AAON INC
Form 10-Q
November 08, 2010

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

FORM 10-Q

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

For the quarterly period ended September 30, 2010

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 of incorporation or organization)	(IRS Employer 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 X 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 X

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 X
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 X

As of October 28, 2010 registrant had outstanding a total of 16,527,496 shares of its $.004 par value Common Stock.

PART I – FINANCIAL INFORMATION
Item 1. Financial Statements.

AAON, Inc., and Subsidiaries
Consolidated Balance Sheets
(unaudited)

		September 30, 2010		December 31, 2009
Assets		(in thousands except share and per share data)		
Current assets:				
Cash and cash equivalents	$	4,149	$	25,639
Certificates of deposit		1,945		-
Investments held to maturity at amortized cost		10,939		-
Accounts receivable, net		36,939		33,381
Note receivable, current		26		-
Inventories, net		34,650		28,788
Prepaid expenses and other		545		1,087
Financial derivative asset		457		2,200
Assets held for sale, net		-		1,522
Deferred tax assets		4,625		3,623
Total current assets		94,275		96,240
Property, plant and equipment:				
Land		1,328		1,328
Buildings		44,326		41,697
Machinery and equipment		98,188		90,213
Furniture and fixtures		6,096		7,225
Total property, plant and equipment		149,938		140,463
Less: Accumulated depreciation		84,322		80,567
Property, plant and equipment, net		65,616		59,896
Notes receivable, long-term		1,118		75
Investments held to maturity at amortized cost		604		-
Total assets	$	161,613	$	156,211
Liabilities and Stockholders' Equity				
Current liabilities:				
Revolving credit facility	$	3,991	$	-
Current maturities of long-term debt		8		76
Accounts payable		13,442		8,524
Dividends payable		-		3,100
Accrued liabilities		21,834		19,186
Total current liabilities		39,275		30,886
Deferred tax liabilities		7,623		7,326
Commitments and contingencies				
Stockholders' equity:				
Preferred stock, $.001 par value, 7,500,000 shares authorized, no shares issued		-		-
Common stock, $.004 par value, 75,000,000 shares authorized, 16,539,254 and 17,214,979 issued and outstanding at September 30, 2010 and December		69		71

31, 2009, respectively				
Additional paid-in capital		-		644
Accumulated other comprehensive income, net of tax		-		1,077
Retained earnings		114,646		116,207
Total stockholders' equity		114,715		117,999
Total liabilities and stockholders' equity	$	161,613	$	156,211

The accompanying notes are an integral part of these statements.

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

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
	(in thousands, except per share data)			
Net sales	$ 64,886	$ 58,492	$ 178,726	$ 191,054
Cost of sales	52,389	40,764	137,729	138,288
Gross profit	12,497	17,728	40,997	52,766
Selling, general and administrative expenses	5,166	5,313	16,592	18,641
Income from operations	7,331	12,415	24,405	34,125
Interest expense	(4)	-	(4)	(9)
Interest income	44	64	162	71
Other income (expense), net	(64)	(173)	(186)	1
Income before income taxes	7,307	12,306	24,377	34,188
Income tax provision	2,134	4,565	8,265	12,622
Net income	$ 5,173	$ 7,741	$ 16,112	$ 21,566
Earnings per share:				
Basic	$ 0.31	$ 0.45	$ 0.95	$ 1.26
Diluted	$ 0.31	$ 0.45	$ 0.95	$ 1.25
Cash dividends declared per common share:	$ 0.00	$ 0.00	$ 0.18	$ 0.18
Weighted average shares outstanding:				
Basic	16,555	17,175	16,892	17,178
Diluted	16,647	17,304	16,981	17,318

The accompanying notes are an integral part of these statements.

AAON, Inc., and Subsidiaries
Consolidated Statements of Stockholders' Equity and Comprehensive Income
(unaudited)

	Common Stock Shares (in thousands)	Common Stock Amount	Paid-in Capital	Accumulated Other Comprehensive Income	Retained Earnings	Total
Balance at December 31, 2009	17,215	$ 71	$ 644	$ 1,077	$ 116,207	$ 117,999
Comprehensive income:						
Net income	–	–	–	–	16,112	16,112
Foreign currency translation adjustment	–	–	–	(1,077)	1,156	79
Total comprehensive income						16,191
Stock options exercised and restricted stock awards vested, including tax benefits	104	–	1,385	–	–	1,385
Share-based compensation	–	–	609	–	–	609
Stock repurchased and retired	(780)	(2)	(2,638)	–	(15,737)	(18,377)
Dividends	–	–	–	–	(3,092)	(3,092)
Balance at September 30, 2010	16,539	$ 69	$ –	$ –	$ 114,646	$ 114,715

The accompanying notes are an integral part of these statements.

