

AARON'S INC  
Form 10-Q  
August 02, 2013

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

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2013

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)

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 (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

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

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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	Shares Outstanding as of July 30, 2013
Common Stock, \$.50 Par Value	75,985,522

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## PART I—FINANCIAL INFORMATION

## Item 1—Financial Statements

AARON'S, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Data)	(Unaudited) June 30, 2013	December 31, 2012
<b>ASSETS:</b>		
Cash and Cash Equivalents	\$210,665	\$129,534
Investments	93,409	85,861
Accounts Receivable (net of allowances of \$6,628 in 2013 and \$6,001 in 2012)	58,473	74,157
Lease Merchandise (net of accumulated depreciation of \$587,237 in 2013 and \$575,527 in 2012)	965,909	964,067
Property, Plant and Equipment at Cost (net of accumulated depreciation and amortization of \$186,213 in 2013 and \$173,915 in 2012)	231,678	230,598
Goodwill	235,048	234,195
Other Intangibles, Net	4,328	6,026
Prepaid Expenses and Other Assets	68,450	77,387
Assets Held For Sale	7,252	11,104
Total Assets	\$1,875,212	\$1,812,929
<b>LIABILITIES &amp; SHAREHOLDERS' EQUITY:</b>		
Accounts Payable and Accrued Expenses	\$223,973	\$225,532
Deferred Income Taxes Payable	254,510	263,721
Customer Deposits and Advance Payments	39,853	46,022
Debt	141,348	141,528
Total Liabilities	659,684	676,803
Commitments and Contingencies (Note 5)		
Shareholders' Equity:		
Common Stock, Par Value \$.50 Per Share; Authorized: 225,000,000 Shares at June 30, 2013 and December 31, 2012; Shares Issued: 90,752,123 at June 30, 2013 and December 31, 2012	45,376	45,376
Additional Paid-in Capital	221,902	220,362
Retained Earnings	1,161,308	1,087,032
Accumulated Other Comprehensive Loss	(86 )	(69 )
	1,428,500	1,352,701
Less: Treasury Shares at Cost		
Common Stock, 14,781,707 Shares at June 30, 2013 and 15,031,741 Shares at December 31, 2012	(212,972 )	(216,575 )
Total Shareholders' Equity	1,215,528	1,136,126
Total Liabilities & Shareholders' Equity	\$1,875,212	\$1,812,929
The accompanying notes are an integral part of the Consolidated Financial Statements.		

AARON'S, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF EARNINGS  
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands, Except Per Share Data)	2013	2012	2013	2012
REVENUES:				
Lease Revenues and Fees	\$436,688	\$414,968	\$904,792	\$850,074
Retail Sales	8,884	8,459	23,303	22,207
Non-Retail Sales	86,785	96,376	177,740	211,939
Franchise Royalties and Fees	16,834	16,142	35,034	33,647
Other	2,873	2,674	6,336	6,748
	552,064	538,619	1,147,205	1,124,615
COSTS AND EXPENSES:				
Retail Cost of Sales	5,307	4,700	13,661	12,424
Non-Retail Cost of Sales	79,369	88,580	162,198	193,462
Operating Expenses	251,924	237,573	505,878	472,483
Legal and Regulatory Expense/(Income)	15,000	—	15,000	(35,500)
Retirement and Vacation Charges	4,917	—	4,917	—
Depreciation of Lease Merchandise	154,422	148,406	322,625	306,567
	510,939	479,259	1,024,279	949,436
OPERATING PROFIT	41,125	59,360	122,926	175,179
Interest Income	770	896	1,522	1,776
Interest Expense	(1,508)	(1,666)	(3,019)	(3,336)
EARNINGS BEFORE INCOME TAXES	40,387	58,590	121,429	173,619
INCOME TAXES	14,533	22,346	44,575	66,149
NET EARNINGS	\$25,854	\$36,244	\$76,854	\$107,470
EARNINGS PER SHARE				
Basic	\$ .34	\$ .48	\$ 1.01	\$ 1.42
Assuming Dilution	\$ .34	\$ .47	\$ 1.00	\$ 1.40
CASH DIVIDENDS DECLARED PER SHARE:				
Common Stock	\$ .017	\$ .015	\$ .034	\$ .030
WEIGHTED AVERAGE SHARES OUTSTANDING:				
Basic	75,901	75,927	75,831	75,949
Assuming Dilution	76,589	76,979	76,579	77,006

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

AARON'S, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
(In Thousands)	2013	2012	2013	2012
Net Earnings	\$25,854	\$36,244	\$76,854	\$107,470
Other Comprehensive Loss:				
Foreign Currency Translation Adjustment	(6	) (921	) (17	) (365
Total Other Comprehensive Loss	(6	) (921	) (17	) (365
Comprehensive Income	\$25,848	\$35,323	\$76,837	\$107,105

