2000 Annual Report

contents

Financial Highlights 1
Letter to Stockholders 2
AAR At-A-Glance 18
Board of Directors 20
Financial Review 21
Stockholder Information 43
Board Committees 44
Corporate Officers 44

financial highlights

(000s omitted, except per share data)

for the year ended May 31,	**2000**	1999	1998	1997	1996
Operating Performance					
Total sales*	**$1,024,333**	$1,050,608	$856,637	$633,553	$549,967
Net income	**35,163**	41,671	35,657	23,025	16,012
Net income per share—diluted	**$ 1.28**	$ 1.49	$ 1.27	$ .91	$ .66
Financial Position					
Working capital	**$ 347,451**	$ 334,600	$319,252	$314,119	$258,627
Total assets	**740,998**	726,630	670,559	529,584	437,846
Total debt	**206,761**	181,359	177,746	118,292	119,766
Stockholders' equity	**339,515**	326,035	300,850	269,259	204,635

**Includes pass through sales*

to our stockholders: *Fiscal 2000 was a year of mixed results for our Company. Revenues for fiscal 2000 exceeded those of any year in the Company's history, however, net income declined from the prior year. Our earnings through the first nine months of the year were ahead of fiscal 1999 by nearly 10 percent. As our fourth quarter unfolded, the business environment was impacted by rising interest rates and fuel prices, leading to customer delays in purchasing big ticket items, in particular aircraft and engines. This, together with lower than expected sales to certain inventory program customers, led to lower results in our March to May period. Throughout the year, we generated positive cash flow from operations and continued to invest in new capabilities and technology.*

Revenues, before pass through sales, grew to a record $957.5 million compared to $918.0 million in fiscal 1999. Net income declined to $35.2 million from $41.7 million the prior year, and we reported diluted earnings per share (EPS) of $1.39, down from $1.49 a year ago. Including the charge to increase bad debt reserves, EPS for fiscal 2000 was $1.28.

The AAR team is working to strengthen our position in a number of markets. Although fourth quarter results for our aircraft and engine sales and leasing businesses were disappointing, we have been leaders in the engine market for many years and have recently re-established ourselves as a niche player in the aircraft market. These are very opportunistic businesses, and with our experienced leadership team, market knowledge and financial resourcefulness, we expect to capitalize in this dynamic market.

Three years ago, AAR entered the new parts distribution business with the acquisition of Cooper Aviation followed shortly thereafter with the purchase of AVSCO, forming AAR Distribution. We bought these businesses to enhance our product offerings to our airline customers and to enter the business and general aviation markets. Since these acquisitions, our commercial aviation distribution business has achieved a 24% compounded annual growth rate while our general aviation business has not met our expectations. To address this, in the first quarter of fiscal 2001, we announced steps to streamline our U.S. distribution network to coincide with the launch of our more robust general aviation web site, allowing customers to research parts from our extensive on-line catalog, place orders 24 hours a day from anywhere in the world, check their order status and learn about special promotions.

"We continue to refine our 'close to the customer' business model and to build our franchise as a value-added provider of high quality products and services to the global aviation/aerospace industry."

David P. Storch, President and Chief Executive Officer

During fiscal 2000, the Company benefited from strong growth in the regional jet market as well as from military outsourcing. Our component repair businesses and landing gear business supporting regional aircraft grew 44% while our sales to military customers of repair services grew 41%. We made additional investments in landing gear to support our regional jet customers including support for the popular Canadair Regional Jet. We also expanded our component repair facilities and capabilities to support new products including environmental control systems, power control units and electrical systems.

The accomplishments we achieved in fiscal 2000 strengthen our franchise as our 2,800 strong employee team implements the below-referenced initiatives. Significant fiscal 2000 highlights include:

- AEROSPAN.COM, a joint venture with SITA, was created to establish the most comprehensive electronic marketplace for the air transport industry. By web-enabling airline purchasing departments, AEROSPAN.COM will provide global access to the wide array of products and services within the air transport universe in a highly efficient processing environment.
- All of our major manufacturing, overhaul, supply and repair business units completed ISO 9000 certification reflecting our unwavering commitment to operational excellence and high quality standards.
- Our AAR Allen Aircraft operating unit was selected by Honeywell as the sole distributor of its Hydro Mechanical Unit (HMU) for the CFM56-7 engine. The CFM56-7 engine powers Boeing's 737 "next generation" aircraft. There are approximately 480 of these 737s in service with an additional 887 next generation 737s on order.

The airline transportation industry is a $100 billion market, and the worldwide aerospace industry is a $500 billion market. The sky is the limit, and we have the entrepreneurial spirit and financial strength to reach for the sky.

- We opened and expanded the following repair facilities:
  - AAR Wheel & Brake Services opened facilities in Dallas, Texas and Miami, Florida to provide repair services for commercial, regional, military, business and general aviation aircraft.
  - AAR Landing Gear Services expanded its facility in Miami, Florida to accommodate additional bushing manufacturing and hydro-mechanical actuator repair.
  - AAR Aircraft Component Services expanded its facility in Garden City, New York to support increased demand for outsourced repair requirements from U.S. military customers.
  - AAR Cargo Systems opened a new FAA-certified repair station in Memphis, Tennessee increasing our cargo component repair business.
  - AAR Aircraft Services' facility in Roswell, New Mexico received FAA certification to provide limited airframe maintenance, storage and tear down services.

We continue to refine our 'close to the customer' business model and to build our franchise as a value-added provider of high quality products and services to the global aviation/aerospace industry. We have a number of initiatives underway pertaining to sales growth, margin expansion, operational excellence and working capital efficiency:

- We are expanding our position in aircraft and engines for sale or lease, utilizing a variety of financing alternatives including joint ventures, leveraged leases, operating leases and existing bank lines.
- We are capitalizing on our industry-leading logistics and supply chain knowledge to expand our inventory and maintenance support programs.
- We are stepping up our investment in FAA-authorized parts manufacturing authority (PMA) to offer our customers quality products at competitive prices.
- We are increasing the emphasis on engineering content in our repair processes.
- We are leveraging our investments in our e-business platform to expand sales.

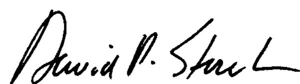
As you read this year's annual report, you'll see that we are expanding the depth, breadth and reach of AAR as we look to gain market share. While we have taken steps to reduce our cost structure, our team is committed, now more than ever, to improving customer satisfaction and financial performance.

We anticipate our business environment will remain challenging in the near term. Consolidation is occurring at both the customer and supplier levels. The major aviation original equipment manufacturers (OEMs) view the services sector as important to their growth strategy and, in some instances, view AAR as a friend and ally, and in others, as a competitor. Many of our direct competitors are struggling financially and, during the year, two of our airline customers filed for bankruptcy protection. Our business continues to benefit from the increase in the worldwide fleet of commercial and regional aircraft and from an increase in outsourcing opportunities in support of the U.S. government.

I believe our strategy of providing a broad array of products and services to the global aviation community which has served our company well in the past, will continue to do so in the future. Additionally, the diversity of our customer base, which includes large U.S. and international airlines, regional carriers, start-up airlines, freight carriers, OEMs, governments, business and general aviation operators, creates a balanced portfolio allowing us to focus our resources on those markets with the greatest demand.

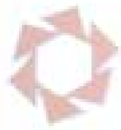
As we venture forth, I would like to express my appreciation to the employees of AAR for their hard work and dedication to excellence. I would also like to acknowledge the contribution of our Board of Directors for their guidance and wisdom imparted to our leadership team. And, I would like to thank you, our shareholders, for your continued support.

Sincerely,



David P. Storch
President and Chief Executive Officer

AAR provides customers with the most extensive array of product and service offerings in the aviation/aerospace industry. Equally important, we have the depth—the marketing, technical and financial expertise, and the people—to back those products and services. Our depth enables us to do things right for our customers—the first time, on time, every time.



epth

One way to pick a winning team is to look at the depth of their bench. AAR's depth starts with our people. We have a highly skilled workforce, 2,800 strong, available 24 hours a day, worldwide, year-round. Add to that a unique combination of marketing, technical and financial expertise that enables us to enhance customer competitiveness and ensure customer satisfaction. Our culture of quality demands every employee does things right—the first time, on time, every time. Proprietary inventory information systems allow us to source, procure, trace, track and sell inventory for a broad array of aircraft types—commercial, military and private.

moving into new opportunities and

Taken together, our people, expertise and emphasis on quality give us the ability to support the major air carriers, business jet operators, original equipment manufacturers and governments in helping them become more efficient and reduce their costs while continuing to emphasize safety. *At AAR, safety of flight is paramount to everything we do*. We also have the ability to apply all of AAR's resources to support smaller airlines as well as start-up airlines in providing the type of sourcing, planning and systems they would not normally be able to afford on their own.

