br>September 30, |        |   | Nine months ended<br>September 30, |        |   |
|--|-------------------------------------|--------|---|------------------------------------|--------|---|
|  | 2016                                | 2015   |   | 2016                               | 2015   |   |
| Federal statutory rate                     | 35.0 %                              | 35.0 % |   | 35.0 %                             | 35.0 % |   |
| State income taxes, net of Federal benefit | 4.9                                 | 5.8    |   | 5.0                                | 5.5    |   |
| Domestic manufacturing deduction           | (3.0)                               | (3.6)  | ) | (3.4)                              | (3.3)  | ) |
| Excess tax benefits                        | (2.8)                               | —      |   | (2.9)                              | —      |   |
| Other                                      | (3.0)                               | (3.1)  | ) | (1.3)                              | (0.8)  | ) |
| Effective tax rate                         | 31.1 %                              | 34.1 % |   | 32.4 %                             | 36.4 % |   |

As discussed in Note 11, the Company early adopted ASU 2016-09, Improvements to Employee Share-Based Payment Accounting, applying the changes for excess tax benefits and tax deficiencies prospectively. As a result, excess tax benefits and deficiencies are reported as an income tax benefit or expense on the statement of income rather than as a component of additional paid-in capital on the statement of equity. Excess tax benefits and deficiencies are treated as discrete items to the income tax provision in the reporting period in which they occur and are noted in the above table.

The Company's estimated annual 2016 effective tax rate, excluding discrete events, is approximately 36%. The Indian Employment Credit and Research and Development Credit were not extended until December 2015 for the 2015 and 2016 tax years. As such, the effective rate for the nine months ended September 30, 2016 is reduced for the impact of these credits while the effective rate for the nine months ended September 30, 2015 does not reflect these credits. Additionally, the Company had a return to provision adjustment for the three months ended September 30, 2016 of approximately \$0.5 million related to a change in estimate of the Company's R&D credit.

We file income tax returns in the U.S., state and foreign income tax returns jurisdictions. We are subject to U.S. examinations for tax years 2012 to present, and to non-U.S. income tax examinations for the tax years of 2011 to present. In addition, we are subject to state and local income tax examinations for the tax years 2011 to present. The Company continues to evaluate its need to file returns in various state jurisdictions. Any interest or penalties would be recognized as a component of income tax expense.

## 11. Share-Based Compensation

We have historically maintained a stock option plan for key employees, directors and consultants ("the 1992 Plan"). The 1992 Plan provided for 14.9 million shares to be issued under the plan in the form of stock options. Under the terms of the 1992 Plan, the exercise price of shares granted may not be less than 85% of the fair market value at the date of the

grant. Options granted to directors vest one-third each year, commencing one year after the date of grant. All other options granted vest at a rate of 20% per year, commencing one year after date of grant, and are exercisable during years 2-10.

On May 22, 2007, our stockholders adopted a Long-Term Incentive Plan ("LTIP") which provided an additional 3.3 million shares that could be granted in the form of stock options, stock appreciation rights, restricted stock awards, performance units and performance awards. Since inception of the LTIP, non-qualified stock options and restricted stock awards were granted with the same vesting schedule as the previous plan. Under the LTIP, the exercise price of shares granted could not be less than 100% of the fair market value at the date of the grant.

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On May 24, 2016, our stockholders adopted the 2016 Long-Term Incentive Plan ("2016 Plan") which provides for approximately 3.8 million shares, comprised of 3.4 million new shares provided for under the 2016 Plan and approximately 0.4 million shares that were available for issuance under the previous LTIP, that are now authorized for issuance under the 2016 Plan, that can be granted in the form of stock options, stock appreciation rights, restricted stock awards, performance awards, dividend equivalent rights, and other awards. Under the 2016 Plan, the exercise price of shares granted may not be less than 100% of the fair market value at the date of the grant. The 2016 Plan will be administered by the Compensation Committee of the Board of Directors or such other committee of the Board of Directors as is designated by the Board of Directors (the "Committee"). Membership on the Committee shall be limited to independent directors. The Committee may delegate certain duties to one or more officers of the Company as provided in the 2016 Plan. The Committee will determine the persons to whom awards are to be made, determine the type, size and terms of awards, interpret the 2016 Plan, establish and revise rules and regulations relating to the 2016 Plan and make any other determinations that it believes necessary for the administration of the 2016 Plan.

The compensation cost related to unvested stock options not yet recognized as of September 30, 2016 is \$5.5 million and is expected to be recognized over a weighted-average period of 2.5 years.

The following weighted average assumptions were used to determine the fair value of the stock options granted on the original grant date for expense recognition purposes for options granted during the nine months ended September 30, 2016 and 2015 using a Black Scholes Model:

|                          | Nine months ended |         |               |  |
|--------------------------|-------------------|---------|---------------|--|
|                          | September 30,     |         | September 30, |  |
|                          | 2016              | 2015    |               |  |
| Director and Officers:   |                   |         |               |  |
| Expected dividend rate   | \$0.22            | \$ 0.18 |               |  |
| Expected volatility      | 42.38 %           | 44.14   | %             |  |
| Risk-free interest rate  | 2.02 %            | 1.97    | %             |  |
| Expected life (in years) | 8.0               | 8.0     |               |  |

|                          |         |         |   |  |
|--------------------------|---------|---------|---|--|
| Employees:               |         |         |   |  |
| Expected dividend rate   | \$0.22  | \$ 0.18 |   |  |
| Expected volatility      | 40.41 % | 44.13   | % |  |
| Risk-free interest rate  | 1.60 %  | 2.05    | % |  |
| Expected life (in years) | 7.3     | 8.0     |   |  |

The expected term of the options is based on evaluations of historical and expected future employee exercise behavior. The risk-free interest rate is based on the U.S. Treasury rates at the date of grant with maturity dates approximately equal to the expected life at the grant date. Volatility is based on historical volatility of our stock over time periods equal to the expected life at grant date.