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

AARON'S, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

	Six Months Ended June 30,	
(In Thousands)	2013	2012
<b>OPERATING ACTIVITIES:</b>		
Net Earnings	\$76,854	\$107,470
Adjustments to Reconcile Net Earnings to Cash Provided by Operating Activities:		
Depreciation of Lease Merchandise	322,625	306,567
Other Depreciation and Amortization	28,351	26,350
Bad Debt Expense	15,703	13,384
Stock-Based Compensation	937	2,231
Loss on Sale of Property, Plant and Equipment and Assets Held for Sale	386	289
Change in Deferred Income Taxes	(9,211)	(18,229)
Excess Tax Benefits from Stock-Based Compensation	(956)	(1,521)
Other Changes, Net	5,516	909
Changes in Operating Assets and Liabilities, Net of Effects Of Acquisitions and Dispositions:		
Additions to Lease Merchandise	(524,107)	(570,032)
Book Value of Lease Merchandise Sold or Disposed	200,835	230,405
Accounts Receivable	(1)	4,565
Prepaid Expenses and Other Assets	(7,052)	(9,327)
Income Tax Receivable	15,530	2,615
Accounts Payable and Accrued Expenses	(17,877)	(9,025)
Accrued Legal and Regulatory Expense	15,000	(41,720)
Customer Deposits and Advance Payments	(6,224)	1,801
Cash Provided by Operating Activities	116,309	46,732
<b>INVESTING ACTIVITIES:</b>		
Purchases of Investments	(31,308)	(71,464)
Proceeds from Maturities and Calls of Investments	22,230	12,000
Additions to Property, Plant and Equipment	(29,854)	(27,786)
Acquisitions of Businesses and Contracts	(2,378)	(23,130)
Proceeds from Sale of Property, Plant and Equipment	4,149	1,991
Cash Used in Investing Activities	(37,161)	(108,389)
<b>FINANCING ACTIVITIES:</b>		
Proceeds from Debt	—	2,546
Repayments on Debt	(934)	(2,630)
Dividends Paid	(1,289)	(2,273)
Acquisition of Treasury Stock	—	(9,536)
Excess Tax Benefits from Stock-Based Compensation	956	1,521
Issuance of Stock Under Stock Option Plans	3,250	5,384
Cash Provided by (Used in) Financing Activities	1,983	(4,988)
Increase (Decrease) in Cash and Cash Equivalents	81,131	(66,645)
Cash and Cash Equivalents at Beginning of Period	129,534	176,257
Cash and Cash Equivalents at End of Period	\$210,665	\$109,612

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



AARON'S, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1: BASIS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

Aaron's, Inc. (the "Company" or "Aaron's") is a leading specialty retailer primarily engaged in the business of leasing and selling consumer electronics, computers, residential furniture, appliances and household accessories throughout the United States and Canada. The Company's major operating divisions are the Sales & Lease Ownership division (established as a monthly payment concept), the HomeSmart division (established as a weekly payment concept) and the Woodhaven Furniture Industries division, which manufactures upholstered furniture and bedding predominantly for use by Company-operated and franchised stores. The Company's Sales & Lease Ownership division includes the Company's RIMCO stores, which lease automobile wheels, tires and rims under sales and lease ownership agreements.

Basis of Presentation

The preparation of the Company's consolidated financial statements in conformity with accounting principles generally accepted in the United States for interim financial information requires management to make estimates and assumptions that affect amounts reported in these financial statements and accompanying notes. Actual results could differ from those estimates. Generally, actual experience has been consistent with management's prior estimates and assumptions. Management does not believe these estimates or assumptions will change significantly in the future absent unanticipated and unforeseen events.

The accompanying unaudited consolidated financial statements do not include all information required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included in the accompanying unaudited consolidated 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, 2012. The results of operations for the three and six months ended June 30, 2013 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. In all periods presented, the Company's RIMCO operations have been reclassified from the Sales and Lease Ownership segment to the RIMCO segment in Note 6 to the consolidated financial statements. Additionally, interest income has been reclassified from "Other" revenues and presented as a component of non-operating income and expenses in the consolidated statements of earnings for all periods presented.

Principles of Consolidation and Variable Interest Entities

The consolidated financial statements include the accounts of Aaron's, Inc. and its wholly owned subsidiaries. Intercompany balances and transactions between consolidated entities have been eliminated.

On October 14, 2011, the Company purchased 11.5% of the common stock of Perfect Home Holdings Limited ("Perfect Home"), a privately-held rent-to-own company that is primarily financed by share capital and subordinated debt. Perfect Home is based in the United Kingdom and operated 60 retail stores as of June 30, 2013. As part of the transaction, the Company also received notes and an option to acquire the remaining interest in Perfect Home at any time through December 31, 2013. If the Company does not exercise the option prior to December 31, 2013, it will be obligated to sell the common stock and notes back to Perfect Home at the original purchase price plus interest. The Company's investment is denominated in British Pounds.

Perfect Home is a variable interest entity ("VIE") as it does not have sufficient equity at risk; however, the Company is not the primary beneficiary and lacks the power through voting or similar rights to direct those activities of Perfect Home that most significantly affect its economic performance. As such, the VIE is not consolidated by the Company.