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

	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
	(in thousands)	
Operating Activities		
Net income	$ 16,112	$ 21,566
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	7,330	6,682
Provision for losses on accounts receivable, net of adjustments	(36)	603
Share-based compensation	609	631
Excess tax benefits from stock options exercised and restricted stock awards vested	(331)	(389)
(Gain) loss on disposition of assets	(105)	4
Unrealized gain on financial derivative asset	-	(1,005)
Deferred income taxes	(705)	(819)
Changes in assets and liabilities:		
Accounts receivable	(3,522)	2,551
Inventories	(5,862)	5,156
Prepaid expenses and other	542	(532)
Financial derivative asset	1,743	-
Accounts payable	4,918	(2,695)
Accrued liabilities	2,979	4,576
Net cash provided by operating activities	23,672	36,329
Investing Activities		
Proceeds from sale of property, plant and equipment	105	-
Investment in certificates of deposit	(1,945)	-
Investments held to maturity at amortized cost	(11,543)	-
Deposits on sale of asset held for sale	453	-
Capital expenditures	(13,050)	(8,644)
Net cash used in investing activities	(25,980)	(8,644)
Financing Activities		
Borrowings under revolving credit facility	6,682	9,972
Payments under revolving credit facility	(2,691)	(12,873)
Payments of long-term debt	(68)	(113)
Stock options exercised	1,054	871
Excess tax benefits from stock options exercised and restricted stock awards vested	331	389
Repurchases of stock	(18,377)	(2,548)
Cash dividends paid to stockholders	(6,192)	(5,874)
Net cash used in financing activities	(19,261)	(10,176)
Effect of exchange rate on cash	79	116

Net increase (decrease) in cash and cash equivalents		(21,490)		17,625
Cash and cash equivalents, beginning of year		25,639		269
Cash and cash equivalents, end of period	$	4,149	$	17,894

The accompanying notes are an integral part of these statements.

AAON, Inc., and Subsidiaries
Notes to the Consolidated Financial Statements
September 30, 2010
(unaudited)

1. Basis of Presentation

AAON, Inc. is a Nevada corporation which was incorporated on August 18, 1987. Our subsidiaries include AAON, Inc., an Oklahoma corporation and AAON Coil Products, Inc., a Texas corporation. The Consolidated Financial Statements include our accounts and the accounts of our subsidiaries. Unless the context otherwise requires, references in this Quarterly Report to "AAON," the "Company", "we," "us," "our" or "ours" refer to AAON, Inc., and subsidiaries.

We closed our manufacturing operations and reclassified our Canadian facility as held for sale in September 2009. In September 2010, we sold the Canadian facility. The products previously manufactured at the Canadian facility will be produced by the Tulsa, Oklahoma and Longview, Texas facilities in the future.

We have prepared the financial statements included herein without audit, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. We believe that the disclosures made in these financial statements are adequate to make the information presented not misleading when read in conjunction with the financial statements and the notes thereto included in our latest audited financial statements which were included in the Form 10-K Report for the fiscal year ended December 31, 2009, filed with the SEC. In the opinion of management, the accompanying financial statements include all normal, recurring adjustments required for a fair presentation of the results of the periods presented. Operating results for the nine months ended September 30, 2010, are not necessarily indicative of the results that may be expected for the year ending December 31, 2010.

Revenue Recognition

We recognize revenues from sales of products when the products are shipped and 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. Our policy is to record the collection and payment of sales taxes through a liability account.

We present revenues 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 which 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 do not provide us with a break-out of the amount of the total order price over the minimum sales price which includes the Representatives' fee and Third Party Product amounts ("Due to Representatives"). The Due to Representatives amount is paid only after all amounts associated with the order are collected from the customer. The amount of payments to our Representatives was $14.5 million and $14.6 million for the three months and $37.9 million and $44.6 million for the nine months ending September 30, 2010 and 2009, respectively.

Currency

Foreign currency transactions and financial statements are translated in accordance with Financial Accounting Standards Board ("FASB") Codification ("FASC") Topic 830, Foreign Currency Matters. We use the U.S. dollar as our functional currency, except for the note receivable, which uses the Canadian dollar.