But we're not content to stop there. We're going to get even better. We have several operational excellence initiatives in place, including training in Continuous Improvement. We are also implementing a Customer Loyalty Measurement System to learn how customers view our business and identify steps we need to take to better help customers meet their goals. At our foundation is AAR's financial strength. We have been in business for almost 50 years and have been profitable every year—even during industry down cycles. We will be here when our customers need us with the financial resources to put into effect the innovative programs that we create on their behalf. Our goal is to continue to create value for customers, stockholders and employees, and in doing so, maintain AAR's industry leadership position.

building long-term relationships,

AAR has a unique portfolio of businesses providing everything from parts (whether a simple light bulb or a complex cockpit computer) to supply chain management (including online inventory control systems and turnkey management of the entire supply chain) to the maintenance of customer aircraft.

Because we provide so many products and services, customers look to AAR when they need solutions. We're up to the task. Our goal is to develop integrated programs for our customers that exceed their expectations and provide them with the convenience of one company for all their product and support needs.

meeting customers' needs and

AAR started out as a broker of used aircraft radios. Over the years, we have grown to become one of the largest parts suppliers in the industry. Today, customers want more. They want to focus on what they do best—flying aircraft. And we help them by doing what AAR does best—everything else. Today, AAR has an extensive selection of products and services to meet customer needs when it comes to parts, supply chain management, component service and aircraft maintenance. These offerings help our customers become more successful by increasing efficiency and reducing costs.

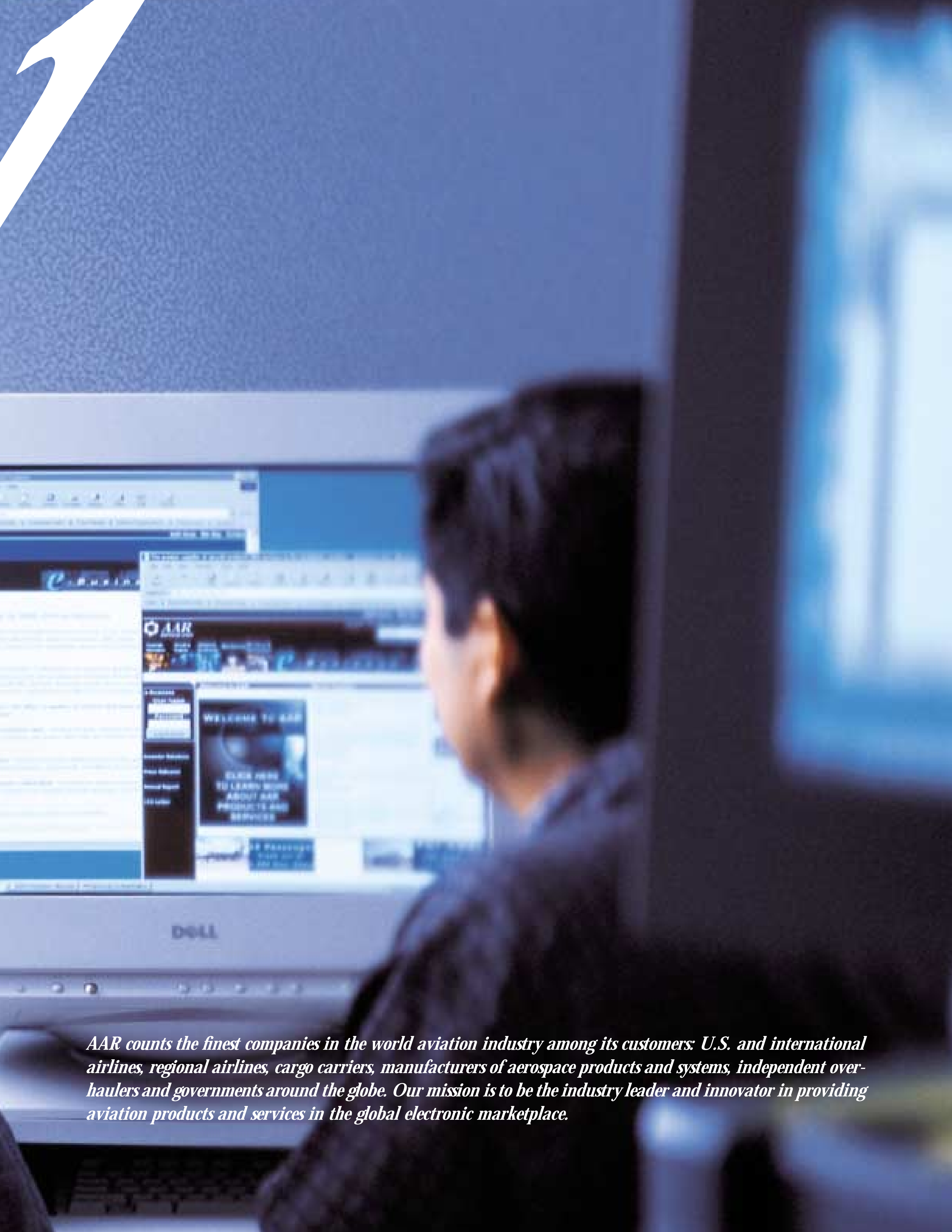
expanding products & services,

El Salvador-based GRUPO TACA, for example, wanted help managing its parts inventory and maintenance operations. We responded with a customized program. Now, instead of buying parts and services for certain aircraft individually from numerous suppliers with multiple purchase orders and repair orders, TACA saves time and money by outsourcing this function to AAR.

In a move that expands AAR's maintenance and overhaul capabilities, AAR Aircraft Services' facility in Roswell, NM received FAA certification to provide limited maintenance and storage services for aircraft including Airbus A300 and A310; Boeing 727, 737 and 747; Douglas DC-9, MD80, DC10 and MD11; and Lockheed L1011. Because Roswell offers access to U.S. Customs, Immigration and Agriculture services, international customers can fly nonstop into the facility avoiding costly clearance stops that incur landing fees, unscheduled maintenance, fuel and crew costs.

And of course, AAR still does a better job than anybody else when it comes to supplying parts to customers. New customer-specific e-Business offerings such as our Commercial Aviation, General Aviation and Military & Government sites will make it even easier for customers to get the products and services they need when they need them. In addition, our Strategic Allies Program allows rapid deployment customers to order complementary items from other companies through our Military & Government site.

reach



AAR counts the finest companies in the world aviation industry among its customers: U.S. and international airlines, regional airlines, cargo carriers, manufacturers of aerospace products and systems, independent overhaulers and governments around the globe. Our mission is to be the industry leader and innovator in providing aviation products and services in the global electronic marketplace.

growing in IT capabilities and

AAR has always made it a priority to stay in touch with customers and their changing needs. Now through major investments in new systems, technology and e-commerce initiatives, we are reaching out to expand our customer base and increase loyalty among existing customers. Through AAR Online Services programs, such as our customer-specific Commercial Aviation and General Aviation sites (which provide access to an extensive inventory of new, overhauled or serviceable components) and Online Partner Services℠ (which allows our inventory management customers to view the status of inventory, purchase and repair orders), we are providing our customers with cutting-edge, web-based business solutions.

spanning the world wide web

We provide similar services to military customers through our Military & Government site and Strategic Allies Program. Each of our customers has access to our very extensive database. Customers also have the opportunity to create additional efficiencies and further reduce costs by accessing our web-based systems.

In a significant joint venture that will open up new sourcing channels and reduce procurement costs for industry participants, AAR and SITA are working together to launch AEROSPAN.COM, a comprehensive electronic marketplace for the air-transport industry. By web-enabling airline purchasing departments, AEROSPAN.COM will provide global access to the wide array of products and services in a highly efficient processing environment.

Customers who use AEROSPAN.COM will have opportunities to achieve increased operating efficiencies through industry-specific functionality and features to automate, streamline and simplify their business processes.

Aircraft & Engines

Aircraft Sales & Leasing. Airlines are constantly changing the composition of their fleets. Whether an airline needs to purchase, lease, sell, or trade aircraft, AAR provides unparalleled service, including locating, evaluating and acquiring aircraft; performing or managing required maintenance, upgrades and conversions; facilitating aircraft trades (buy or sell); structuring operating leases; purchasing existing leases; and providing innovative financing solutions.

Engine Sales & Leasing. AAR maintains a sizable inventory of engines that meets customers' exact specifications. Our portfolio includes engines from the world's most respected manufacturers, including CFM International, General Electric, International Aero Engines, Pratt & Whitney and Rolls Royce. Customers can choose from a variety of purchase, variable-term lease and exchange programs that meet both their short- and long-term needs.

Engine Parts Supply. AAR is the aviation industry's largest independent supplier of aircraft engine components and inventory management services designed to reduce maintenance costs and increase efficiency. We offer a full range of engine parts services, including parts supply, just-in-time delivery, repair and exchange, onsite warehouse management and inventory management.

Engine Component Repair. AAR provides turbine engine component overhaul for aircraft operators, independent overhaul facilities and power generation companies. Our capabilities also include on-site overhaul of industrial steam and gas turbines, replacement parts, blade and valve repair, installation of erosion shields, diaphragm and nozzle coatings, and rotor overhaul and balancing.