The following is a summary of stock options vested and exercisable as of September 30, 2016:

| Range of Exercise Prices | Number of Shares | Weighted Average Remaining Contractual Life (in years) | Weighted Average Exercise Price | Intrinsic Value (in thousands) |
|--------------------------|------------------|--|---------------------------------|--------------------------------|
| \$4.54-\$8.65            | 329,433          | 4.79   | \$ 7.62                         | \$ 6,984                       |
| \$8.70-\$22.76           | 38,598           | 7.01   | 15.09                           | 530                            |

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|                 |         |      |         |          |
|-----------------|---------|------|---------|----------|
| \$23.57-\$28.20 | 7,764   | 8.31 | 23.61   | 40       |
| Total           | 375,795 | 5.09 | \$ 8.72 | \$ 7,554 |

The following is a summary of stock options vested and exercisable as of September 30, 2015:

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| Range of Exercise Prices | Number of Shares | Weighted Average Remaining Contractual Life (in years) | Weighted Average Exercise Price | Intrinsic Value (in thousands) |
|--------------------------|------------------|--|---------------------------------|--------------------------------|
| \$4.31-\$7.18            | 261,442          | 4.11   | \$ 5.93                         | \$ 3,516                       |
| \$7.44-\$8.17            | 17,550           | 5.84   | 7.72                            | 205                            |
| \$8.65-\$23.57           | 176,895          | 6.71   | 9.04                            | 1,830                          |
| Total                    | 455,887          | 5.18   | \$ 7.20                         | \$ 5,551                       |

A summary of option activity under the plans is as follows:

| Options                           | Shares     | Weighted Average Exercise Price |
|-----------------------------------|------------|---------------------------------|
| Outstanding at December 31, 2015  | 1,130,910  | \$ 13.38                        |
| Granted                           | 236,210    | 25.03                           |
| Exercised                         | (227,244 ) | 7.39                            |
| Forfeited or Expired              | (48,939 )  | 20.09                           |
| Outstanding at September 30, 2016 | 1,090,937  | \$ 16.85                        |
| Exercisable at September 30, 2016 | 375,795    | \$ 8.72                         |

The total intrinsic value of options exercised during the nine months ended September 30, 2016 and 2015 was \$4.3 million and \$7.0 million, respectively. The cash received from options exercised during the nine months ended September 30, 2016 and 2015 was \$1.7 million and \$2.6 million, respectively. The impact of these cash receipts is included in financing activities in the accompanying Consolidated Statements of Cash Flows.

Since 2007, as part of the LTIP and since May 2016 as part of the 2016 Plan, the Compensation Committee of the Board of Directors has authorized and issued restricted stock awards to directors and key employees. Restricted stock awards granted to directors vest one-third each year. All other restricted stock awards vest at a rate of 20% per year. The fair value of restricted stock awards is based on the fair market value of AAON, Inc. common stock on the respective grant dates, reduced for the present value of dividends.

These awards are recorded at their fair value on the date of grant and compensation cost is recorded using straight-line vesting over the service period. At September 30, 2016, unrecognized compensation cost related to unvested restricted stock awards was approximately \$7.2 million, which is expected to be recognized over a weighted average period of 2.0 years.

A summary of the unvested restricted stock awards is as follows:

| Restricted stock              | Shares  | Weighted Average Grant Date Fair Value |
|-------------------------------|---------|--|
| Unvested at December 31, 2015 | 410,023 | \$ 18.78                               |
| Granted                       | 131,850 | 22.82                                  |

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|                                |           |          |
|--------------------------------|-----------|----------|
| Vested                         | (92,391 ) | 17.73    |
| Forfeited                      | (12,759 ) | 18.51    |
| Unvested at September 30, 2016 | 436,723   | \$ 20.23 |

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A summary of share-based compensation is as follows:

|  | Three months ended |        | Nine months ended  |          |
|--|--------------------|--------|--------------------|----------|
|  | September 30, 2016 |        | September 30, 2015 |          |
|  | 2016               | 2015   | 2016               | 2015     |
| Grant date fair value of awards during the period: (in thousands)    |                    |        |                    |          |
| Options  | \$360              | \$ —   | \$2,419            | \$ 657   |
| Restricted stock   | 67                 | 262    | 3,009              | 2,818    |
| Total  | \$427              | \$ 262 | \$5,428            | \$ 3,475 |
| Share-based compensation expense:                                    |                    |        |                    |          |
| Options  | \$457              | \$203  | \$1,198            | \$601    |
| Restricted stock   | 672                | 592    | 1,974              | 1,475    |
| Total  | \$1,129            | \$795  | \$3,172            | \$2,076  |
| Income tax benefit/(deficiency) related to share-based compensation: |                    |        |                    |          |
| Options  |                    |        | \$311              | \$(123)  |
| Restricted stock   |                    |        | 326                | (112)    |
| Total  |                    |        | \$637              | \$(235)  |

In March 2016, the FASB issued ASU 2016-09, Improvements to Employee Share-Based Payment Accounting, which makes several modifications to Topic 718 including: accounting for excess tax benefits and deficiencies; classifying excess tax benefits on the statement of cash flows; accounting for forfeitures; classifying awards that permit share repurchases to satisfy statutory tax-withholding requirement; and classifying tax payments on behalf of employees on the statement of cash flows. The ASU becomes effective for interim and annual reporting periods beginning after December 31, 2016. We early adopted the ASU effective July 1, 2016.