Financial Derivatives

We occasionally use financial derivatives to mitigate our exposure to volatility in copper prices. Fluctuations in copper commodity prices impact the value of the financial derivative that we hold. We are subject to gains which we record as a financial derivative asset if the forward copper commodity prices increase and losses which we record as a financial derivative liability if they decrease. We record the fair value of the financial derivative position in the Consolidated Balance Sheets. We use COMEX index pricing to support our fair value calculation, which is a Level 2 input per the valuation hierarchy as the pricing is for instruments similar but not identical to the contract we will settle (see Note 17, Fair Value Measurements). We did not designate the financial derivative as a cash flow hedge. We record changes in the financial derivative's fair value currently in earnings based on mark-to-market accounting. The change in fair value is recorded to cost of sales in the Consolidated Statements of Income. We do not use financial derivatives for speculative purposes.

Investments

We made investments through a large firm that we intend to hold to maturity. The investments are comprised of cash equivalents and money market accounts, certificates of deposit and corporate notes and bonds. The amortized cost and accrued interest on the corporate notes and bonds are reflected in the Consolidated Balance Sheets. The interest and amortization of bond premiums on the corporate notes and bonds are reflected in interest income in the Consolidated Statements of Income.

Subsequent Events

We have determined that no subsequent events exist which require recognition or disclosure in our Consolidated Financial Statements.

New Accounting Pronouncements

In January 2010, the FASB issued ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements ("ASU 2010-06"), which requires reporting entities to provide information about movements of assets among Levels 1 and 2 of the three-tier fair value hierarchy. Separate disclosures need to be made of the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements along with a description of the reason for the transfers. Also, disclosure of activity in Level 3 fair value measurements needs to be made on a gross basis rather than as one net number. ASU 2010-06 also requires: (1) fair value measurement disclosures for each class of assets and liabilities, and (2) disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements, which are required for fair value measurements that fall in either Level 2 or Level 3. The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the Level 3 activity disclosures, which are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Adoption of ASU 2010-06 will not have a material impact on our Consolidated Financial Statements.

2. Certificates of Deposit

We have $1.9 million of current assets in certificates of deposit as of September 30, 2010 with various maturities of less than one year. The certificates of deposit bear interest ranging from 0.5% to 4.3% per annum. We did not invest in any certificates of deposit in 2009.

3. Investments Held to Maturity

Our investments held to maturity include $11.5 million ($10.9 million of current assets) in corporate notes and bonds with maturities of less than two years. The investments have moderate risk with S&P ratings ranging from AA+ to BBB-. We did not invest in any investments held to maturity in 2009.

The following summarizes the amortized cost and estimated fair value of our investments held to maturity:

	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value
		(in thousands)		
Current Assets:				
Investments held to maturity	$ 10,939	$ -	$ (326)	$ 10,613
Non-Current Assets: (1)				
Investments held to maturity	604	-	(5)	599
Total	$ 11,543	$ -	$ (331)	$ 11,212

(1) Non-current assets have maturities of between one to two years.

Investments held to maturity have been in a loss position for less than nine months as of September 30, 2010. We evaluate for other-than-temporary impairments on a quarterly basis. We do not believe that any of the unrealized losses represent an other-than-temporary impairment.

4. Accounts Receivable

We grant credit to customers and perform ongoing credit evaluations. We generally do not require collateral or charge interest. We establish an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends, economic and market conditions and the age of the receivable. Past due accounts are generally written off against the allowance for doubtful accounts only after all collection attempts have been exhausted.

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

	September 30, 2010	December 31, 2009
	(in thousands)	
Accounts receivable	$ 37,619	$ 34,157
Less: Allowance for doubtful accounts	(680)	(776)
Total, net	$ 36,939	$ 33,381

	Nine Months Ended	
	September 30, 2010	September 30, 2009
	(in thousands)	
Allowance for doubtful accounts:		
Balance, beginning of period	$ 776	$ 795
Provision for losses on accounts receivable	451	491
Adjustments to provision	(487)	112
Accounts receivable written off, net of recoveries	(60)	(16)
Balance, end of period	$ 680	$ 1,382

5. Note Receivable

In September 2010, we sold our Canadian facility (see Note 16, Canadian Facility) and assumed a note receivable from one borrower secured by the property. The $1.1 million, fifteen-year note receivable is based on a 4.0% interest rate with a $0.6 million balloon payment due in September 2025. The loan calls for monthly combined interest and principal payments beginning in October 2010.