Because the Company is not able to exercise significant influence over the operating and financial decisions of Perfect Home, the equity portion of the investment in Perfect Home, totaling less than a thousand dollars at June 30, 2013 and December 31, 2012, is accounted for as a cost method investment and is included in prepaid expenses and other assets in the consolidated balance sheets. The notes purchased from Perfect Home totaling £11.9 million (\$18.1 million) and £11.4 million (\$18.4 million) at June 30, 2013 and December 31, 2012, respectively, are accounted for as

held-to-maturity securities in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 320, Debt and Equity Securities, and are included in investments in the consolidated balance sheets. The increase in the Company’s British pound-denominated notes during the six months ended June 30, 2013 relates to accretion of the original discount on the notes with a

face value of £10 million. Utilizing a Black-Scholes model, the options to buy the remaining interest in Perfect Home and to sell the Company's interest in Perfect Home were determined to have only nominal values.

The Company's maximum exposure to any potential losses associated with this VIE is equal to its total recorded investment which totals \$18.1 million at June 30, 2013.

#### Accounting Policies and Estimates

See Note 1 to the consolidated financial statements in the 2012 Annual Report on Form 10-K.

#### Income Taxes

The Company files a federal consolidated income tax return in the United States, and the Company and its subsidiaries file in various state 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 2009.

As of June 30, 2013 and December 31, 2012, the amount of uncertain tax benefits that, if recognized, would affect the effective tax rate is \$1.0 million for both periods, including interest and penalties. The Company recognizes potential interest and penalties related to uncertain tax benefits as a component of income tax expense.

#### 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, restricted stock units (RSUs) and restricted stock awards (RSAs) as determined under the treasury stock method. The following table shows the calculation of dilutive stock awards for the three and six months ended June 30 (shares in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Weighted average shares outstanding	75,901	75,927	75,831	75,949
Effect of dilutive securities:				
Stock options	471	843	506	859
RSUs	202	204	229	193
RSAs	15	5	13	5
Weighted average shares outstanding assuming dilution	76,589	76,979	76,579	77,006

For all periods presented, no stock options, RSUs or RSAs were anti-dilutive. In addition, approximately 233,000 and 283,000 performance-based RSUs are not included in the computation of diluted EPS for the three and six months ended June 30, 2013, respectively, due to the fact that the revenue and pre-tax profit margin targets applicable to these awards either have not been met or relate to future performance periods as of June 30, 2013. Refer to Note 10 in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 for additional information regarding the Company's restricted stock arrangements.

#### Lease Merchandise

All lease merchandise is available for lease or sale. On a monthly basis, all damaged, lost or unsalable merchandise identified is written off. The Company records lease merchandise adjustments on the allowance method. Lease merchandise write-offs totaled \$11.8 million and \$12.5 million for the three months ended June 30, 2013 and 2012, respectively, and \$24.6 million and \$23.5 million for the six months ended June 30, 2013 and 2012, respectively. Lease merchandise adjustments are included in operating expenses in the accompanying consolidated statements of earnings.

#### Cash and Cash Equivalents

The Company classifies highly liquid investments with maturity dates of less than three months when purchased as cash equivalents.

The Company maintains 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.



## Investments

The Company maintains investments in various corporate debt securities, or bonds. The Company has the positive intent and ability to hold its investments in debt securities, which mature at various dates from 2013 to 2015.

Accordingly, the Company classifies its investments in debt securities as held-to-maturity securities and carries the investments at amortized cost in the consolidated balance sheets.

The Company evaluates securities for other-than-temporary impairment on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. The Company does not intend to sell the securities and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases.

## Accounts Receivable

Accounts receivable consist primarily of receivables due from customers of Company-operated stores, corporate receivables incurred during the normal course of business and franchisee obligations. Accounts receivable, net of allowances, consist of the following:

(In Thousands)	June 30, 2013	December 31, 2012
Customers	\$8,297	\$7,840
Corporate	17,769	17,215
Franchisee	32,407	49,102
	\$58,473	\$74,157

## Assets Held for Sale

Certain properties, primarily consisting of parcels of land and commercial buildings, met the held for sale classification criteria at June 30, 2013 and December 31, 2012. After adjustment to fair value, the \$7.3 million and \$11.1 million carrying value of these properties has been classified as assets held for sale in the consolidated balance sheets as of June 30, 2013 and December 31, 2012, respectively. 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 ASC Topic 820, Fair Value Measurements.

During the three and six months ended June 30, 2013, the Company recorded impairment charges of \$1.0 million and \$3.1 million, respectively, within operating expenses. Such impairment charges related primarily to the impairment of various land outparcels and buildings included in the Sales and Lease Ownership segment that the Company decided not to utilize for future expansion. During the three and six months ended June 30, 2012, the Company recorded a \$600,000 impairment charge related to assets held for sale included in the Other segment.

## Deferred Compensation

The Company maintains the Aaron's, Inc. Deferred Compensation Plan (the "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 elected 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 \$10.9 million and \$9.5 million as of June 30, 2013 and December 31, 2012, 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. 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 insurance contracts totaled \$11.8 million and \$10.4 million as of June 30, 2013 and

December 31, 2012, respectively, and is included in prepaid expenses and other assets in the consolidated balance sheets.