The Company previously applied a forfeiture rate to its share-based compensation expense and adjusted expense to actual as awards vested and/or were forfeited. Upon adoption of ASU 2016-09, the Company accounts for forfeitures as they occur, rather than estimating forfeitures as of an award's grant date. This change in accounting policy election was adopted using a modified retrospective transition method and the Company recognized a cumulative-effect adjustment to retained earnings of approximately \$150,000.

Tax payments made on behalf of an employee by repurchasing shares of stock are now shown separately as cash outflows from financing activities on the statement of cash flows. This provision was retrospectively adopted and prior period cash flows have been reclassified to conform with this presentation.

Additionally, the Company retrospectively adopted the provision to classify excess tax benefits and deficiencies as cash flows from operating activities as part of cash payments for taxes on the statement of cash flows. Prior period cash flows have been reclassified to conform with this presentation.

## 12. Earnings Per Share

Basic net income per share is calculated by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted net income per share assumes the conversion of all potentially dilutive securities and is calculated by dividing net income by the sum of the weighted average number of shares of common stock outstanding plus all potentially dilutive securities. Dilutive common shares consist primarily of stock options and restricted stock awards.

ASU 2016-09 impacts the calculation of diluted weighted average shares under the treasury stock method as the Company no longer increases or decreases the assumed proceeds from an employee vesting in, or exercising, a share-based payment award by the amount of excess tax benefits or deficiencies taken to additional paid-in capital.





|   | Three months ended<br>September 30,<br>2016     |            | September 30,<br>2015 |  | Nine months ended<br>September 30,<br>2016 |            | September 30,<br>2015 |  |
|---|---|------------|-----------------------|--|--|------------|-----------------------|--|
|   | (in thousands, except share and per share data) |            |                       |  |  |            |                       |  |
| Numerator:  |   |            |                       |  |  |            |                       |  |
| Net income  | \$ 15,682                                       | \$ 13,251  |                       |  | \$ 41,956                                  | \$ 32,780  |                       |  |
| Denominator:  |   |            |                       |  |  |            |                       |  |
| Basic weighted average shares                         | 52,891,875                                      | 54,209,942 |                       |  | 52,942,574                                 | 54,160,649 |                       |  |
| Effect of dilutive stock options and restricted stock | 502,452   | 369,648    |                       |  | 524,452                                    | 462,514    |                       |  |
| Diluted weighted average shares                       | 53,394,327                                      | 54,579,590 |                       |  | 53,467,026                                 | 54,623,163 |                       |  |
| Earnings per share:                                   |   |            |                       |  |  |            |                       |  |
| Basic   | \$0.30  | \$ 0.24    |                       |  | \$0.79                                     | \$ 0.61    |                       |  |
| Diluted   | \$0.29  | \$ 0.24    |                       |  | \$0.78                                     | \$ 0.60    |                       |  |
| Anti-dilutive shares:                                 |   |            |                       |  |  |            |                       |  |
| Shares  | 551,940   | 138,661    |                       |  | 512,823                                    | 135,971    |                       |  |

Our recent dividends are as follows:

| Declaration Date | Record Date      | Payment Date      | Dividend<br>per<br>Share |
|------------------|------------------|-------------------|--------------------------|
| May 19, 2015     | June 12, 2015    | July 1, 2015      | \$ 0.11                  |
| October 29, 2015 | December 2, 2015 | December 23, 2015 | \$ 0.11                  |
| May 24, 2016     | June 10, 2016    | July 1, 2016      | \$ 0.11                  |

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#### 14. Commitments and Contingencies

We are subject to various claims and legal actions that arise in the ordinary course of business. We closely monitor these claims and legal actions and frequently consult with our legal counsel to determine whether they may, when resolved, have a material adverse effect on our financial position, results of operations or cash flows and we accrue and/or disclose loss contingencies as appropriate. We have concluded that the likelihood is remote that the ultimate resolution of any pending litigation or claims will be material or have a material adverse effect on the Company's business, financial position, results of operations or cash flows.

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the notes thereto, which are included in this report, and our audited consolidated financial statements and the notes thereto, which are included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2015. This discussion contains or incorporates by reference “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are not historical facts, but rather are based on expectations, estimates, assumptions and projections about our industry, business and future financial results, based on information available at the time this report is filed with the SEC or, with respect to any document incorporated by reference, available at the time that such document was prepared. Our actual results could differ materially from the results contemplated by these forward-looking statements due to a number of factors, including those identified in the section entitled “Forward-Looking Statements” in this Item 2 of this Quarterly Report on Form 10-Q and in the section entitled “Risk Factors” in Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2015. We do not assume any obligation to update or revise any forward-looking statements to reflect changed assumptions, the occurrence of anticipated or unanticipated events, new information or circumstances or otherwise, except as required by law.