6. 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.

Inventory balances are as follows:

	September 30, 2010 (in thousands)	December 31, 2009
Raw materials	$ 29,855	$ 26,581
Work in process	3,196	1,835
Finished goods	1,949	1,132
	35,000	29,548
Less: Allowance for excess and obsolete inventories	(350)	(760)
Total, net	$ 34,650	$ 28,788

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

	Nine Months Ended September 30, 2010 (in thousands)	September 30, 2009
Allowance for excess and obsolete inventories:		
Balance, beginning of period	$ 760	$ 350
Provision for excess and obsolete inventories	600	1,264
Adjustments to reserve	(600)	(850)
Inventories written off	(410)	-
Balance, end of period	$ 350	$ 764

7. Financial Derivatives

We entered into a financial derivative instrument during the third quarter 2009 with a large financial institution to mitigate our exposure to volatility in copper prices. We monitor our financial derivative and the credit worthiness of the financial institution. We do not anticipate losses due to counterparty non-performance. We do not use financial derivatives for speculative purposes.

The financial derivative is in the form of a commodity futures contract. The financial derivative contract began settling monthly in January 2010 and will continue through December 2010. The contract is for a total of 2,250,000 pounds of copper (450,000 pounds remaining as of September 30, 2010) at $2.383 per pound. In March 2010, we locked in the settlement price of $3.3975 per pound for the remainder of 2010. The contract is for quantities equal to or less than those expected to be used in our manufacturing operations in 2010.

Generally, fluctuations in copper commodity prices impact the value of the financial derivative. Prior to locking in the settlement price, we would have been subject to gains which we would have recorded as a financial derivative asset if the forward copper commodity prices increased and losses which we would have recorded as a financial derivative liability if they decreased. We will be in a gain or financial derivative asset position for the remainder of 2010 based on the settlement price we locked into. We will recognize the following financial derivative asset at fair value for the remainder of 2010 in the Consolidated Balance Sheets, which will only be reduced by the amount of monthly settlements:

Type of Contract	Balance Sheet Location		Fair Value (in thousands)
Financial derivative not designated as hedging instruments:			
Commodity futures contract	Financial Derivative Asset	$	457
Total financial derivative not designated as hedging instruments		$	457

We did not designate the financial derivative as a cash flow hedge. We recorded changes in the financial derivative's fair value currently in earnings based on mark-to-market accounting.

We recorded the following realized gain on our financial derivative asset at fair value in the Consolidated Statements of Income for the nine months ended September 30, 2010:

Type of Contract	Income Statement Location		Amount (in thousands)
Financial derivative not designated as hedging instruments:			
Commodity futures contract	Cost of sales	$	14
Total financial derivative not designated as hedging instruments		$	14

We will not realize any additional gain or loss related to our financial derivative asset during 2010 because we locked in the settlement price for the remainder of 2010. We use COMEX index pricing to support our fair value calculation, which is a Level 2 input per the valuation hierarchy as the pricing is for instruments similar but not identical to the contract we will settle (see Note 17, Fair Value Measurements).

8. Accrued Liabilities

Accrued liabilities are as follows:

		September 30, 2010		December 31, 2009
		(in thousands)		
Warranty	$	7,100	$	7,200
Due to Representatives1		8,301		7,975
Payroll		1,949		1,633
Workers' compensation		754		591
Medical self-insurance		1,541		1,410
Employee benefits and other		2,189		377
Total	$	21,834	$	19,186

1 Due to Representatives was previously described as Commissions. We will use the term Due to Representatives going forward to better represent the true nature of these items, which is the excess of the total order price over the minimum sales price, which includes both the Representatives' fee and Third Party Products.

9. Supplemental Cash Flow Information

Interest payments of approximately $4,000 and $9,000 were made for the nine months ended September 30, 2010 and 2009. Payments for income taxes of $6.7 million and $9.5 million were made during the nine months ended September 30, 2010 and 2009, respectively. We sold the $1.5 million asset held for sale and recorded a $1.1 million note receivable during the nine months ended September 30, 2010. Dividends payable of $3.1 million were declared in December 2009 and paid in January 2010. Dividends payable of $3.1 million were declared in June 2010, released for payment to our transfer agent in June 2010 and paid to stockholders in July 2010.