Airframe & Accessories

Aircraft Maintenance, Modification and Services. AAR provides major maintenance inspections, line maintenance, aircraft modifications and upgrades to the world's major, regional and cargo airline fleets, and the U.S. military and government agencies. Our facility in Oklahoma City has over 200,000 square feet in seven hangars to support six "nose-to-tail" narrow-body aircraft maintenance lines.

Aircraft Component Repair. AAR services rotable components with AOG service, 24 hours a day, 365 days a year, at facilities in Amsterdam, London and New York, where we repair, overhaul and maintain more than 22,000 parts including avionics, instruments, pneumatics, hydraulics, electronics, fuel controls and electrical accessories.

Landing Gear Repair. AAR specializes in the exchange and overhaul of landing gear for all commercial aircraft and, through its subsidiary, AAR Tempco, all regional aircraft. Additional capabilities include bushing manufacturing and hydro-mechanical actuator repair.

Airframe Parts Supply. AAR offers a vast inventory of new and refurbished airframe parts for virtually every commercial aircraft type. We also provide inventory management and exchange programs that help customers reduce costs, increase parts availability, reduce lead times and ensure quality.

Distribution. AAR provides high-quality, factory-new products to the worldwide commercial, general and business aviation markets. We stock over 35,000 items from over 250 aviation equipment manufacturers, providing customers with expert sales staff, same-day shipping and full coverage of the market from private aircraft to jumbo jets.

Continued growth in worldwide passenger and air cargo traffic means ongoing growth opportunities for AAR's Aircraft and Engine Group.

AAR's repair operations encompass a broad range of capabilities including aircraft and landing gear maintenance and airframe and engine component repair and overhaul. Our focus is on extending on-wing performance and reducing downtime.

AAR At-A-Glance: Comprised of 2,800 employees at 40 facilities located in 12 countries, AAR is one of the world's largest and most diverse aviation aftermarket support companies. Since our founding in 1951, we have grown by anticipating customer requirements in this very competitive market, developing innovative, cost-effective products and programs, and delivering on a commitment to do things right.

Manufacturing

Cargo Loading Systems. AAR designs and manufactures in-aircraft cargo loading systems known for rugged durability, high reliability and customized features. Customers rely on us to develop innovative systems that maximize cargo transportation efficiencies.

Rapid Deployment Support Products. AAR offers rapid deployment support products for use by branches of the U.S. military. Significant products include transportable shelters for varied uses in the field, as well as containers ranging from small weaponry carriers to room-sized, self-powered refrigerated units suitable for medical supplies. In addition, our Strategic Allies Program allows rapid deployment customers to order complementary items from other companies online through our Military & Government web site.

Composites. AAR provides design, engineering and manufacture of composite interior and exterior structures for the aerospace industry. We specialize in aircraft interior modifications that reduce noise, increase cabin space and extend the service of aircraft components through superior durability, strength and noncorrosive characteristics.

Technology

AAR is committed to being on the leading edge of IT solutions for our customers. Our Enterprise Resource Planning systems are state-of-the-art supply chain applications that provide enhanced customer service and allow for more efficient business processes. AAR Online Services customer-specific web sites allow our Commercial Aviation, General Aviation and Military & Government customers to check available inventory and services and order online. Meanwhile, Online Partner Services[SM] offers information to participants in our long-term inventory management programs, including tracking purchase orders, repair orders and material requisitions. This system is capable of reflecting a customer's on-shelf inventory as well as consigned and available inventory.

The introduction of these services means significantly increased speed in transaction processing, more accurate and timely information on order status, and access to pertinent information without regard to global time zones. Our goal is to communicate with customers on their terms and make it easier for them to do business with us.

AAR designs and manufactures onboard cargo systems for military and commercial aircraft, rapid deployment support products for the U.S. and other governments, and composite structures and components for aircraft manufacturers and modification/repair centers.

Significant investments in information technology (IT) bring the highest quality product and overhaul capabilities to our customers faster and more economically.

board of directors

(pictured back row to front row, left to right)

A. Robert Abboud
President, A. Robert Abboud & Co.

Edgar D. Jannotta
Senior Director, William Blair & Company, L.L.C.

Lee B. Stern
President, LBS Co.

Joel D. Spungin
Managing Partner, DMS Enterprises, L.P.
Chairman Emeritus of United Stationers, Inc.

Erwin E. Schulze
Chairman Emeritus, Chicago Stock Exchange
Retired Chairman of the Board, Ceco Industries, Inc.

Ira A. Eichner
Chairman of the Board and Founder, AAR CORP.

Howard B. Bernick
President and Chief Executive Officer, Alberto-Culver Company

David P. Storch
President and Chief Executive Officer, AAR CORP.

Richard D. Tabery
Aviation Business Consultant

(in thousands, except percentage data)

RESULTS OF OPERATIONS

The Company reports its activities in one business segment: Aviation Services. The table below sets forth sales for the Company's classes of similar products and services within this segment for each of the last three fiscal years ended May 31.

for the year ended May 31,	**2000**	1999	1998
Sales:			
Aircraft and Engines	**$ 440,502**	$ 416,196	$339,299
Airframe and Accessories	**397,090**	376,259	333,283
Manufacturing	**119,933**	125,581	109,541
	957,525	918,036	782,123
Pass through sales	**66,808**	132,572	74,514
	$1,024,333	$1,050,608	$856,637

Three-Year Sales Summary

Over the last three fiscal years, consolidated sales, before pass through sales, increased from $782,123 in fiscal 1998 to $957,525 in fiscal 2000. Total sales, which include pass through sales, increased from $856,637 in fiscal 1998 to $1,024,333 in fiscal 2000. The growth in sales was the result of the growing demand for the Company's broad line of products and services in the aviation/aerospace market, whose rate of growth declined slightly the last two fiscal years. In fiscal 1998, most of the world's major airlines, excluding those in Asia, reported record or near record operating earnings driven by strong revenue growth and their various initiatives to control costs. In 1999 and 2000, however, many of the world's airlines experienced lower operating earnings compared to 1998 reflecting slower revenue growth and higher expenses. Certain domestic aviation/aerospace original equipment manufacturers also experienced lower operating earnings during the latter half of the three-year period reflecting the overall softening aviation/aerospace market. In addition, during the latter part of the three-year period, many airlines replaced older aircraft, such as the 727 and DC-9, powered by the JT8D engine family, and older 747s, generally powered by the JT9D engine family, in favor of newer aircraft, such as the 737-300, 747-400, 777, A320 and A330/A340. The Company continues to develop new repair and overhaul capabilities and other support programs for the newer generation aircraft and engines.

During fiscal 1998 and 1999, the Company's sales before pass through sales benefited from the aggressive pursuit of market opportunities in the relatively strong aviation/aerospace market. Sales in Aircraft and Engines benefited from new inventory management programs and higher sales of its aircraft and engine sales and leasing products. Sales in Airframe and Accessories increased as a result of greater demand for the Company's repair and overhaul services and the impact from the acquisition of a new aircraft parts distribution company during 1998. Sales in Manufacturing increased in 1999 compared to 1998 from strong demand of the Company's products supporting U.S. deployment needs.

During fiscal 2000, sales, before pass through sales, increased due to greater demand for the Company's repair and overhaul services, as well as the Company's aircraft and engine sales and leasing products. Sales in Aircraft and Engines during fiscal 2000 were negatively impacted by lower engine part sales reflecting fewer shop visits at a main customer's engine overhaul facilities. Sales in Manufacturing during fiscal 2000 were lower mainly as a result of the divestiture of the Company's floor maintenance products manufacturing facility which occurred in the second quarter of fiscal 1999.

Pass through sales increased in fiscal 1999 compared to 1998 mainly as a result of new engine parts inventory management programs, but declined in fiscal 2000 primarily as a result of the aforementioned fewer shop visits at a certain customer's engine overhaul facilities.

The Company believes that its established global market position, its ability to respond to changes in the industry, including technological changes, and its diverse customer base, position the Company to take advantage of future opportunities in the aviation/aerospace market.*

**This section contains forward-looking statements which are identified with an asterisk (*). Please see comments on forward-looking statement risk factors in the "Forward-Looking Statements" section on page 24.*

Fiscal 2000 Compared with Fiscal 1999

Consolidated sales in fiscal 2000, before pass through sales, increased 4.3% to $957,525 from $918,036 in fiscal 1999. This increase was attributable to higher demand for the Company's aircraft and engine sales and leasing products, as well as strong demand for the Company's repair and overhaul services. Sales in Aircraft and Engines increased $24,306 or 5.8%, as the Company experienced strong demand for its whole engine and aircraft products, partially offset by a continued decrease in sales from engine parts inventory management programs. This decrease is primarily the result of reduced demand by a major customer for certain engine parts due principally to significantly fewer engine shop visits to this customer for the engine types the Company supports. The Company is working to resolve pending issues with this customer, but no assurance can be given that sales to this customer will continue at historical levels in the future. The Company is aggressively pursuing inventory management programs with other customers and building its engine parts manufacturing capabilities to offset potential future reduced sales to this customer.* Sales in Airframe and Accessories increased $20,831 or 5.5%, reflecting increased demand for the Company's aircraft maintenance and landing gear and small component overhaul and repair services. These increases were partially offset by lower new aircraft parts sales to general aviation customers. Sales in Manufacturing declined $5,648 or 4.5%, as a result of the divestiture of the Company's floor maintenance products manufacturing subsidiary in November 1998, partially offset by higher sales of the Company's products supporting U.S. deployment needs. Pass through sales were $66,808 compared to $132,572 in the prior year. As certain of the Company's inventory management programs have matured, pass through sales have declined as the Company has sourced more of its customers' parts requirements with used, serviceable parts, rather than with factory-new parts. The reduction in pass through sales during the current fiscal year is attributable to the maturation of the Company's existing long-term inventory management programs, as well as a decline in the number of shop visits for the engine types the Company supports at certain long-term inventory management programs.