#### Overview

We engineer, manufacture and market air conditioning and heating equipment consisting of standard, semi-custom and custom rooftop units, chillers, packaged outdoor mechanical rooms, air handling units, makeup air units, energy recovery units, condensing units, geothermal/water-source heat pumps and coils. These products are marketed and sold to retail, manufacturing, educational, lodging, supermarket, medical and other commercial industries. We market our products to all 50 states in the United States and certain provinces in Canada. Foreign sales were approximately \$11.7 million of our total net sales for the nine months just ended and \$11.1 million of our sales during the same period of 2015.

Our business can be affected by a number of economic factors, including the level of economic activity in the markets in which we operate. The uncertainty of the economy has negatively impacted the commercial and industrial new construction markets. A further decline in economic activity could result in a decrease in our sales volume and profitability. Sales in the commercial and industrial new construction markets correlate closely to the number of new homes and buildings that are built, which in turn is influenced by cyclical factors such as interest rates, inflation, consumer spending habits, employment rates and other macroeconomic factors over which we have no control.

We sell our products to property owners and contractors through a network of manufacturers' representatives and our internal sales force. The demand for our products is influenced by national and regional economic and demographic factors. The commercial and industrial new construction market is subject to cyclical fluctuations in that it is generally tied to housing starts, but has a lag factor of six to 18 months. Housing starts, in turn, are affected by such factors as interest rates, the state of the economy, population growth and the relative age of the population. When new

construction is down, we emphasize the replacement market. The new construction market in 2015 through the third quarter of 2016 continued to be unpredictable and uneven. Thus, we continue to emphasize promotion of the benefits of AAON equipment to property owners in the replacement market.

The principal components of cost of goods sold are labor, raw materials, component costs, factory overhead, freight and engineering expense. The principal high volume raw materials used in our manufacturing processes are steel, copper and aluminum, and are obtained from domestic suppliers. We also purchase from domestic manufacturers certain components, including compressors, motors and electrical controls.

The price levels of our raw materials have remained relatively consistent the past few years, but the market continues to be volatile and unpredictable as a result of the uncertainty related to the U.S. economy and a weakening global economy. For the nine months ended September 30, 2016, the price for copper, galvanized steel, stainless steel and aluminum decreased by approximately 8.6%, 15.9%, 17.3% and 2.9%, respectively, from the nine months ended September 30, 2015.

In 2011, we began using an all aluminum microchannel condenser coil on our small rooftop unit product line and, in 2013, we began using this condenser coil in our larger rooftop product line as well. The condenser coil is the outdoor coil of a conventional air conditioning system. We are using this type of condenser coil substantially throughout the complete rooftop unit product line. This has reduced our copper tube usage in this component of the product, however, copper will remain a high volume raw material because of its use throughout the equipment.

The following are recent highlights and items that impacted our results of operations, cash flows and financial condition:

• Overall unit sales increased approximately 20.4% as compared to the same period last year, driving the increase in sales for the quarter.

• Cash and cash equivalents increased \$6.7 million primarily from cash inflows from operations.

• We invested \$23.6 million in capital expenditures in connection with the construction of our new research and development lab, water source heat pump line and other internal projects.

## Results of Operations

Three Months Ended September 30, 2016 vs. Three Months Ended September 30, 2015

### Units Sold

|                          | Three<br>Months<br>Ended<br>September<br>30,<br>2016 2015 |       |
|--------------------------|---|-------|
| Rooftop Units            | 4,694   | 3,934 |
| Split Systems            | 1,104   | 883   |
| Outdoor Mechanical Rooms | 15  | 11    |
| Total Units              | 5,813   | 4,828 |

### Net Sales

|             | Three Months Ended<br>September 30, |          |          |             |
|-------------|-------------------------------------|----------|----------|-------------|
|             | 2016                                | 2015     | Change   | %<br>Change |
|             | (in thousands, except unit data)    |          |          |             |
| Net sales   | \$104,568                           | \$94,360 | \$10,208 | 10.8 %      |
| Total units | 5,813                               | 4,828    | 985      | 20.4 %      |

Sales increased primarily due to increased volume as compared to the prior year, offset by changes in product mix.

### Cost of Sales

| Three Months<br>Ended<br>September 30, |      | Percent of<br>Sales |      |
|--|------|---------------------|------|
| 2016                                   | 2015 | 2016                | 2015 |
| (in thousands)                         |      |                     |      |

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|               |          |          |       |       |
|---------------|----------|----------|-------|-------|
| Cost of sales | \$71,476 | \$64,175 | 68.4% | 68.0% |
| Gross Profit  | 33,092   | 30,185   | 31.6% | 32.0% |

The principal components of cost of sales are labor, raw materials, component costs, factory overhead, freight out and engineering expense. The principal high volume raw materials used in our manufacturing processes are steel, copper and aluminum, which are obtained from domestic suppliers. Cost of sales increased overall due to the corresponding increase in sales.