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10. Revolving Credit Facility

Our revolving credit facility provides for maximum borrowings of $15.2 million which is provided by the Bank of Oklahoma, National Association. Under the line of credit, there is one standby letter of credit totaling $0.9 million. The letter of credit is a requirement of our workers compensation insurance and will expire December 31, 2010. Interest on borrowings is payable monthly at the greater of 4% or LIBOR plus 2.5% (4.00% at September 30, 2010). No fees are associated with the unused portion of the committed amount.

We had a $4.0 million outstanding balance under the revolving credit facility at September 30, 2010. We did not have an outstanding balance under the revolving credit facility at December 31, 2009. Borrowings available under the revolving credit facility at September 30, 2010 were $10.3 million. At September 30, 2010, we were in compliance with our financial ratio covenants. The covenants are related to our tangible net worth, total liabilities to tangible net worth ratio and working capital. At September 30, 2010 our tangible net worth was $114.7 million which meets the requirement of being at or above $75.0 million. Our total liabilities to tangible net worth ratio was 1 to 2 which meets the requirement of not being above 2 to 1. Our working capital was $55.0 million which meets the requirement of being at or above $30.0 million. On July 30, 2010, we renewed the line of credit with a maturity date of July 30, 2011 with terms substantially the same as the previous agreement.

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 4.4 million shares of common stock to be issued under the plan. 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 prior to May 25, 2004, vest one year from the date of grant and are exercisable for three years thereafter. Options granted to directors on or after May 25, 2004, 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 provides an additional 750,000 shares that can 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 have been granted with the same vesting schedule as the previous plan. Under the LTIP, the exercise price of shares granted may not be less than 100% of the fair market value at the date of the grant.

We apply the provisions of FASC Topic 718, Compensation – Stock Compensation. The compensation cost is based on the grant date fair value of stock options issued calculated using a Black-Scholes-Merton Option Pricing Model, or the grant date fair value of a restricted stock award less the present value of dividends expected during the vesting period.

We recognized approximately $107,000 and $135,000 for the three months ended and $334,000 and $363,000 for the nine months ended September 30, 2010 and 2009, respectively, in pre-tax compensation expense related to stock options in the Consolidated Statements of Income. The total pre-tax compensation cost related to unvested stock options not yet recognized as of September 30, 2010 is $1.1 million and is expected to be recognized over a weighted average period of 2.4 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:

	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Directors and Officers:		
Expected dividend yield	1.59%	1.86%
Expected volatility	45.37%	47.47%
Risk-free interest rate	2.63%	2.53%
Expected life	7.0 years	7.0 years
Forfeiture rate	0%	0%
Employees:		
Expected dividend yield	1.59%	1.86%
Expected volatility	45.42%	46.94%
Risk-free interest rate	2.48%	2.62%
Expected life	8.0 years	8.0 years
Forfeiture rate	31%	31%

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.

A summary of stock options outstanding is as follows:

	Options Outstanding				Options Exercisable	
Range of Exercise Prices	Number Outstanding at September 30, 2010	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Aggregate Intrinsic Value	Number Exercisable at September 30, 2010	Weighted Average Exercise Price
$9.68 – $10.82	72,000	3.48	$ 10.27	$ 13.25	72,000	$ 10.27
$11.29 – $15.99	179,300	6.87	14.61	8.91	81,300	13.89
$16.13 – $20.68	121,800	7.17	18.49	5.03	49,600	18.23
$21.42 – $24.08	50,000	9.57	23.17	0.35	1,000	21.42
Total	423,100	6.70	$ 16.00	$ 9.82	203,900	$ 13.70

A summary of stock option activity is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value ($000)
Outstanding at January 1, 2010	460,513	$ 14.22		

Granted	72,000			22.24		
Exercised	(91,413	)		11.52		
Forfeited or Expired	(18,000	)		18.22		
Outstanding at September 30, 2010	423,100			16.00	6.70	$ 3,181
Exercisable at September 30, 2010	203,900		$	13.70	5.05	$ 2,002

The weighted average grant date fair value of options granted during the nine months ended September 30, 2010 and 2009 was $9.63 and $6.87, respectively. The total intrinsic value of options exercised during the nine months ended September 30, 2010 and 2009 was $2.6 million and $2.1 million, respectively. The cash received from options exercised during the nine months ended September 30, 2010 and 2009 was $1.1 million and $0.9 million, respectively. The impact of these cash receipts is included in financing activities in the accompanying Consolidated Statements of Cash Flows.