Consolidated gross profit was essentially even with the prior fiscal year. The fiscal 2000 consolidated gross profit margin, excluding the impact from pass through sales, was 18.1% in the current fiscal year compared to 18.9% in the prior year. The reduction in the consolidated gross profit margin was primarily due to the unfavorable impact of the mix of inventories sold. Selling, general and administrative expenses increased $6,317 or 6.6%, as a result of a $4,000 fourth quarter charge to increase bad debts reserve in response to the Company's accounts receivable exposure, which included two airlines that filed for bankruptcy protection during fiscal 2000, as well as increased information technology costs incurred as a result of the Company's e-business activities. Interest expense increased $4,864 principally as a result of increased average short-term borrowings outstanding during fiscal year 2000 as compared to the prior year, and interest income increased $1,327 as a result of an increase in average outstanding interest-bearing notes receivable during the current year compared to the prior year.

Consolidated net income declined $6,508 or 15.6%, from the prior year as a result of the above factors.

Fiscal 1999 Compared with Fiscal 1998

Consolidated sales in fiscal 1999, before pass through sales, increased 17.4% to $918,036 from $782,123 in fiscal 1998. This increase was attributable to continued strong demand for the Company's broad range of products and services and, among other things, full-year sales from businesses acquired in fiscal 1998. Aircraft and Engines sales increased $76,897 or 22.7%, resulting from higher sales of engine parts, driven primarily from strength in inventory management programs, and increased aircraft sales and leasing revenues. These increases were partially offset by the impact of certain engine parts sales which were recorded by Turbine Engine Asset Management L.L.C. (an unconsolidated joint venture company) during fiscal 1999, but were recorded by Aircraft and Engines during the first half of fiscal 1998. Airframe and Accessories sales increased $42,976 or 12.9%, driven primarily by the impact of full-year sales from the new-parts distribution companies acquired during fiscal 1998, as well as increased demand for aircraft maintenance and landing gear overhaul repair capabilities. Manufacturing sales increased $16,040 or 14.6%, due to increased sales of products supporting the U.S. Government's rapid deployment program, the inclusion of full-year sales from AAR Composites (acquired in fiscal 1998) and higher sales of cargo handling systems. These gains were partially offset by the unfavorable impact on sales as a result of the divestiture of the Company's floor maintenance products manufacturing subsidiary in November 1998. Pass through sales were $132,572 compared

to $74,514 in the prior year. The increase in pass through sales in the current year as compared to the prior year was attributable to the addition of new inventory management programs during fiscal 1999 and late fiscal 1998.

Consolidated gross profit increased $24,853 or 16.7%, due to increased consolidated net sales. The fiscal 1999 consolidated gross profit margin of 18.9%, excluding the impact from pass through sales, is slightly less than the consolidated gross profit margin of 19.0% of the prior year. Consolidated operating income increased $12,665 or 19.6% over the prior year on the strength of increased sales, partially offset by increased selling, general and administrative expenses. Selling, general and administrative expenses were lower as a percentage of consolidated net sales; however, total expenses increased due to the impact from companies acquired during fiscal 1998, as well as increased marketing support and information technology costs, which include Year 2000 compliance costs. Interest expense increased $4,073 or 28.1% over the prior year primarily due to the full-year effect of the $60,000 of unsecured 6.875% Notes issued in December 1997.

Consolidated net income increased $6,014 or 16.9% over the prior year as a result of the above-noted factors.

Fiscal 1998 Compared with Fiscal 1997

Consolidated sales, before pass through sales, increased $192,795 or 32.7% over the prior fiscal year, reflecting strong demand for the Company's broad range of products and services and the effect of acquisitions during fiscal 1998. Acquisitions, net of prior year dispositions, contributed $77,234 to the sales increase over the prior year. Aircraft and Engines sales increased $76,225 or 29.0%, resulting from higher sales in its engine and engine parts businesses, as well as increased aircraft sales. Airframe and Accessories sales increased $111,850 or 50.5%, driven primarily by sales from the new-parts distribution companies, which were acquired in fiscal 1998, and increased demand for the Company's aircraft maintenance and aircraft component overhaul and repair capabilities. Sales in Manufacturing increased $4,720 or 4.5%, reflecting increased cargo loading and handling system sales and the inclusion of sales from ATR (AAR Composites), which was acquired in October 1997, partially offset by lower sales from products supporting the U.S. Government's rapid deployment program. Pass through sales were $74,514 compared to $44,225 reflecting strong demand of engine parts in the Company's inventory management programs.

Consolidated gross profit increased $39,865 or 36.7%, due to increased consolidated net sales and an increase in the consolidated gross profit margin to 19.0%, excluding the impact from pass through sales, from 18.4% in the prior year. The increase in the consolidated gross profit margin during fiscal 1998 reflected the favorable mix of inventories sold and improved margins in certain manufactured products.

Consolidated operating income increased $21,826 or 50.9% over the prior fiscal year as a result of the increase in net sales and the higher gross profit margin, partially offset by increased selling, general and administrative expenses. Selling, general and administrative expenses were lower as a percentage of consolidated net sales; however, total expenses increased principally due to the inclusion of recently acquired companies and increased personnel costs. Interest expense increased $3,708 or 34.4% over the prior year, principally due to the impact of the Company's sale of $60,000 of unsecured 6.875% Notes in December 1997.

Consolidated net income increased $12,632 or 54.9% over the prior year as a result of the factors previously discussed.

Liquidity and Capital Resources

At May 31, 2000, the Company's liquidity and capital resources included cash and cash equivalents of $1,241 and working capital of $347,451. At May 31, 2000, the Company's long-term debt-to-capitalization ratio was 34.7% compared to 35.7% at May 31, 1999, and the Company's total debt-to-capitalization ratio was 37.8% at May 31, 2000, compared to 35.7% at May 31, 1999. The Company continues to maintain its external sources of financing with $153,326 of unused available bank lines and a shelf registration statement on file with the Securities and Exchange Commission under which up to $200 million of common stock, preferred stock or medium- or long-term debt securities may be issued or sold subject to market conditions.

During fiscal 2000, the Company generated $10,051 of cash flow from operations compared to $28,525 and $22,823 during fiscal 1999 and 1998, respectively. The reduction in cash flow generated from operations was principally due to a reduction in accounts and notes payable and accrued liabilities during the current fiscal year.

During fiscal 2000, the Company's investing activities used $23,209, primarily reflecting the Company's investment in property, plant and equipment of $22,344.

During fiscal 2000, the Company's financing activities generated $6,029 of cash, reflecting proceeds from short-term borrowings of $25,885, partially offset by the purchase of the Company's stock of $10,530 and the payment of cash dividends of $9,218.

The Company believes that its liquidity and available sources of capital will continue to provide the Company with the ability to meet its ongoing working capital requirements, make anticipated capital expenditures, meet contractual commitments and pay dividends.*

A summary of key indicators of financial condition and lines of credit follows:

May 31,	**2000**	1999
Working capital	**$347,451**	$334,600
Current ratio	**3.1:1**	2.9:1
Bank credit lines:		
Borrowings outstanding	**$ 25,885**	$ —
Available but unused lines	**153,326**	178,800
Total credit lines	**$179,211**	$178,800
Long-term debt, less current maturities	**$180,447**	$180,939
Ratio of long-term debt to capitalization	**34.7%**	35.7%
Ratio of total debt to capitalization	**37.8%**	35.7%

Forward-Looking Statements

Management's Discussion and Analysis of Financial Condition and Results of Operations contains certain statements relating to future results, which are forward-looking statements as that term is defined in the Private Securities Litigation Reform Act of 1995 and are identified by an asterisk(*). These forward-looking statements are based on beliefs of Company management, as well as assumptions and estimates based on information currently available to the Company, and are subject to certain risks and uncertainties that could cause actual results to differ materially from historical results or those anticipated, depending on a variety of factors, including: ability to acquire inventory at favorable prices; integration of acquisitions; marketplace competition; economic and aviation/aerospace market stability and Company profitability. Should one or more of these risks or uncertainties materialize adversely, or should underlying assumptions or estimates prove incorrect, actual results may vary materially from those described.