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Twelve-month average raw material cost per pound as of September 30:

|                  | 2016   | 2015   | %<br>Change |
|------------------|--------|--------|-------------|
| Copper           | \$3.38 | \$3.70 | (8.6 )%     |
| Galvanized Steel | \$0.37 | \$0.44 | (15.9)%     |
| Stainless Steel  | \$1.15 | \$1.39 | (17.3)%     |
| Aluminum         | \$1.65 | \$1.70 | (2.9 )%     |

#### Selling, General and Administrative Expenses

|                     | Three Months<br>Ended<br>September 30, |          | Percent of<br>Sales |       |   |
|---------------------|--|----------|---------------------|-------|---|
|                     | 2016                                   | 2015     | 2016                | 2015  |   |
|                     | (in thousands)                         |          |                     |       |   |
| Warranty            | \$1,012                                | \$1,289  | 1.0%                | 1.4   | % |
| Profit Sharing      | 2,572                                  | 2,265    | 2.5%                | 2.4   | % |
| Salaries & Benefits | 3,150                                  | 2,722    | 3.0%                | 2.9   | % |
| Stock Compensation  | 751                                    | 579      | 0.7%                | 0.6   | % |
| Advertising         | 271                                    | 259      | 0.3%                | 0.3   | % |
| Depreciation        | 201                                    | 245      | 0.2%                | 0.3   | % |
| Insurance           | 292                                    | 305      | 0.3%                | 0.3   | % |
| Professional Fees   | 605                                    | 419      | 0.6%                | 0.4   | % |
| Donations           | 41                                     | 447      | — %                 | 0.5   | % |
| Bad Debt Expense    | 72                                     | 53       | 0.1%                | 0.1   | % |
| Other               | 1,433                                  | 1,479    | 1.4%                | 1.6   | % |
| Total SG&A          | \$10,400                               | \$10,062 | 9.9%                | 10.7% |   |

The overall increase in SG&A was primarily due to increased compensation and profit sharing expenses due to better results versus the same period last year. The increase was partially offset by decreases in non-recurring donations and warranty expenses.

#### Income Taxes

|                      | Three Months<br>Ended<br>September 30, |         | Effective Tax<br>Rate |        |
|----------------------|--|---------|-----------------------|--------|
|                      | 2016                                   | 2015    | 2016                  | 2015   |
|                      | (in thousands)                         |         |                       |        |
| Income tax provision | \$7,080                                | \$6,862 | 31.1 %                | 34.1 % |

The Company's estimated annual 2016 effective tax rate, excluding discrete events, is expected to be approximately 36.0%. The Indian Employment Credit and Research and Development Credit were not extended until December 2015 for the 2015 and 2016 tax years. As such, the effective rate for the three months ended September 30, 2016 is reduced for the impact of these credits while the effective rate for the three months ended September 30, 2015 does not reflect these credits. Additionally, the Company early adopted ASU 2016-09, Improvements to Employee Share-Based Payment Accounting, applying the changes for excess tax benefits and tax deficiencies prospectively. As a result, excess tax benefits and deficiencies are reported as an income tax benefit or expense on the statement of income rather than as a component of additional paid-in capital on the statement of equity. Excess tax benefits and

deficiencies are treated as discrete items to the income tax provision in the reporting period in which they occur. For the three months ended September 30, 2016, the Company recorded \$0.6 million in excess tax benefits as an income tax benefit.

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Nine Months Ended September 30, 2016 vs. Nine Months Ended September 30, 2015

#### Units Sold

|                          | Nine Months<br>Ended<br>September 30,<br>2016 2015 |        |
|--------------------------|--|--------|
| Rooftop Units            | 13,086   | 11,115 |
| Split Systems            | 2,843  | 2,501  |
| Outdoor Mechanical Rooms | 46   | 42     |
| Total Units              | 15,975   | 13,658 |

#### Net Sales

|             | Nine Months Ended<br>September 30, |           |          |             |
|-------------|------------------------------------|-----------|----------|-------------|
|             | 2016                               | 2015      | Change   | %<br>Change |
|             | (in thousands, except unit data)   |           |          |             |
| Net sales   | \$292,309                          | \$261,403 | \$30,906 | 11.8 %      |
| Total units | 15,975                             | 13,658    | 2,317    | 17.0 %      |

Sales increased primarily due to increased volume as compared to the prior year.

#### Cost of Sales

|               | Nine Months<br>Ended<br>September 30, |           | Percent of<br>Sales |       |
|---------------|---------------------------------------|-----------|---------------------|-------|
|               | 2016                                  | 2015      | 2016                | 2015  |
|               | (in thousands)                        |           |                     |       |
| Cost of sales | \$200,739                             | \$182,303 | 68.7%               | 69.7% |
| Gross Profit  | 91,570                                | 79,100    | 31.3%               | 30.3% |

The principal components of cost of sales are labor, raw materials, component costs, factory overhead, freight out and engineering expense. The principal high volume raw materials used in our manufacturing processes are steel, copper and aluminum, which are obtained from domestic suppliers. Cost of sales increased overall due to the corresponding increase in sales.

Twelve-month average raw material cost per pound as of September 30:

|                  | 2016   | 2015   | %<br>Change |
|------------------|--------|--------|-------------|
| Copper           | \$3.38 | \$3.70 | (8.6 )%     |
| Galvanized Steel | \$0.37 | \$0.44 | (15.9)%     |
| Stainless Steel  | \$1.15 | \$1.39 | (17.3)%     |
| Aluminum         | \$1.65 | \$1.70 | (2.9 )%     |