During the three month periods ended June 30, 2013 and 2012, deferred compensation expense charged to operations for the Company's matching contributions totaled \$36,000 and \$84,000, respectively. Deferred compensation expense charged to operations for the Company's matching contributions totaled \$73,000 and \$162,000 in the six months periods ended June 30, 2013 and 2012, respectively. Total benefits of \$470,000 and \$565,000 were paid in the first six months of 2013 and 2012, respectively.

#### Accumulated Other Comprehensive Loss

Changes in accumulated other comprehensive loss by component for the six months ended June 30, 2013 are as follows:

(In Thousands)	Foreign Currency	Total
Balance at January 1, 2013	\$ (69 )	\$(69 )
Other comprehensive loss	(17 )	(17 )
Balance at June 30, 2013	\$ (86 )	\$(86 )

There were no reclassifications out of accumulated other comprehensive loss for the six months ended June 30, 2013.

#### Fair Value Measurement

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. To increase the comparability of fair value measures, the following hierarchy prioritizes the inputs to valuation methodologies used to measure fair value:

Level 1—Valuations based on quoted prices for identical assets and liabilities in active markets.

Level 2—Valuations based on observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets and liabilities in markets that are not active, or other inputs that are observable or can be corroborated by observable market data.

Level 3—Valuations based on unobservable inputs reflecting our own assumptions, consistent with reasonably available assumptions made by other market participants. These valuations require significant judgment.

The Company measures assets held for sale at fair value on a nonrecurring basis and records impairment charges when they are deemed to be impaired. The Company maintains certain financial assets and liabilities, including investments and fixed-rate long term debt, that are not measured at fair value but for which fair value is disclosed.

The fair values of the Company's other current financial assets and liabilities, including cash and cash equivalents, accounts receivable and accounts payable, approximate their carrying values due to their short-term nature.

#### Recent Accounting Pronouncements

In February 2013, the FASB issued ASU 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income ("ASU 2013-02"). ASU 2013-02 requires preparers to report, in one place, information about reclassifications out of accumulated other comprehensive income ("AOCI"). The ASU also requires companies to report changes in AOCI balances. For significant items reclassified out of AOCI to net income in their entirety in the same reporting period, reporting (either on the face of the statement where net income is presented or in the notes) is required about the effect of the reclassifications on the respective line items in the statement where net income is presented. For items that are not reclassified to net income in their entirety in the same reporting period, a cross reference to other disclosures currently required under U.S. GAAP is required in the notes. The above information must be presented in one place (parenthetically on the face of the financial statements by income statement line item or in a note). ASU 2013-02 is effective for fiscal years and interim periods within those years beginning after December 15, 2012. The adoption of ASU 2013-02 did not have a material effect on the Company's consolidated financial statements.

**NOTE 2. ACQUISITIONS**

The following table summarizes the Company's acquisitions of lease contracts, merchandise and the related assets of sales and lease ownership stores, none of which was individually material to the Company's consolidated financial statements, during the six months ended June 30:

(In Thousands, except for store data)	2013	2012
Number of stores acquired, net	3	16
Aggregate purchase price (primarily cash consideration)	\$2,378	\$23,130
Purchase price allocation:		
Lease Merchandise	1,195	8,688
Property, Plant and Equipment	78	579
Other Current Assets and Current Liabilities	(35	) (4
Identifiable Intangible Assets <sup>1</sup>		
Customer Relationships	130	1,255
Non-Compete Agreements	111	881
Acquired Franchise Development Rights	66	578
Goodwill <sup>2</sup>	833	11,153

The Company amortizes customer relationship intangible assets on a straight-line basis over a two-year estimated useful life. The Company amortizes non-compete intangible assets on a straight-line basis over a three-year estimated useful life. The Company amortizes acquired franchise development rights on a straight-line basis over the unexpired life of the franchisee's ten year area development agreement.

Goodwill recognized from acquisitions primarily relates to the future strategic benefits expected to be realized upon integrating the businesses. All goodwill resulting from the Company's 2013 and 2012 acquisitions is expected to be deductible for tax purposes. During the six months ended June 30, 2013, goodwill of approximately \$833,000 was assigned to the Company's Sales and Lease Ownership operating segment. During the six months ended June 30, 2012, goodwill of approximately \$10.6 million and \$476,000 was assigned to the Company's Sales and Lease Ownership and HomeSmart operating segments, respectively.

Acquisitions have been accounted for as business combinations, and the results of operations of the acquired businesses are included in the Company's results of operations from their dates of acquisition. The effect of these acquisitions on the consolidated financial statements for the six months ended June 30, 2013 and 2012 was not significant. The purchase price allocations related to current year acquisitions are tentative and preliminary; the Company anticipates finalizing them prior to December 31, 2013.