Quantitative and Qualitative Disclosures about Market Risk

The Company's exposure to market risk is limited to fluctuating interest rates under its unsecured bank credit agreements and foreign exchange rates. During fiscal 2000 and 1999, the Company did not utilize derivative financial instruments to offset these risks.

At May 31, 2000, $65,300 was available under credit lines with domestic banks, $84,115 was available under revolving credit and term loan agreements with domestic banks, and $3,911 was available under credit agreements with foreign banks (credit facilities). Interest on amounts borrowed under the credit facilities is based on an overnight bid rate. As of May 31, 2000, the outstanding balance under these agreements was $25,885. A hypothetical 10 percent increase to the average interest rate under the credit facilities would not have had a material impact on the results of operations for the Company during fiscal 2000.

Revenues and expenses of the Company's foreign operations in The Netherlands are translated at average exchange rates during the year and balance sheet accounts are translated at year-end exchange rates. Balance sheet translation adjustments are excluded from the results of operations and are recorded in stockholders' equity as a component of accumulated other comprehensive income (loss). A hypothetical 10 percent devaluation of foreign currencies against the U.S. dollar would not have a material impact on the financial position or results of operations of the Company.

Financial Statistics

(000's omitted, except per share data, ratios and employees)

for the year ended May 31,	**2000**	1999	1998	1997	1996
Operating Performance					
Sales	**$ 957,525**	$ 918,036	$782,123	$589,328	$504,990
Pass through sales (a)	**66,808**	132,572	74,514	44,225	44,977
Total sales	**1,024,333**	1,050,608	856,637	633,553	549,967
Gross profit	**172,853**	173,259	148,406	108,541	90,765
Operating income	**70,658**	77,381	64,716	42,890	32,442
Interest expense	**23,431**	18,567	14,494	10,786	10,616
Income before provision for income taxes	**49,526**	59,786	51,157	32,975	22,782
Net income	**35,163**	41,671	35,657	23,025	16,012
Financial Position					
Working capital	**$ 347,451**	$ 334,600	$319,252 (d)	$314,119 (e)	$258,627
Total assets	**740,998**	726,630	670,559	529,584 (e)	437,846
Short-term debt	**26,314**	420	237 (d)	1,474	1,474
Long-term debt	**180,447**	180,939	177,509 (d)	116,818	118,292
Total debt	**206,761**	181,359	177,746 (d)	118,292	119,766
Stockholders' equity	**339,515**	326,035	300,850	269,259 (e)	204,635
Number of shares outstanding at end of year (b)	**26,865**	27,381	27,717	27,306 (e)	23,997
Book value per share of common stock (b)	**$ 12.64**	$ 11.91	$ 10.85	$ 9.86	$ 8.53
Ratio Analysis					
Current ratio	**3.1:1**	2.9:1	3.1:1	4.1:1	4.3:1
Return on sales (c)	**3.7%**	4.5%	4.6%	3.9%	3.2%
Gross profit margin (c)	**18.1%**	18.9%	19.0%	18.4%	18.0%
Return on average invested capital	**9.3%**	10.9%	10.4%	8.5%	7.1%
Return on average equity	**10.5%**	13.3%	12.5%	10.2%	8.2%
Ratio of long-term debt to capitalization	**34.7%**	35.7%	37.1% (d)	30.3%	36.6%
Ratio of total debt to capitalization	**37.8%**	35.7%	37.2% (d)	30.5%	37.1%
Sales per employee (c)	**$ 331**	$ 323	$ 318	$ 271	$ 244
Share Data (b)					
Earnings per share—basic	**$ 1.30**	$ 1.51	$ 1.29	$ .92	$ .67
Earnings per share—diluted	**$ 1.28**	$ 1.49	$ 1.27	$ .91	$ .66
Cash dividends per share	**$ .34**	$ .34	$ .33	$ .32	$ .32
Average common shares outstanding—basic	**27,103**	27,549	27,588	25,026 (e)	23,967
Average common shares outstanding—diluted	**27,415**	28,006	28,174	25,399 (e)	24,248
Number of Employees	**2,900**	2,900	2,700	2,100	2,140

(a) In connection with certain long-term inventory management programs, the Company purchases factory-new products on behalf of its customers from original equipment manufacturers. These products are purchased from the manufacturer and "passed through" to the Company's customers at the Company's cost. Beginning with the third quarter of fiscal 2000, the Company began reporting "pass through" sales on the Income Statement.

(b) All share and per share information reflects the three-for-two stock split on February 23, 1998.

(c) Ratios are calculated on sales before pass through sales.

(d) In December 1997, the Company sold $60,000 of unsecured 6.875% Notes due December 15, 2007.

(e) In February 1997, the Company sold three million shares of its common stock for $50,075, net of expenses.

Quarterly Results of Operations

(000's omitted, except per share data)

Fiscal 2000

Quarter	Sales	Gross Profit	Net Income	Diluted Earnings Per Share
First	**$ 266,683**	**$ 44,190**	**$10,831**	**$ .39**
Second	**260,240**	**45,728**	**10,906**	**.40**
Third	**272,331**	**45,074**	**10,955**	**.40**
Fourth	**225,079**	**37,861**	**2,471**	**.09**
	$1,024,333	**$172,853**	**$35,163**	**$1.28**

Fiscal 1999

Quarter	Sales	Gross Profit	Net Income	Diluted Earnings Per Share
First	$ 250,491	$ 41,049	$ 9,623	$ .34
Second	282,232	42,740	10,035	.36
Third	250,984	42,706	10,278	.37
Fourth	266,901	46,764	11,735	.42
	$1,050,608	$173,259	$41,671	$1.49

Market Prices and Dividends

Per Common Share	**Fiscal 2000**			Fiscal 1999		
	Market Prices		**Quarterly**	Market Prices		Quarterly
Quarter	**High**	**Low**	**Dividends**	High	Low	Dividends
First	**23 1/4**	**18 3/8**	**$.085**	29 15/16	22 1/8	$.085
Second	**21 15/16**	**15 15/16**	**.085**	25 3/8	17 3/4	.085
Third	**26 7/8**	**15 13/16**	**.085**	25 3/8	15	.085
Fourth	**23 5/8**	**13 7/8**	**.085**	21 9/16	15 3/8	.085
			$.340			$.340

Consolidated Statements of Income

(000s omitted except per share data)

for the year ended May 31,	**2000**	1999	1998
Sales	**$ 957,525**	$ 918,036	$782,123
Pass through sales	**66,808**	132,572	74,514
	1,024,333	1,050,608	856,637
Costs and operating expenses:			
Cost of sales	**851,480**	877,349	708,231
Selling, general and administrative	**102,195**	95,878	83,690
	953,675	973,227	791,921
Operating income	**70,658**	77,381	64,716
Interest expense	**(23,431)**	(18,567)	(14,494)
Interest income	**2,299**	972	935
Income before provision for income taxes	**49,526**	59,786	51,157
Provision for income taxes	**14,363**	18,115	15,500
Net income	**$ 35,163**	$ 41,671	$ 35,657
Earnings per share of common stock—basic	**$ 1.30**	$ 1.51	$ 1.29
Earnings per share of common stock—diluted	**$ 1.28**	$ 1.49	$ 1.27

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

Consolidated Balance Sheets

(000s omitted)

Assets	May 31, 2000	May 31, 1999
Current assets:		
Cash and cash equivalents	$ 1,241	$ 8,250
Accounts receivable	128,348	164,302
Inventories	275,817	270,654
Equipment on or available for short-term leases	60,201	33,845
Deferred tax assets, deposits and other	45,660	31,135
Total current assets	511,267	508,186
Property, plant and equipment, at cost:		
Land	6,331	6,331
Buildings and improvements	68,387	66,123
Equipment, furniture and fixtures	127,879	111,718
	202,597	184,172
Accumulated depreciation	(92,594)	(80,160)
	110,003	104,012
Other assets:		
Investment in leveraged leases	34,487	34,053
Cost in excess of underlying net assets of acquired companies, net	38,840	40,093
Other	46,401	40,286
	119,728	114,432
	$740,998	$726,630

Liabilities and Stockholders' Equity		
Current liabilities:		
Short-term debt	$ 25,885	$ —
Current maturities of long-term debt	429	420
Accounts and trade notes payable	107,879	129,703
Accrued liabilities	26,596	36,803
Accrued taxes on income	3,027	6,660
Total current liabilities	163,816	173,586
Long-term debt, less current maturities	180,447	180,939
Deferred tax liabilities	56,020	44,870
Retirement benefit obligation	1,200	1,200
	237,667	227,009
Stockholders' equity:		
Preferred stock, $1.00 par value, authorized 250 shares; none issued	—	—
Common stock, $1.00 par value, authorized 100,000 shares; issued 29,168 and 28,998, respectively	29,168	28,998
Capital surplus	146,557	144,095
Retained earnings	210,474	184,529
Treasury stock, 2,303 and 1,617 shares at cost, respectively	(37,236)	(25,463)
Accumulated other comprehensive income (loss)—cumulative translation adjustments	(9,448)	(6,124)
	339,515	326,035
	$740,998	$726,630