A summary of the unvested stock options is as follows:

	Shares	Weighted Average Grant Date Fair Value
Unvested at January 1, 2010	216,200	$ 6.77
Granted	72,000	9.63
Vested	(57,300)	6.43
Forfeited	(11,700)	7.47
Unvested at September 30, 2010	219,200	$ 7.76

The Compensation Committee of the Board of Directors ("Board") has authorized and issued restricted stock awards to our directors and key employees. The restricted stock award program offers the opportunity to earn shares of AAON common stock over time, rather than options that give the right to purchase stock at a set price. Restricted stock awards granted to directors vest one-third each year. All other restricted stock awards vest at a rate of 20% per year. Restricted stock awards are grants that entitle the holder to shares of common stock subject to certain terms. The fair value of restricted stock awards is based on the fair market value of AAON common stock on the respective grant dates, reduced for the present value of dividends expected during the vesting period.

These awards are recorded at their fair values on the date of grant and compensation cost is recorded using straight-line vesting over the service period. We recognized approximately $80,000 and $96,000 for the three months and $275,000 and $268,000 for the nine months ended September 30, 2010 and 2009, respectively in pre-tax compensation expense related to restricted stock awards in the Consolidated Statements of Income. In addition, as of September 30, 2010, unrecognized compensation cost related to unvested restricted stock awards was $0.5 million which is expected to be recognized over a weighted average period of 1.7 years.

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

	Shares
Unvested at January 1, 2010	33,250
Granted	14,850
Vested	(18,600)
Forfeited	(1,050)
Unvested at September 30, 2010	28,450

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.

	Three Months Ended		Nine Months Ended	
	September 30, 2010	September 30, 2009	September 30, 2010	September 30, 2009
	(in thousands, except share and per share data)			
Numerator:				
Net income	$ 5,173	$ 7,741	$ 16,112	$ 21,566
Denominator:				
Denominator for basic earnings per share – Weighted average shares	16,555,307	17,175,390	16,891,634	17,178,050
Effect of dilutive employee stock options and restricted stock awards	91,754	128,841	88,948	140,189
Denominator for diluted earnings per share – Weighted average shares	16,647,061	17,304,231	16,980,582	17,318,239
Earnings per share:				
Basic	$ 0.31	$ 0.45	$ 0.95	$ 1.26
Diluted	$ 0.31	$ 0.45	$ 0.95	$ 1.25
Anti-dilutive shares	91,850	228,950	91,850	228,950
Weighted average exercise price	$ 22.18	$ 15.63	$ 22.18	$ 15.63

13. Income Taxes

We file income tax returns in the U.S. federal jurisdiction, and various state and foreign jurisdictions and account for income taxes in accordance with FASC Topic 740, Income Taxes. As of September 30, 2010, we do not have any unrecognized tax benefits that if recognized would affect the effective tax rate. We do not expect to record any unrecognized tax benefits during the next twelve months.

We recognize accrued interest and penalties related to unrecognized tax benefits in income tax expense. At September 30, 2010, we did not have any accruals for the potential payment of interest or penalties.

As of September 30, 2010, we are subject to U.S. Federal income tax examinations for the tax years 2007 through 2009, and to non-U.S. income tax examinations for the tax years of 2007 through 2009. In addition, we are subject to state and local income tax examinations for the tax years 2006 through 2009.

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14. Stock Repurchase

On November 6, 2007, the Board authorized a stock buyback program, targeting repurchases of up to approximately 10% (1.8 million shares) of our outstanding stock from time to time in open market transactions. On May 12, 2010, we completed the stock buyback program. Through May 12, 2010, we repurchased a total of 1,800,000 shares under this program for an aggregate price of $36,061,425, or an average price of $20.03 per share. We purchased the shares at current market prices.

On May 17, 2010, the Board authorized a new stock buyback program, targeting repurchases of up to approximately 5% (approximately 850,000 shares) of our outstanding stock from time to time in open market transactions. Through September 30, 2010, we repurchased a total of 478,493 shares under this program for an aggregate price of $11,509,433, or an average price of $24.05 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 AAON's 401(k) savings and investment plan are entitled to have shares of AAON stock in their accounts sold to us to provide diversification of their investments. The maximum number of shares to be repurchased is unknown under the program as the amount is contingent on the number of shares sold by employees. Through September 30, 2010, we repurchased 951,353 shares for an aggregate price of $16,940,986, or an average price of $17.81 per share. We purchased the shares at current market prices.