**NOTE 3. FAIR VALUE MEASUREMENT****Financial Assets and Liabilities Measured at Fair Value on a Recurring Basis**

The following table summarizes financial assets and liabilities measured at fair value on a recurring basis:

(In Thousands)	June 30, 2013			December 31, 2012		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Deferred Compensation Liability	\$—	\$(10,917	) \$—	\$—	\$(9,518	) \$—

The Company maintains a deferred compensation plan as described in Note 1 to these consolidated financial statements. The liability representing benefits accrued for plan participants is valued at the quoted market prices of the participants' investment elections, which consist of equity and debt "mirror" funds. As such, the Company has classified the deferred compensation liability as a Level 2 liability.

## Non-Financial Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

The following table summarizes assets measured at fair value on a nonrecurring basis:

(In Thousands)	June 30, 2013			December 31, 2012		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Assets Held for Sale	\$—	7,252	\$—	\$—	11,104	\$—

Assets held for sale represents real estate properties that consist mostly of parcels of land and commercial buildings. The highest and best use of these assets is as real estate land parcels for development or real estate properties for use or lease; however, the Company has chosen not to develop or use these properties. In accordance with ASC Topic 360, Property, Plant and Equipment, assets held for sale are written down to fair value less cost to sell, and the adjustment is recorded in operating expenses. The Company estimated the fair values of these properties using the market values for similar properties.

## Certain Financial Assets and Liabilities Not Measured at Fair Value

The following table summarizes the fair value of assets (liabilities) that are not measured at fair value in the consolidated balance sheets, but for which the fair value is disclosed:

(In Thousands)	June 30, 2013			December 31, 2012		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Corporate Bonds <sup>1</sup>	\$—	\$75,161	\$—	\$—	\$67,470	\$—
Perfect Home Notes <sup>2</sup>	—	—	18,115	—	—	18,449
Fixed-Rate Long Term Debt <sup>3</sup>	—	(131,245 )	—	—	(127,261 )	—

<sup>1</sup> The fair value of corporate bonds is determined through the use of model-based valuation techniques for which all significant assumptions are observable in the market.

The Perfect Home notes were initially valued at cost. The Company periodically reviews the valuation utilizing company-specific transactions or changes in Perfect Home's financial performance to determine if fair value adjustments are necessary.

The fair value of fixed-rate long term debt is estimated using the present value of underlying cash flows discounted at a current market yield for similar instruments. The carrying value of fixed-rate long term debt was \$125 million at June 30, 2013 and December 31, 2012.

## Held-to-Maturity Securities

The Company classifies its investments in debt securities as held-to-maturity securities based on its intent and ability to hold these securities to maturity. Accordingly, the debt securities, which mature at various dates during 2013 through 2015, are recorded at amortized cost in the consolidated balance sheets. At June 30, 2013 and December 31, 2012, investments classified as held-to-maturity securities consisted of the following:

(In Thousands)	Gross Unrealized			Fair Value
	Amortized Cost	Gains	Losses	
June 30, 2013				
Corporate Bonds	\$ 75,294	\$49	\$(182 )	\$75,161
Perfect Home Notes	18,115	—	—	18,115
Total	\$ 93,409	\$49	\$(182 )	\$93,276
December 31, 2012				
Corporate Bonds	\$ 67,412	\$99	\$(41 )	\$67,470
Perfect Home Notes	18,449	—	—	18,449
Total	\$ 85,861	\$99	\$(41 )	\$85,919

The amortized cost and fair value of held-to-maturity debt securities by contractual maturity at June 30, 2013 are as follows:

(In Thousands)	Amortized Cost	Fair Value
Due in one year or less	\$43,793	\$43,831
Due in years one through two	49,616	49,445
Total	\$93,409	\$93,276



Information pertaining to held-to-maturity debt securities with gross unrealized losses is as follows:

	Less than 12 months		12 months or longer		Total	
(In Thousands)	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
June 30, 2013						
Corporate Bonds	\$40,636	\$(182 )	\$—	\$—	\$40,636	\$(182 )
December 31, 2012						
Corporate Bonds	\$22,785	\$(41 )	\$—	\$—	\$22,785	\$(41 )

The unrealized losses relate principally to the increases in short-term market interest rates that occurred since the securities were purchased. As of June 30, 2013, 24 of the 41 bonds are in an unrealized loss position and at December 31, 2012, 16 of the 38 securities were in an unrealized loss position. The fair value is expected to recover as the securities approach their maturity or if market yields for such investments decline. In analyzing an issuer's financial condition, management considers whether downgrades by bond rating agencies have occurred. The Company has the intent and ability to hold the investments until their amortized cost basis is recovered on the maturity date. As a result of management's analysis and review, no declines are deemed to be other than temporary. The Company has estimated that the carrying value of its Perfect Home notes approximates fair value and, therefore, no impairment is considered to have occurred as of June 30, 2013. While no impairment was noted during the six months ended June 30, 2013, if profitability is delayed as a result of the significant start-up expenses associated with Perfect Home, there could be a change in the valuation of the Perfect Home notes that may result in the recognition of an impairment loss in future periods.

#### NOTE 4. INDEBTEDNESS

See Note 6 to the consolidated financial statements in the 2012 Annual Report on Form 10-K.