## Selling, General and Administrative Expenses

|                     | Nine Months<br>Ended<br>September 30, |          | Percent of<br>Sales |        |  |  |
|---------------------|---------------------------------------|----------|---------------------|--------|--|--|
|                     | 2016                                  | 2015     | 2016                | 2015   |  |  |
|                     | (in thousands)                        |          |                     |        |  |  |
| Warranty            | \$2,654                               | \$3,254  | 0.9 %               | 1.2 %  |  |  |
| Profit Sharing      | 7,022                                 | 5,817    | 2.4 %               | 2.2 %  |  |  |
| Salaries & Benefits | 9,352                                 | 7,842    | 3.2 %               | 3.0 %  |  |  |
| Stock Compensation  | 2,156                                 | 1,506    | 0.7 %               | 0.6 %  |  |  |
| Advertising         | 1,028                                 | 651      | 0.4 %               | 0.2 %  |  |  |
| Depreciation        | 638                                   | 711      | 0.2 %               | 0.3 %  |  |  |
| Insurance           | 935                                   | 914      | 0.3 %               | 0.3 %  |  |  |
| Professional Fees   | 1,444                                 | 1,421    | 0.5 %               | 0.5 %  |  |  |
| Donations           | 253                                   | 403      | 0.1 %               | 0.2 %  |  |  |
| Bad Debt Expense    | 10                                    | (41 )    | — %                 | — %    |  |  |
| Other               | 4,382                                 | 5,101    | 1.5 %               | 2.0 %  |  |  |
| Total SG&A          | \$29,874                              | \$27,579 | 10.2 %              | 10.6 % |  |  |

The overall increase in SG&A was primarily due to increased compensation costs and profit sharing expenses due to better results versus the same period last year. The increase was partially offset by a decrease in warranty expense related to continued improvement in quality control and other expense, which was higher in 2015 due to sales taxes to certain states. As a percentage of sales, SG&A decreased .4% due to effective cost management and efficiencies gained.

## Income Taxes

|                      | Nine Months<br>Ended<br>September 30, |          | Effective Tax<br>Rate |        |
|----------------------|---------------------------------------|----------|-----------------------|--------|
|                      | 2016                                  | 2015     | 2016                  | 2015   |
|                      | (in thousands)                        |          |                       |        |
| Income tax provision | \$20,098                              | \$18,781 | 32.4 %                | 36.4 % |

The Company's estimated annual 2016 effective tax rate, excluding discrete events, is expected to be approximately 36.0%. The Indian Employment Credit and Research and Development Credit were not extended until December 2015 for the 2015 and 2016 tax years. As such, the effective rate for the nine months ended September 30, 2016 is reduced for the impact of these credits while the effective rate for the nine months ended September 30, 2015 does not reflect these credits. Additionally, the Company early adopted ASU 2016-09, Improvements to Employee Share-Based Payment Accounting, applying the changes for excess tax benefits and tax deficiencies prospectively. As a result, excess tax benefits and deficiencies are reported as an income tax benefit or expense on the statement of income rather than as a component of additional paid-in capital on the statement of equity. Excess tax benefits and deficiencies are treated as discrete items to the income tax provision in the reporting period in which they occur. For the nine months ended September 30, 2016, the Company recorded \$1.8 million in excess tax benefits as an income tax benefit.

## Liquidity and Capital Resources

Our working capital and capital expenditure requirements are generally met through net cash provided by operations and the occasional use of our revolving credit facility.

Our cash and short-term investments increased \$10.9 million from December 31, 2015 to September 30, 2016 and totaled \$41.3 million at September 30, 2016; while long-term investments decreased \$6.9 million, from \$6.9 million to \$0.0 million, respectively.

Under the line of credit, there was one standby letter of credit of \$0.8 million as of September 30, 2016. At September 30, 2016, we have \$29.2 million of borrowings available under the revolving credit facility. No fees are associated with the unused portion of the committed amount.

We had no outstanding balance under the revolving credit facility at September 30, 2016 and December 31, 2015. Interest on borrowings is payable monthly at LIBOR plus 2.5%. The termination date of the revolving credit facility is July 27, 2018.

At September 30, 2016, we were in compliance with all of the covenants under the revolving credit facility. We are obligated to comply with certain financial covenants under the revolving credit facility. These covenants require that we meet certain parameters related to our tangible net worth and total liabilities to tangible net worth ratio. At September 30, 2016, our tangible net worth was \$204.8 million, which meets the requirement of being at or above \$125.0 million. Our total liabilities to tangible net worth ratio was 0.26 to 1.0 which meets the requirement of not being above 2 to 1.

The Board has authorized three stock repurchase programs for the Company. The Company may purchase shares on the open market from time to time, up to a total of 5.7 million shares. The Board must authorize the timing and amount of these purchases. Effective May 24, 2016, the Board authorized up to \$25.0 million in open market repurchases and on June 2, 2016, the Company executed a repurchase agreement in accordance with the rules and regulations of the SEC allowing the Company to repurchase an aggregate amount of \$25.0 million or a total of approximately 2.0 million shares from the open market. The agreement will terminate upon the aforementioned thresholds having been met, on April 15, 2017, or upon other provisions contained in the repurchase agreement by either the Company or its agent. The Company also has a stock repurchase arrangement by which employee-participants in our 401(k) savings and investment plan are entitled to have shares in AAON, Inc. stock in their accounts sold to the Company. The maximum number of shares to be repurchased is contingent upon the number of shares sold by employee-participants. Lastly, the Company repurchases shares of AAON, Inc. stock from certain of its directors and employees for payment of statutory tax withholdings on stock transactions. Any other repurchases from directors or employees is contingent upon Board approval. All repurchases are done at current market prices.