On November 7, 2006, the Board of Directors authorized us to repurchase shares from certain directors and officers following their exercise of stock options. The maximum number of shares to be repurchased under the program is unknown as the amount is contingent on the number of shares sold. Through September 30, 2010, we repurchased 379,750 shares for an aggregate price of $7,894,792, or an average price of $20.79 per share. We purchased the shares at current market prices.

15. Commitments and Contingencies

We are subject to claims and legal actions that arise in the ordinary course of business. Management believes that the ultimate liability from these claims and actions, if any, will not have a material effect on our results of operations or financial position.

We are a party to several short-term, cancelable and noncancelable, fixed price contracts with major suppliers for the purchase of raw material and component parts. We expect to receive delivery of raw materials for use in our manufacturing operations from our fixed price contracts. These contracts are not accounted for as derivative instruments because they meet the normal purchases and sales exemption. In the normal course of business we expect to purchase 0.5 million pounds of aluminum at a price of $0.80 per pound or $0.4 million during the remainder of 2010 and 1.4 million pounds of aluminum at a price of $1.138 per pound or $1.6 million during 2011.

16. Canadian Facility

On May 18, 2009 we announced the closure of our Canadian facility and filed an 8-K to that effect. At the same time, we notified the 47 Canadian employees of the expected closure date of July 23, 2009. The actual closure date was at the end of September 2009. We accrued and charged to expense $0.3 million through December 31, 2009, in closure costs related to employee termination benefits in accordance with Canadian labor laws and regulations. We incurred employee termination costs as well as costs to dispose of inventory. We accrued and charged to expense $0.4 million as an adjustment to our inventory reserve in second quarter 2009 to account for inventory items we did not transfer to our other locations.

The following closure costs were included in income from continuing operations in the income statement and paid as of December 31, 2009:

	Balance June 30, 2009	Additional Accrual (in thousands)	Charged to Expense
Employee termination benefits	$ 280	$ 26	$ 306
Inventory reserve adjustments	389	-	389
Total	$ 669	$ 26	$ 695

We reclassified certain fixed assets to assets held for sale upon closure of our Canadian manufacturing operations in September 2009. The assets consist of a building and land valued at the lower of cost or market. No additional depreciation expense was taken on the building as of October 1, 2009. In September 2010, we sold the building and land. The sale price was $1.5 million which was equivalent to the carrying value of the assets held for sale on our Consolidated Balance Sheets. The products previously manufactured at the Canadian facility will be produced by the Tulsa, Oklahoma and Longview, Texas facilities in the future.

17. Fair Value Measurements

We follow the provisions of FASC Topic 820, Fair Value Measurements and Disclosures related to financial assets and liabilities that are being measured and reported on a fair value basis. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the principal market at the measurement date (exit price). We are required to classify fair value measurements in one of the following categories:

Level 1 inputs which are defined as quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 inputs which are defined as inputs other than quoted prices included within Level 1 that are observable for the assets or liabilities, either directly or indirectly.

Level 3 inputs are defined as unobservable inputs for the assets or liabilities.

Financial assets and liabilities are classified based on the lowest level of input that is significant to the fair value measurement. Our assessment of the significance of a particular input to the fair value measurement requires judgment, and may affect the valuation of the fair value of assets and liabilities and their placement within the fair value hierarchy levels.

Financial Derivatives Fair Value Measurements

Our financial derivative asset consists of a forward purchase contract that is measured at fair value using the quoted prices in the COMEX commodity markets which is the lowest level of input significant to measurement. The financial derivative contract began settling monthly in January 2010 and ending in December 2010. The contract is for a total of 2,250,000 pounds of copper (450,000 pounds remaining at September 30, 2010) at $2.383 per pound. In March 2010, we locked in the settlement price of $3.3975 per pound for the remainder of 2010. The fair value and carrying amount of our financial derivative asset at September 30, 2010 is $0.5 million. The measurement is based on pricing for instruments similar but not identical to the contract we will settle. These prices are based upon regularly traded commodities on COMEX. Therefore we consider the market for our contract to be active.

We record changes in the financial derivative's fair value currently in earnings based on mark-to-market accounting. During the nine months ended September 30, 2010, we recorded approximately $14,000 to cost of sales from the realized gain on our financial derivative asset at fair value in the Consolidated Statements of Income. We will not realize any additional gain or loss related to our financial derivative asset during 2010 because we locked in the settlement price for the remainder of 2010.