#### NOTE 5. COMMITMENTS AND CONTINGENCIES

##### Leases

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 20 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.

##### Guarantees

The Company has guaranteed certain debt obligations of some of its franchisees under a 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, 2013, the maximum amount that the Company would be obligated to repay in the event franchisees defaulted was \$107.5 million. The Company has recourse rights to franchisee assets securing the debt obligations, which consist primarily of lease merchandise inventory and fixed assets. As a result, the Company has never incurred, nor does management expect to incur, any significant losses under these guarantees. The Company has estimated the fair value of the franchise-related borrowings guarantee to approximate \$2.7 million, which is included in accounts payable and accrued expenses in the consolidated balance sheet as of June 30, 2013.

## Legal Proceedings

From time to time, the Company is party to various legal and regulatory proceedings arising in the ordinary course of business.

Some of the proceedings to which we are currently a party are described below. We believe we have meritorious defenses to all of the claims described below, and intend to vigorously defend against the claims. However, these proceedings are still developing and due to the inherent uncertainty in litigation, regulatory and similar adversarial proceedings, there can be no guarantee that we will ultimately be successful in these proceedings, or in others to which we are currently a party. Substantial losses from these proceedings or the costs of defending them could have a material adverse impact upon our business, financial position and results of operations.

The Company establishes an accrued liability for legal and regulatory proceedings when the Company determines that a loss is both probable and the amount of the loss can be reasonably estimated. We continually monitor our litigation and regulatory exposure, and review the adequacy of our legal and regulatory reserves on a quarterly basis in accordance with applicable accounting rules. The amount of any loss ultimately incurred in relation to matters for which an accrual has been established may be higher or lower than the amounts accrued for such matters.

At June 30, 2013, the Company had accrued \$18.0 million for pending legal and regulatory matters for which it believes losses are probable, which is our best estimate of our exposure to loss and mostly relates to the regulatory investigation by the California Attorney General described below. The Company estimates that the aggregate range of possible loss in excess of accrued liabilities for such probable loss contingencies is between \$0 and \$45.9 million. Finally, at June 30, 2013, the Company estimated that the aggregate range of loss for all material pending legal and regulatory proceedings for which a loss is reasonably possible, but less likely than probable, is from \$665,000 to \$10.6 million. Those matters for which a reasonable estimate is not possible are not included within estimated ranges and, therefore, the estimated ranges do not represent the Company's maximum loss exposure. Our estimates as to legal and regulatory accruals, as to aggregate probable loss amounts and as to reasonably possible loss amounts are all subject to the uncertainties and variables described above.

## Labor and Employment

In *Kunstmann et al v. Aaron Rents, Inc.*, filed with the United States District Court, Northern District of Alabama (Case No.: 2:08-CV-01969-KOB-JEO) on October 22, 2008, plaintiffs alleged that the Company improperly classified store general managers as exempt from the overtime provisions of the Fair Labor Standards Act ("FLSA"). The case was conditionally certified as an FLSA collective action on January 25, 2010, and it now includes 227 individuals, nearly all of whom terminated from the general manager position more than two years ago. Plaintiffs seek to recover unpaid overtime compensation and other damages. On October 4, 2012, the Court denied the Company's motion for summary judgment as to the claims of Kunstmann, the named plaintiff. On January 23, 2013, the Court denied the Company's motion to decertify the class. The Company has since filed two additional motions for summary judgment, including one that seeks summary judgment in the entirety on all class members' claims, or alternatively on matters that will reduce the size of the class or exposure arising from the class claims. Briefing on these motions began in July 2013. The matter of *Kurtis Jewell v. Aaron's, Inc.* was originally filed in the United States District Court, Northern District of Ohio, Eastern Division on October 27, 2011 and was transferred on February 23, 2012 to the United States District Court for the Northern District of Georgia (Atlanta Division) (Civil No.: 1:12-CV-00563-AT). Plaintiff, on behalf of himself and all other non-exempt employees who worked in Company stores, alleges that the Company violated the FLSA when it automatically deducted 30 minutes from employees' time for meal breaks on days when plaintiffs allegedly did not take their meal breaks. Plaintiff claims he and other employees actually worked through meal breaks or were interrupted during the course of their meal breaks and asked to perform work. As a result of the automatic deduction, plaintiff alleges that the Company failed to account for all of his working hours when it calculated overtime, and consequently underpaid him. Plaintiffs seek to recover unpaid overtime compensation and other damages for all similarly situated employees nationwide for the applicable time period. On June 28, 2012, the Court issued an order granting conditional certification of a class consisting of all hourly store employees from June 28, 2009 to the present. The class size is approximately 1,788 opt-in plaintiffs, which is less than seven percent of the potential class members. The parties are engaging in discovery. Discovery is expected to continue until April 2014. In *Sowell, et al. v. Aaron's, Inc.*, United States District Court for the Northern District of Georgia (Civil No.: 1:12-cv-03867-CAP-ECS), two former Company associates filed separate lawsuits on November 5, 2012;