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

Consolidated Statements of Stockholders' Equity

(000s omitted)

for the three years ended May 31, 2000	Common Stock Shares	Common Stock Amount	Treasury Stock Shares	Treasury Stock Amount	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Comprehensive Income (Loss)
Balance, May 31, 1997	18,932	$18,932	728	$(13,365)	$141,016	$125,694	$ (3,018)	
Net income	—	—	—	—	—	35,657	—	$35,657
Cash dividends	—	—	—	—	—	(9,118)	—	
Issuance of common stock	—	—	(93)	1,699	1,158	—	—	
Treasury stock	—	—	126	(4,804)	—	—	—	
Three-for-two stock split	9,589	9,589	367	—	(9,589)	—	—	
Exercise of stock options and stock awards	311	311	—	—	8,313	—	—	
Adjustment for net translation loss	—	—	—	—	—	—	(1,625)	(1,625)
Comprehensive income for fiscal 1998								$34,032
Balance, May 31, 1998	28,832	$28,832	1,128	$(16,470)	$140,898	$152,233	$ (4,643)	
Net income	—	—	—	—	—	41,671	—	$41,671
Cash dividends	—	—	—	—	—	(9,375)	—	
Treasury stock	—	—	489	(8,993)	—	—	—	
Exercise of stock options and stock awards	166	166	—	—	3,197	—	—	
Adjustment for net translation loss	—	—	—	—	—	—	(1,481)	(1,481)
Comprehensive income for fiscal 1999								$40,190
Balance, May 31, 1999	28,998	$28,998	1,617	$(25,463)	$144,095	$184,529	$(6,124)	
Net income	—	—	—	—	—	35,163	—	$35,163
Cash dividends	—	—	—	—	—	(9,218)	—	
Treasury stock	—	—	686	(11,773)	—	—	—	
Exercise of stock options and stock awards	170	170	—	—	2,462	—	—	
Adjustment for net translation loss	—	—	—	—	—	—	(3,324)	(3,324)
Comprehensive income for fiscal 2000								$31,839
Balance, May 31, 2000	**29,168**	**$29,168**	**2,303**	**$(37,236)**	**$146,557**	**$210,474**	**$(9,448)**	

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

Consolidated Statements of Cash Flows

(000s omitted)

for the year ended May 31,	**2000**	1999	1998
Cash flows from operating activities:			
Net income	**$ 35,163**	$ 41,671	$ 35,657
Adjustments to reconcile net income to net cash provided from operating activities:			
Depreciation and amortization	**18,373**	17,063	14,283
Deferred taxes	**9,570**	10,970	3,780
Change in certain assets and liabilities:			
Accounts receivable	**31,532**	(6,991)	(14,922)
Inventories	**(6,644)**	(46,212)	(34,706)
Equipment on or available for short-term leases	**(26,593)**	3,214	6,664
Accounts and trade notes payable	**(21,536)**	24,659	2,730
Accrued liabilities and taxes on income	**(13,786)**	(3,933)	16,936
Other	**(16,028)**	(11,916)	(7,599)
Net cash provided from operating activities	**10,051**	28,525	22,823
Cash flows from investing activities:			
Property, plant and equipment expenditures, net	**(22,344)**	(36,131)	(17,495)
Acquisitions, less cash acquired	**—**	(15,175)	(28,148)
Proceeds from sale of business	**—**	11,685	—
Investment in equipment on long-term leases and leveraged leases	**(434)**	23,369	(33,538)
Notes receivable and other	**(431)**	(6,641)	(19,948)
Net cash used in investing activities	**(23,209)**	(22,893)	(99,129)
Cash flows from financing activities:			
Proceeds from issuance of long-term notes payable	**—**	—	59,347
Proceeds from short-term debt	**25,885**	—	—
Change in borrowings	**(484)**	2,053	(10,170)
Cash dividends	**(9,218)**	(9,375)	(9,118)
Purchases of treasury stock	**(10,530)**	(7,558)	—
Proceeds from exercise of stock options and other	**376**	278	1,642
Net cash provided from (used in) financing activities	**6,029**	(14,602)	41,701
Effect of exchange rate changes on cash	**120**	(2)	122
(Decrease) in cash and cash equivalents	**(7,009)**	(8,972)	(34,483)
Cash and cash equivalents, beginning of year	**8,250**	17,222	51,705
Cash and cash equivalents, end of year	**$ 1,241**	$ 8,250	$ 17,222

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

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Business

AAR CORP. (the Company) supplies a variety of products and services to the worldwide aviation/aerospace industry. Products and services are sold primarily to commercial, domestic and foreign airlines; business aircraft operators; aviation original equipment manufacturers; aircraft leasing companies; domestic and foreign military agencies and independent aviation support companies.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its subsidiaries after elimination of intercompany accounts and transactions.

The Company conducts portions of its business through joint venture investments accounted for under the equity method. These equity affiliates are primarily engaged in the distribution of certain engine parts and aircraft rotable spares to worldwide aviation customers. The financial position and results of operations for the joint ventures during fiscal 2000 and 1999 are not material.

Revenue Recognition

Sales and related cost of sales are recognized primarily upon shipment of products and performance of services. Lease revenue is recognized as earned.

In connection with certain long-term inventory management programs, the Company purchases factory-new products on behalf of its customers from original equipment manufacturers. These products are purchased from the manufacturer and “passed through” to the Company’s customer at the Company’s cost. Previously, the Company disclosed these “pass through” sales in the notes to the consolidated financial statements and excluded these transactions from sales and cost of sales.

During the third quarter of fiscal 2000, the SEC issued Staff Accounting Bulletin (SAB) No. 101 summarizing the SEC’s view in applying generally accepted accounting principles to revenue recognition. As a result of SAB No. 101, the Company now believes that pass through sales should be included in sales. Prior to issuance of SAB No. 101, the Company believed that excluding pass through sales from sales was appropriate given the limited nature of the services provided for these transactions. Beginning with the third quarter Form 10-Q, the Company reported pass through sales and the related cost of sales on the Consolidated Income Statement. This change has no impact on the current period or historical net income, earnings per share, condensed consolidated balance sheets, statements of cash flows or comprehensive income.

Segment Information

SFAS No. 131 “Disclosures about Segments of an Enterprise and Related Information” establishes standards for public companies to report financial and descriptive information about reportable operating segments in annual financial statements and interim financial reports issued to stockholders. The Company operates in one segment: Aviation Services. The Company’s determination of its reportable segment is based on the commonalities among the products and services within its Aviation Services segment, and is consistent with the manner in which the Company’s management reviews and evaluates operating performance.

New Accounting Standards

SFAS No. 133 “Accounting for Derivative Instruments and Hedging Activities” is effective for fiscal years beginning after June 15, 2000. SFAS No. 133 establishes accounting and reporting standards for derivative instruments and for certain hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. The Company is evaluating the new Statement’s provisions to determine the impact, if any, and will adopt SFAS No. 133 in its first quarter of fiscal 2002.

Cash and Cash Equivalents

The Company considers all highly liquid investments with maturities of three months or less to be cash equivalents. At May 31, 2000 and 1999, cash equivalents of approximately $122 and $116, respectively, represent investments in funds holding high-quality commercial paper, Eurodollars and U.S. Government agency-issued securities. The carrying amount of cash equivalents approximates fair value at May 31, 2000 and 1999, respectively.

Transfer of Financial Assets

During fiscal 1998, the Company adopted SFAS No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," which requires the Company to recognize the financial and servicing assets it controls and the liabilities it has incurred, and to derecognize financial assets when control has been surrendered.

The Company has an agreement to sell, on a revolving basis, an interest in a defined pool of trade accounts receivable up to $35,000. The Company, as agent for the purchaser of the accounts receivable, retains collection and administrative responsibilities for the participating interests of accounts receivable. Accounts receivable sold under this arrangement were $29,359 and $25,300 at May 31, 2000 and 1999, respectively.

Foreign Currency

Gains and losses on foreign currency translation and foreign exchange contracts are determined in accordance with the method of accounting prescribed by SFAS No. 52. All balance sheet accounts of foreign and certain domestic subsidiaries transacting business in currencies other than the Company's functional currency are translated at year-end or historical exchange rates. Revenues and expenses are translated at average exchange rates during the year. Translation adjustments are excluded from the results of operations and are recorded in stockholders' equity as a component of accumulated other comprehensive income (loss).