The following table presents the fair value of our assets and liabilities measured at fair value on a recurring basis as of September 30, 2010:

	Quoted Prices in Active Markets for Identical Assets Level 1 (in thousands)	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Total
Assets:				
Financial derivative asset	$ -	$ 457	$ -	$ 457
Total	$ -	$ 457	$ -	$ 457

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

We engineer, manufacture and market air-conditioning and heating equipment consisting of standardized and rooftop units, chillers, air-handling units, make-up air units, heat recovery units, condensing units, commercial self contained units and coils. These units are marketed and sold to retail, manufacturing, educational, medical and other commercial industries. We market units to all 50 states in the United States and certain provinces in Canada. International sales are less than five percent of our sales.

We sell our products to property owners and contractors through a network of manufacturers' representatives and our internal sales force. 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 6-18 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 principal components of cost of goods sold 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. We also purchase from other domestic manufactures certain components, including compressors, electric motors and electrical controls used in our products. The suppliers of these components are significantly affected by the raw material costs as steel, copper and aluminum are used in their products. The raw materials market was volatile during 2010 and 2009 due to the economic environment. We have entered into aluminum contracts that are below the average index price as of September 30, 2010. We have included a three-year comparison to show fluctuations in raw materials costs, which have increased by approximately 11% for aluminum and 16% for copper and decreased by approximately 14% for steel from September 30, 2008 to September 30, 2010.

We entered into a financial derivative instrument in the third quarter of 2009 with a large financial institution to mitigate our exposure to volatility in copper prices. The financial derivative is in the form of a commodity futures contract. The contract began settling monthly in January 2010 and will continue through December 2010. The contract is for a total of 2,250,000 pounds of copper (450,000 pounds remaining at September 30, 2010) at $2.383 per pound. In March 2010, we locked in the settlement price of $3.3975 per pound for the remainder of 2010. The contract is for quantities equal to or less than those expected to be used in our manufacturing operations in 2010.

In addition to our financial derivative instrument, we attempt to limit the impact of price fluctuations on these materials by entering into cancelable and noncancelable fixed price contracts with our major suppliers for periods of 6 - 18 months. We expect to receive delivery of raw materials from our fixed price contracts for use in our manufacturing operations. These contracts are not accounted for as derivative instruments because they meet the normal purchases and sales exemption.

We are subject to claims and legal actions that arise in the ordinary course of business. Management believes that the ultimate liability from these claims and actions, if any, will not have a material effect on our results of operations or financial position.

Selling, general, and administrative ("SG&A") costs include our internal sales force, warranty costs, profit sharing and administrative expense. Warranty expense is estimated based on historical trends and other factors. Our product warranty is: the earlier of one year from the date of first use or 18 months from date of shipment for parts; an additional four years on compressors; 15 years on gas-fired heat exchangers; and 25 years on stainless steel heat exchangers. Warranty charges on heat exchangers occur infrequently.

Our plant and office facilities in Tulsa, Oklahoma consist of a 342,000 sq. ft. building (327,000 sq. ft. of manufacturing/ warehouse space and 15,000 sq. ft. of office space) located at 2425 S. Yukon Avenue ("the original facility"), and a 693,000 sq. ft. manufacturing/warehouse building and a 22,000 sq. ft. office building ("the expansion facility") located across the street from the original facility at 2440 S. Yukon Avenue. We own both the original facility and the expansion facility.

In the expansion facility we use 22,000 sq. ft. for office space, 20,000 sq. ft. for warehouse space and 80,000 sq. ft. for two production lines; an additional 106,000 sq. ft. is utilized for sheet metal fabrication. The remaining 487,000 sq. ft. is presently being prepared as additional plant space for long-term growth.

Other operations in Longview, Texas are conducted in a plant/office building at 203-207 Gum Springs Road, containing 258,000 sq. ft. (251,000 sq. ft. of manufacturing/ warehouse and 7,000 sq. ft. of office space). An additional 15 acres were purchased in 2004 and 2005 for future expansion. We own both the existing plant/office building, and the 15 acres designated for future expansion.

Our previous operations in Burlington, Ontario, Canada, were located at 279 Sumach Drive, consisting of an 82,000 sq. ft. office/manufacturing facility. The facility was classified as available for sale upon closure of our manufacturing operations in September 2009 (see Note 16, Canadian Facility). In September 2010, we sold the Canadian facility.

Set forth below is unaudited income statement information for the periods ended September 30, 2010 and 2009:

	Three Months Ended		Nine Months Ended
	September 30, 2010	September 30, 2009	