Elizabeth Cook filed in Fulton County Georgia State Court and Brittany Sowell filed in the U.S. District Court for the Northern District of Georgia. Plaintiff Sowell then filed a First Amended Complaint in the U.S. District Court of the Northern District of Georgia on November 28, 2012. Thereafter, Plaintiff Sowell filed a Second Amended Complaint on December 21, 2012, which included Cook's claims and consolidated the cases. Plaintiffs assert numerous common law tort claims, including assault, battery, intentional infliction of emotional distress, and negligent hiring and retention, and federal employment law claims, including sex discrimination and

harassment and retaliation, against the Company. Specifically, plaintiffs allege that their manager and manager's supervisor made repeated sexual, racial, and sexual orientation-based comments, engaged in inappropriate touchings, and threatened them with violence if plaintiffs reported these acts to management. Plaintiffs further allege that they complained to management; that the Company failed to act; and that the Company's hiring processes were deficient. Plaintiffs seek compensatory and punitive damages and attorneys' fees. The case is currently in the discovery phase with discovery set to close in October 2013.

#### Consumer

In *Margaret Korrow, et al. v. Aaron's, Inc.*, originally filed in the Superior Court of New Jersey, Middlesex County, Law Division on October 26, 2010, plaintiff filed suit on behalf of herself and others similarly situated alleging that the Company is liable in damages to plaintiff and each class member because the Company's lease agreements issued after March 16, 2006 purportedly violated certain New Jersey state consumer statutes. Plaintiff's complaint seeks treble damages under the New Jersey Consumer Fraud Act, and statutory penalty damages of \$100 per violation of all contracts issued in New Jersey, and also claim that there are multiple violations per contract. The Company removed the lawsuit to the United States District Court for the District of New Jersey on December 6, 2010 (Civil Action No.: 10-06317(JAP)(LHG)). Plaintiff on behalf of herself and others similarly situated seeks equitable relief, statutory and treble damages, pre- and post-judgment interest and attorneys' fees. Discovery on this matter is closed. On July 31, 2013, the Court certified a class comprising all persons who entered into a rent-to-own contract with the Company in New Jersey from March 16, 2006 through March 31, 2011. The Company is currently evaluating its next step.

#### Privacy and Related Matters

In *Crystal and Brian Byrd v. Aaron's, Inc., Aspen Way Enterprises, Inc., John Does (1-100) Aaron's Franchisees and Designerware, LLC*, filed on May 16, 2011, in the United States District Court, Western District of Pennsylvania (Case No. 1:11-CV-00101-SPB), plaintiffs alleged that the Company and its independently owned and operated franchisee Aspen Way Enterprises ("Aspen Way") knowingly violated plaintiffs' privacy in violation of the Electronic Communications Privacy Act and the Computer Fraud Abuse Act and sought certification of a putative nationwide class. Plaintiffs based these claims on Aspen Way's use of a software program called "PC Rental Agent." The District Court dismissed the Company from the lawsuit on March 20, 2012. On September 14, 2012, plaintiffs filed a second amended complaint against the Company and its franchisee Aspen Way, asserting claims for violation of the Electronic Communications Privacy Act and common law invasion of privacy by intrusion upon seclusion. Plaintiffs also asserted certain vicarious liability claims against the Company based on Aspen Way's alleged conduct. On October 15, 2012, the Company filed a motion to dismiss the amended complaint, and on February 27, 2013, plaintiffs filed a motion for leave of the Court to file a third amended complaint against the Company. On May 23, 2013, the Court granted plaintiffs' motion for leave to file a third amended complaint, which asserts the same claims against the Company as the second amended complaint but also adds a request for injunction and names additional independently owned and operated Company franchisees as defendants. Plaintiffs filed the third amended complaint, and the Company has moved to dismiss that complaint on substantially the same grounds as it sought to dismiss plaintiffs' second amended complaint. That motion remains pending. Plaintiffs filed their motion for class certification on July 1, 2013, and the Company's response is due on August 2, 2013. A hearing on plaintiffs' motion for class certification is tentatively set for September 2013. Plaintiffs seek monetary damages as well as injunctive relief.

In *Michael Winslow and Fonda Winslow v. Sultan Financial Corporation, Aaron's, Inc., John Does (1-10), Aaron's Franchisees and Designerware, LLC*, filed on March 5, 2013 in the Los Angeles Superior Court (Case No. BC502304), plaintiffs assert claims against the Company and its independently owned and operated franchisee, Sultan Financial Corporation (as well as certain John Doe franchisees), for unauthorized wiretapping, eavesdropping, electronic stalking, and violation of California's Comprehensive Computer Data Access and Fraud Act and its Unfair Competition Law. Each of these claims arises out of the alleged use of PC Rental Agent software. The plaintiffs are seeking injunctive relief and damages in connection with the allegations of the complaint. Plaintiffs are also seeking certification of a putative California class. Plaintiffs are represented by the same counsel as in the above described Byrd litigation. In April 2013, the Company timely removed this matter to federal Court. On May 8, 2013, the Company filed a motion to stay this litigation pending resolution of the Byrd litigation, a motion to dismiss for failure to state a claim, and a motion to strike certain allegations in the complaint. The Court subsequently stayed the case. The Company's motions to dismiss and strike certain allegations remain pending.