Our repurchase activity is as follows:

| Program                 | Nine Months Ended<br>September 30,<br>2016 |              |              | 2015    |             |              | Inception to date |               |              |
|-------------------------|--|--------------|--------------|---------|-------------|--------------|-------------------|---------------|--------------|
|                         | Shares                                     | Total \$     | \$ per share | Shares  | Total \$    | \$ per share | Shares            | Total \$      | \$ per share |
| Open market             | 151,266                                    | \$4,041,685  | \$26.72      | —       | \$—         | \$—          | 3,820,487         | \$60,549,487  | \$15.85      |
| 401(k)                  | 402,623                                    | 10,531,020   | 26.16        | 403,172 | 9,075,481   | 22.51        | 5,944,566         | 61,387,891    | 10.33        |
| Directors and employees | 21,367                                     | 558,532      | 26.14        | 15,740  | 361,977     | 23.00        | 1,864,927         | 15,398,694    | 8.26         |
| Total                   | 575,256                                    | \$15,131,237 | \$26.30      | 418,912 | \$9,437,458 | \$22.53      | 11,629,980        | \$137,336,072 | \$11.81      |

Subsequent to September 30, 2016, the Company has repurchased approximately an additional 34,455 shares for \$1.0 million.

Dividends - At the discretion of the Board of Directors, we pay semi-annual cash dividends. Board approval is required to determine the date of declaration and amount for each semi-annual dividend payment.

Our recent dividends are as follows:

| Declaration Date | Record Date      | Payment Date      | Dividend<br>per<br>Share |
|------------------|------------------|-------------------|--------------------------|
| May 19, 2015     | June 12, 2015    | July 1, 2015      | \$ 0.11                  |
| October 29, 2015 | December 2, 2015 | December 23, 2015 | \$ 0.11                  |
| May 24, 2016     | June 10, 2016    | July 1, 2016      | \$ 0.11                  |

Based on historical performance and current expectations, we believe our cash and cash equivalents balance, the projected cash flows generated from our operations, our existing committed revolving credit facility (or comparable financing) and our expected ability to access capital markets will satisfy our working capital needs, capital expenditures and other liquidity requirements associated with our operations in 2016 and the foreseeable future.

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## Statement of Cash Flows

The following table reflects the major categories of cash flows for the nine months ended September 30, 2016 and 2015. For additional details, see the Condensed Consolidated Statements of Cash Flows in the condensed consolidated financial statements.

|   | Nine months ended<br>September 30,<br>2016      2015<br>(in thousands) |            |
|---|--|------------|
| Operating Activities  |  |            |
| Net Income  | \$41,956   | \$32,780   |
| Income statement adjustments, net   | 11,787   | 9,704      |
| Changes in assets and liabilities:  |  |            |
| Accounts receivable   | (3,340 )   | (1,685 )   |
| Income taxes  | 2,230  | 2,614      |
| Inventories   | (5,322 )   | (3,323 )   |
| Prepaid expenses and other  | (287 )   | (154 )     |
| Accounts payable  | 949  | (3,801 )   |
| Deferred revenue  | 334  | 138        |
| Accrued liabilities & donations   | (1,300 )   | 2,130      |
| Net cash provided by operating activities   | 47,007   | 38,403     |
| Investing Activities  |  |            |
| Capital expenditures  | (23,627 )  | (12,775 )  |
| Purchases of investments  | (14,496 )  | (20,383 )  |
| Maturities of investments and proceeds from called investments  | 16,973   | 15,322     |
| Other   | 67   | 105        |
| Net cash used in investing activities   | (21,083 )  | (17,731 )  |
| Financing Activities  |  |            |
| Stock options exercised and excess tax benefits from stock options exercised and restricted stock awards vested | 1,681  | 2,640      |
| Repurchase of stock   | (14,572 )  | (9,074 )   |
| Employee taxes paid by withholding shares   | (559 )   | (362 )     |
| Cash dividends paid to stockholders   | (5,820 )   | (5,965 )   |
| Net cash used in financing activities   | \$(19,270)   | \$(12,761) |

## Cash Flows Provided by Operating Activities

The increase in cash flows from operations is primarily due to the increase in net income and decreases in our estimated tax payments offset by cash outflows in accounts receivable and inventory caused by the increased level of sales in 2016 versus 2015.

## Cash Flows Used in Investing Activities

Capital expenditures increased compared to the prior year due to continued investment in our new research and development lab as well as other construction projects. The capital expenditure program for 2016 is estimated to be approximately \$32.7 million. Overall purchases of investments have decreased due to the increase in capital expenditures.

Cash Flows Used in Financing Activities

Cash outflows increased primarily due to our renewed stock buyback program.

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#### Off-Balance Sheet Arrangements

We are not party to any off-balance sheet arrangements that have or are reasonably likely to have a material current or future effect on our financial condition, changes in financial condition, revenues, expenses, results of operations, liquidity, capital expenditures or capital resources.

#### Contractual Obligations

We had no material contractual purchase agreements as of September 30, 2016.

#### Critical Accounting Policies

There have been no material changes in the Company's critical accounting policies during the nine months ended September 30, 2016 other than our early adoption of ASU 2016-09, Improvements to Employee Share-Based Payment Accounting as discussed in the Notes to the Consolidated Financial Statements.

#### Recent Accounting Pronouncements

See Note 1 of the Notes to the Consolidated Financial Statements for a discussion of recent accounting pronouncements.