Financial Instruments and Concentrations of Market or Credit Risk

Financial instruments that potentially subject the Company to concentrations of market or credit risk consist principally of trade receivables. While the Company's trade receivables are diverse based on the number of entities and geographic regions, the majority are in the aviation/aerospace industry. The Company performs evaluations of customers' financial condition prior to extending credit privileges and performs ongoing credit evaluations of payment experience, current financial condition and risk analysis. The Company typically requires collateral in the form of security interest in assets, letters of credit, and/or obligation guarantees from financial institutions, or sells its receivables, usually on a nonrecourse basis, for transactions other than normal trade terms.

SFAS No. 107 "Disclosures about Fair Value of Financial Instruments" requires disclosure of the fair value of certain financial instruments. Cash and cash equivalents, accounts receivable, short-term borrowings, accounts payable and accrued liabilities are reflected in the consolidated financial statements at fair value because of the short-term maturity of these instruments. The carrying value of noncurrent notes receivable and long-term debt bearing a variable interest rate approximates fair market value.

Fair value estimates are made at a specific point in time based on relevant market information about the financial instrument. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Inventories

Inventories are priced at the lower of cost or market. Cost is determined by either the specific identification, average cost or first-in, first-out method.

The following is a summary of inventories:

May 31,	**2000**	1999
Raw materials and parts	**$ 44,235**	$ 50,352
Work-in-process	**12,318**	12,733
Purchased aircraft, parts, engines and components held for sale	**219,264**	207,569
	$275,817	$270,654

Equipment under Operating Leases

Lease revenue is recognized as earned. The cost of the asset under lease is original purchase price plus overhaul costs. Depreciation is computed on a straight-line method over the estimated service life of the equipment, and maintenance costs are expensed as incurred. The balance sheet classification is based on the lease term, with fixed-term leases less than twelve months classified as short-term and all others classified as long-term.

Equipment on short-term lease consists of aircraft engines and parts on or available for lease to satisfy customers' immediate short-term requirements. The leases are renewable with fixed terms, which generally vary from one to twelve months.

Property, Plant and Equipment

Depreciation is computed on the straight-line method over useful lives of 10–40 years for buildings and improvements and 3–10 years for equipment, furniture and fixtures, and capitalized software. Leasehold improvements are amortized over the shorter of the estimated useful life or the term of the applicable lease.

Repairs and maintenance expenditures are expensed as incurred. Upon sale or disposal, cost and accumulated depreciation are removed from the accounts, and related gains and losses are included in results of operations.

Leveraged Leases

The Company acts as an equity participant in leveraged lease transactions. The equipment cost in excess of equity contribution is financed by third parties in the form of secured debt. Under the lease agreements, the third parties have no recourse against the Company for nonpayment of the obligations. The third-party debt is collateralized by the lessees' rental obligations and the leased equipment.

The Company has ownership rights to the leased assets and is entitled to the investment tax credits and benefits of tax deductions for depreciation on the leased assets and for interest on the secured debt financing.

Cost in Excess of Underlying Net Assets of Acquired Companies

The cost in excess of underlying net assets of acquired companies is being amortized over a period of 40 years. Amortization expense was $1,213, $802 and $565 in fiscal 2000, 1999 and 1998, respectively. Accumulated amortization is $6,188 and $4,975 at May 31, 2000 and 1999, respectively. The Company evaluates the existence of impairment on the basis of whether the cost in excess of underlying net assets of acquired companies is fully recoverable from projected, undiscounted net cash flows.

Income Taxes

Income taxes are determined in accordance with SFAS No. 109.

The benefits of investment tax credits are recognized for financial reporting purposes under the deferral method of accounting for leveraged leases. The investment tax credits are recognized in the year earned for income tax purposes.

Statements of Cash Flows

Supplemental information on cash flows follows:

for the year ended May 31,	**2000**	1999	1998
Interest paid	**$22,800**	$18,800	$11,600
Income taxes paid	**11,300**	4,400	6,200
Income tax refunds and interest received	**500**	900	6,000

Use of Estimates

Management of the Company has made estimates and assumptions relating to the reporting of assets and liabilities and the disclosure of contingent liabilities to prepare these consolidated financial statements in conformity with generally accepted accounting principles. Actual results could differ from those estimates.

Reclassification

Certain amounts in the prior years' consolidated financial statements have been reclassified to conform to the current year's presentation.

2. FINANCING ARRANGEMENTS

Term loans consisted of:

May 31,	2000	1999	1998
Current maturities of long-term debt	**$429**	$420	$237

Short-term borrowing activity was as follows:

for the year ended May 31,	2000	1999	1998
Maximum amount borrowed	**$127,600**	$92,300	$59,200
Average daily borrowings	**94,881**	45,455	20,689
Average interest rate during the year	**5.9%**	5.4%	6.0%

At May 31, 2000, aggregate unsecured bank credit arrangements were $179,211. Of this amount, $65,300 was available under credit lines with domestic banks, $84,115 was available under revolving credit and term loan agreements with domestic banks, and $3,911 was available under credit agreements with foreign banks. There are no compensating balance requirements in connection with domestic or foreign lines of credit. Borrowings under domestic bank lines bear interest at or below the corporate base rate.

The Company may borrow a maximum of $110,000 (available through February 9, 2002) under revolving credit and term loan agreements with domestic banks. Revolving credit borrowings may, at the Company's option, be converted to term loans payable in equal quarterly installments over five years. Interest is based on the corporate base rate or quoted Eurodollar or multicurrency rates during the revolving credit period and one-half percent over the corporate base rate or quoted Eurodollar rate thereafter. Borrowings outstanding under these agreements at May 31, 2000 were $25,885. There are no compensating balance requirements on any of the committed lines, but the Company is required to pay a commitment fee. There are no restrictions on the withdrawal or use of these funds.

Long-term debt was as follows:

May 31,	2000	1999
Notes payable due November 1, 2001 with interest of 9.5% payable semi-annually on May 1 and November 1	**$ 65,000**	$ 65,000
Notes payable due October 15, 2003 with interest of 7.25% payable semi-annually on April 15 and October 15	**50,000**	50,000
Notes payable due December 15, 2007 with interest of 6.875% payable semi-annually on June 15 and December 15	**60,000**	60,000
Industrial revenue bonds due in quarterly installments to 2011 with weighted average interest of approximately 4.60% at May 31, 2000 (secured by trust indentures on property, plant and equipment)	**2,158**	2,358
Industrial revenue bonds due in installments to 2002 with weighted average interest of approximately 7.47% at May 31, 2000 (secured by trust indentures on property, plant and equipment)	**84**	141
Industrial revenue bonds due in monthly installments to 2019 with interest of 5.65% (secured by trust indentures on property, plant and equipment)	**2,171**	2,235
Note payable due in annual installments to October 2003 with interest of 6.5%	**1,463**	1,625
	180,876	181,359
Current maturities	**(429)**	(420)
	$180,447	$180,939

The Company is subject to a number of covenants under the revolving credit and term loan agreements, including restrictions which relate to the payment of cash dividends, maintenance of minimum net working capital and tangible net worth levels, sales of assets, additional financing, purchase of the Company's shares and other matters. The Company is in compliance with all restrictive financial provisions of the agreements. At May 31, 2000, unrestricted consolidated retained earnings available for payment of dividends and purchase of the Company's shares was approximately $19,504. Effective June 1, 2000, unrestricted consolidated retained earnings increased to $37,086 due to inclusion of 50% of the consolidated net income of the Company for fiscal 2000. The aggregate amount of long-term debt maturing during each of the next five fiscal years is $429 in 2001, $65,411 in 2002, $394 in 2003, $51,407 in 2004 and $284 in 2005. The

Company's long-term debt was estimated to have a fair value of approximately $172,426 at May 31, 2000 and was based on estimates using discounted future cash flows at an assumed rate for borrowings currently prevailing in the marketplace for similar instruments.

3. INCOME TAXES

The provision for income taxes included the following components:

for the year ended May 31,	**2000**	1999	1998
Current			
Federal	**$ 4,070**	$ 6,045	$ 9,950
Foreign	**—**	—	720
State	**723**	1,100	1,050
	$ 4,793	$ 7,145	$11,720
Deferred	**9,570**	10,970	3,780
	$14,363	$18,115	$15,500

The deferred tax provisions result primarily from differences between financial reporting and tax income arising from depreciation and leveraged leases.

Deferred tax liabilities and assets result primarily from the differences in the timing of the recognition for transactions between financial reporting and income tax purposes and consist of the following components:

May 31,	**2000**	1999
Deferred tax liabilities:		
Depreciation	**$28,710**	$16,920
Leveraged leases	**27,120**	27,440
Other	**630**	620
Total deferred tax liabilities	**$56,460**	$44,980
Deferred tax assets—current:		
Inventory costs	**$ 3,160**	$ 3,090
Employee benefits	**2,980**	2,410
Alternative minimum tax	**1,090**	—
Other	**240**	390
Total deferred tax assets—current	**$ 7,470**	$ 5,890
Deferred tax assets—noncurrent:		
Postretirement benefits	**$ 440**	$ 110
Total deferred tax assets—noncurrent	**440**	110
Total deferred tax assets	**$ 7,910**	$ 6,000
Net deferred tax liabilities	**$48,550**	$38,980

The Company has determined that the realization of deferred tax assets is more likely than not, and that a valuation allowance is not required based upon the Company's history of prior operating earnings, its expectations for continued future earnings and the scheduled reversal of deferred tax liabilities, primarily related to leveraged leases, which exceed the amount of the deferred tax assets.