In Lomi Price v. Aaron's, Inc. and NW Freedom Corporation, filed on February 27, 2013, in the State Court of Fulton County, Georgia (Case No. 13-EV-016812B), an individual plaintiff asserts claims against the Company and its independently owned and operated franchisee, NW Freedom Corporation, for invasion of privacy/intrusion on seclusion, computer invasion of privacy and infliction of emotional distress. Each of these claims arises out of the alleged use of PC Rental Agent software. The plaintiff is seeking compensatory and punitive damages of not less than \$250,000. On April 3, 2013, the Company filed an answer and affirmative defenses. On that same day, the Company also filed a motion to stay the litigation pending resolution of

the Byrd Litigation, a motion to dismiss for failure to state a claim, and a motion to strike certain allegations in the complaint. All three motions remain pending.

#### Regulatory Investigations

**Federal Trade Commission Investigation.** There is a pending, active investigation by the Federal Trade Commission relating to the alleged use of PC Rental Agent software by certain independently owned and operated Company franchisees, as noted above in the Privacy and Related Matters section, and the Company's alleged responsibility for that use. The Company is continuing to cooperate in this investigation and anticipates achieving a comprehensive resolution that would resolve this investigation without active litigation.

**California Attorney General Investigation.** The California Attorney General has been investigating the Company's retail transactional practices, including various leasing and marketing practices, information security and privacy policies and practices related to the alleged use of PC Rental Agent software by certain independently owned and operated Company franchisees. The Company has been cooperating with the investigation, including producing documents for the Attorney General's office and engaging in discussions about a possible resolution of this matter. While the outcome of the investigation is inherently uncertain, the Company currently anticipates achieving a comprehensive resolution without litigation.

**Pennsylvania Attorney General Investigation.** There is a pending, active investigation by the Pennsylvania Attorney General relating to the Company's privacy practices in Pennsylvania. The privacy issues are related to the alleged use of PC Rental Agent software by certain independently owned and operated Company franchisees, and the Company's alleged responsibility for that use. The Company is continuing to cooperate in the investigation.

#### Other Commitments

At June 30, 2013, the Company had non-cancelable commitments primarily related to certain advertising and marketing programs of \$12.7 million. At June 30, 2013, the Company had \$658,000 in non-cancelable commitments to purchase delivery vehicles.

The Company is a party to various claims and legal and regulatory proceedings arising in the ordinary course of business. Management regularly assesses the Company's insurance deductibles, analyzes litigation information with the Company's 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.

See Note 8 to the consolidated financial statements in the 2012 Annual Report on Form 10-K for further information.

#### NOTE 6. SEGMENTS

As of June 30, 2013, the Company had five operating and reportable segments: Sales and Lease Ownership, HomeSmart, RIMCO, Franchise and Manufacturing. The Company has evaluated the characteristics of its operating segments and has determined that certain of its operating segments no longer meet the aggregation criteria in ASC 280, Segment Reporting. Accordingly, for all periods presented, RIMCO has been reclassified from the Sales and Lease Ownership segment to the RIMCO segment.

The Aaron's Sales & Lease Ownership division offers electronics, residential furniture, appliances and computers to consumers primarily on a monthly payment basis with no credit requirements. The HomeSmart division was established to offer electronics, residential furniture, appliances and computers to consumers primarily on a weekly payment basis with no credit requirements. The Company's RIMCO stores lease automobile tires, wheels and rims to customers under sales and lease ownership agreements. The Company's Franchise operation sells and supports franchisees of its sales and lease ownership concept. The Manufacturing segment manufactures upholstered furniture and bedding predominantly for use by Company-operated and franchised stores. Therefore, the Manufacturing segment's revenues and earnings before income taxes are primarily the result of intercompany transactions, substantially all of which revenues and earnings are eliminated through the elimination of intersegment revenues and intersegment profit.



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(In Thousands)	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2013	2012	2013	2012
Revenues From External Customers:				
Sales and Lease Ownership	\$506,221	\$499,919	\$1,059,972	\$1,054,376
HomeSmart	15,588	13,461	32,525	26,280
RIMCO	4,960	3,996	10,393	8,303
Franchise	16,834	16,142	35,034	33,647
Manufacturing	27,410	21,866	55,121	52,094
Other	454	677	1,232	2,343
Revenues of Reportable Segments	571,467	556,061	1,194,277	1,177,043
Elimination of Intersegment Revenues	(26,729 )	(21,866 )	(53,754 )	(52,094 )
Cash to Accrual Adjustments	7,326	4,424	6,682	(334 )
Total Revenues from External Customers	\$552,064	\$538,619	\$1,147,205	\$1,124,615
Earnings (Loss) Before Income Taxes:				
Sales and Lease Ownership	\$47,449	\$48,219	\$111,274	\$151,110
HomeSmart	(779 )	)		