#### Forward-Looking Statements

This Quarterly Report on Form 10-Q includes "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as "expects", "anticipates", "intends", "plans", "believes", "seeks", "estimates", "should", and variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions, which are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date on which they are made. We undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise. Important factors that could cause results to differ materially from those in the forward-looking statements include (1) the timing and extent of changes in raw material and component prices, (2) the effects of fluctuations in the commercial/industrial new construction market, (3) the timing and extent of changes in interest rates, as well as other competitive factors during the year, and (4) general economic, market or business conditions.

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

##### Commodity Price Risk

We are exposed to volatility in the prices of commodities used in some of our products and we may use fixed price cancellable and non-cancellable contracts with our major suppliers for periods of six to 18 months to manage this exposure.

#### Item 4. Controls and Procedures.

##### (a) Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this Quarterly Report on Form 10-Q, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer with the oversight of the Audit Committee, regarding the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded, as of the end of the period covered by this Quarterly Report, that our disclosure controls and procedures were effective.

(c) Changes in Internal Control over Financial Reporting

There have been no changes in internal control over financial reporting that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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## PART II – OTHER INFORMATION

## Item 1. Legal Proceedings.

We are subject to various claims and legal actions that arise in the ordinary course of business. We closely monitor these claims and legal actions and frequently consult with our legal counsel to determine whether they may, when resolved, have a material adverse effect on our financial position, results of operations, or cash flows and we accrue and/or disclose loss contingencies as appropriate. We have concluded that the likelihood is remote that the ultimate resolution of any pending litigation or claims will be material or have a material adverse effect on the Company's business, financial position, results of operations or cash flows.

## Item 1A. Risk Factors.

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2015. The risk factors described in our Annual Report could materially adversely affect our business, financial condition or future results. There have been no material changes to the risk factors included in our 2015 Annual Report.

## Item 2. Unregistered Sales of Equity and Securities and Use of Proceeds.

On May 17, 2010, the Board authorized a stock buyback program, targeting open market repurchases of up to approximately 5% (2.9 million shares) of the Company's outstanding stock. In May 2015, the Board authorized repurchases up to an additional 2.75 million shares, or a total of approximately 5.7 million shares. In October 2015, the Board authorized \$25.0 million for use under the Company's stock buyback program. Effective May 24, 2016, the Board authorized up to \$25.0 million in open market repurchases and on June 2, 2016, the Company executed a repurchase agreement in accordance with the rules and regulations of the SEC allowing the Company to repurchase an aggregate amount of \$25.0 million or a total of approximately 2.0 million shares from the open market. The agreement will terminate upon the aforementioned thresholds having been met, on April 15, 2017, or upon other provisions contained in the repurchase agreement by either the Company or its agent. We have repurchased a total of approximately 3.8 million shares under these programs for an aggregate price of \$60.5 million, or an average price of \$15.85 per share. We purchased the shares at current market prices.

On July 1, 2005, we entered into a stock repurchase arrangement by which employee-participants in our 401(k) savings and investment plan are entitled to have shares of AAON, Inc. stock in their accounts sold to the Company. The maximum number of shares to be repurchased is contingent upon the number of shares sold by employees. Through September 30, 2016, we repurchased approximately 5.9 million shares for an aggregate price of \$61.4 million, or an average price of \$10.33 per share. We purchased the shares at current market prices.

Periodically, the Company repurchases shares of AAON, Inc. stock from certain of its directors and employees. The number of shares to be repurchased is contingent upon Board approval. Through September 30, 2016, we repurchased approximately 1.9 million shares for an aggregate price of \$15.4 million, or an average price of \$8.26 per share. We purchased the shares at current market prices.

Repurchases during the third quarter of 2016 were as follows:

| Period | ISSUER PURCHASES OF EQUITY<br>SECURITIES |                  |                 |                       |
|--------|--|------------------|-----------------|-----------------------|
|        | (a)                                      | (b)              | (c)             | (d)                   |
|        | Total<br>Number                          | Average<br>Price | Total<br>Number | Maximum<br>Number (or |

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|                | of<br>Shares<br>(or<br>Units)<br>Purchased | Paid<br>Per<br>Share<br>(or<br>Unit) | of Shares<br>(or<br>Units)<br>Purchased<br>as part of<br>Publicly<br>Announced<br>Plans or<br>Programs | Approximate<br>Dollar<br>Value) of<br>Shares (or<br>Units) that<br>may yet be<br>Purchased<br>under the<br>Plans or<br>Programs |
|----------------|--|--------------------------------------|--|---|
| July 2016      | 92,335                                     | \$ 26.90                             | 92,335   | —   |
| August 2016    | 94,649                                     | 26.99                                | 94,649   | —   |
| September 2016 | 86,767                                     | 27.88                                | 86,767   | —   |
| Total          | 273,751                                    | \$ 27.24                             | 273,751  | —   |

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Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 4A. Submission of Matters to a Vote of Security Holders.

None.

Item 5. Other Information.

None.

Item 6. Exhibits.

(a) Exhibits

- (i) Exhibit 31.1 Section 302 Certification of CEO
- (ii) Exhibit 31.2 Section 302 Certification of CFO
- (iii) Exhibit 32.1 Section 1350 Certification of CEO
- (iv) Exhibit 32.2 Section 1350 Certification of CFO

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.

AAON, INC.

Dated: November 3, 2016 By: /s/ Norman H. Asbjornson  
Norman H. Asbjornson  
President/CEO

Dated: November 3, 2016 By: /s/ Scott M. Asbjornson  
Scott M. Asbjornson  
Chief Financial Officer