The provision for income taxes differs from the amount computed by applying the U.S. Federal statutory income tax rate of 35% for fiscal 2000, 1999 and 1998, for the following reasons:

for the year ended May 31,	**2000**	1999	1998
Provision for income taxes at the Federal statutory rate	**$17,330**	$20,925	$17,905
Tax benefits on exempt earnings from export sales	**(3,815)**	(3,690)	(3,100)
State income taxes, net of Federal benefit and refunds	**900**	900	900
Amortization of goodwill	**298**	280	200
Differences between foreign tax rates and the U.S. Federal statutory rate	**—**	—	(200)
Other, net	**(350)**	(300)	(205)
Provision for income taxes as reported	**$14,363**	$18,115	$15,500
Effective income tax rate	**29.0%**	30.3%	30.3%

4. COMMON STOCK AND STOCK OPTION PLANS

The Company has established stock option plans for officers and key employees of the Company. Stock option awards typically expire ten years from the date of grant or earlier upon termination of employment, become exercisable in five equal increments on successive grant anniversary dates at the New York Stock Exchange closing stock price on the date of grant and are accompanied by reload features and, for certain individuals, stock rights exercisable in the event of a change in control of the Company.

The Company accounts for these plans under APB No. 25, under which no compensation cost has been recognized. Proforma information regarding net income and earnings per share is required by SFAS No. 123 and has been determined as if the Company had accounted for its employee stock options under the fair value method of SFAS No. 123. The fair value of each option grant, including reloads, is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

Stock Options Granted in Fiscal Year	**2000**	1999	1998
Risk-free interest rate	**6.57%**	5.74%	5.97%
Expected volatility of common stock	**38.7%**	31.6%	25.5%
Dividend yield	**1.6%**	1.8%	2.0%
Expected option term in years	**4.0**	4.0	4.0

The fair value weighted average per share of stock options granted during fiscal 2000, 1999 and 1998 was $7.81, $5.20 and $5.04, respectively. Had compensation cost for stock options awarded under the plans been determined in accordance with SFAS No. 123, the Company's net income and earnings per share would have been changed to the following proforma amounts:

May 31,	**2000**	1999	1998
Net income:			
As reported	**$35,163**	$41,671	$35,657
Proforma	**33,097**	40,403	34,478
Earnings per share—basic:			
As reported	**1.30**	1.51	1.29
Proforma	**1.22**	1.47	1.25
Earnings per share—diluted:			
As reported	**1.28**	1.49	1.27
Proforma	**1.21**	1.44	1.22

A summary of changes in stock options granted to officers, key employees and non-employee directors under stock option plans for the three years ended May 31, 2000 follows:

	Number of Shares	Weighted Average Exercise Price
Outstanding, May 31, 1997 (664 exercisable)	1,978	$12.48
Granted	891	23.57
Exercised	(339)	11.32
Surrendered/expired/cancelled	(46)	16.17
Outstanding, May 31, 1998 (785 exercisable)	2,484	$16.54
Granted	827	19.41
Exercised	(71)	11.95
Surrendered/expired/cancelled	(64)	18.53
Outstanding, May 31, 1999 (1,148 exercisable)	3,176	$17.36
Granted	519	22.48
Exercised	(105)	12.40
Surrendered/expired/cancelled	(164)	20.05
Outstanding, May 31, 2000 (1,508 exercisable)	**3,426**	**$18.16**

The following table provides additional information regarding options outstanding as of May 31, 2000:

Option Exercise Price Range	Options Outstanding	Weighted Average Remaining Contractual Life of Options (Years)	Number of Options Exercisable	Weighted Average Exercise Price of Options Exercisable
$ 6.13–12.25	649	4.1	582	$ 9.74
$12.26–18.38	1,253	6.7	619	15.65
$18.39–24.50	1,435	7.9	226	22.61
$24.51–30.63	89	4.6	81	27.09
	3,426	6.6	1,508	$14.98

The AAR CORP. Stock Benefit Plan also provides for the grant of restricted stock awards. Restrictions are released at the end of applicable restricted periods. The number of shares and the restricted period, which varies from two to ten years, are determined by the Compensation Committee of the Board of Directors. The market value of the award on the date of grant is recorded as a deferred expense, Common stock and Capital surplus. The deferred expense is included in results of operations over the vesting period. The expense relating to outstanding restricted stock awards was $1,354, $1,667 and $1,400 in fiscal 2000, 1999 and 1998, respectively.

The AAR CORP. Employee Stock Purchase Plan is open to employees of the Company (other than officers, directors or participants in other stock option plans of the Company) and permits employees to purchase common stock in periodic offerings by payroll deductions.

The numbers of options and awards outstanding and available for grant or issuance for each of the Company's stock plans are as follows:

May 31, 2000	Outstanding	Available	Total
Stock Benefit Plan (officers, directors and key employees)	3,751	1,314	5,065
Employee Stock Purchase Plan	29	133	162

Pursuant to a shareholder rights plan adopted in 1997, each outstanding share of the Company's common stock carries with it a Right to purchase one and one half additional shares at a price of $83.33 per share (adjusted to reflect the February 23, 1998 stock split and subject to further antidilution adjustments). The Rights become exercisable (and separate from the shares) when certain specified events occur, including the acquisition of 15% or more of the common stock by a person or group (an "Acquiring Person") or the commencement of a tender or exchange offer for 15% or more of the common stock. In the event that an Acquiring Person acquires 15% or more of the common stock, or if the Company is the surviving corporation in a merger involving an Acquiring Person or if the Acquiring Person engages in certain types of self-dealing transactions, each Right entitles the holder to purchase, for $83.33 per share (or the then-current exercise price), shares of the Company's common stock having a market value of $166.66 (or two times the exercise price), subject to certain exceptions. Similarly, if the Company is acquired in a merger or other business combination or 50% or more of its assets or earning power is sold, each Right entitles the holder to purchase at the then-current exercise price that number of shares of common stock of the surviving corporation having a market value of two times the exercise price. The Rights, which do not entitle the holder thereof to vote or to receive dividends, replace the common stock purchase rights which were initially distributed to the Company's shareholders in 1987 and which expired by their own terms on August 6, 1997. The Rights will expire on August 6, 2007, and may be redeemed by the Company for $.01 per Right under certain circumstances.

On September 21, 1990, the Board of Directors authorized the Company to purchase up to 1,500 shares (adjusted for the three-for-two stock split) of the Company's common stock on the open market or through privately negotiated transactions. On October 13, 1999, the Board of Directors authorized the Company to purchase up to 1,500 additional shares of the Company's common stock. As of May 31, 2000, the Company had purchased 1,701 shares of its common stock on the open market under these programs at an average price of $14.12 per share.

5. EARNINGS PER SHARE

The computation of basic earnings per share is based on the weighted average number of common shares outstanding during the year. Diluted earnings per share is based on the weighted average number of common shares outstanding during the year plus, when their effect is dilutive, common stock equivalents consisting of shares subject to stock options. The following table provides a reconciliation of the computations of basic and diluted earnings per share information for each of the years in the three-year period ended May 31, 2000.

May 31,	**2000**	1999	1998
Basic EPS:			
Net income	**$35,163**	$41,671	$35,657
Average common shares outstanding	**27,103**	27,549	27,588
Earnings per share—basic	**$ 1.30**	$ 1.51	$ 1.29
Diluted EPS:			
Net income	**$35,163**	$41,671	$35,657
Average common shares outstanding	**27,103**	27,549	27,588
Additional shares due to hypothetical exercise of stock options	**312**	457	586
Earnings per share—diluted	**$ 1.28**	$ 1.49	$ 1.27

In January 1998, the Board of Directors declared a three-for-two stock split, which was effected in the form of a stock dividend on February 23, 1998, to shareholders of record February 2, 1998, and a quarterly cash dividend of 8.5 cents per share on the increased shares, which effectively increased the cash dividend payment by 6.25%.

6. EMPLOYEE BENEFIT PLANS

The Company has defined contribution or defined benefit plans covering substantially all full-time domestic employees and certain employees in The Netherlands.

Defined Benefit Plans

Prior to January 1, 2000, the pension plan for domestic salaried employees had benefit formulas primarily based on years of service and compensation. Effective January 1, 2000, the Company converted its existing defined benefit plan for substantially all domestic salaried employees to a cash balance pension plan. Under the cash balance pension plan, the retirement benefit is expressed as a dollar amount in an account that grows with annual pay-based credits and interest on the account balance. The pension benefit for hourly employees is generally based on a fixed amount per year of service. The Company follows the provisions of SFAS No. 87 "Employers' Accounting for Pensions" and SFAS No. 132 "Employers' Disclosures about Pension and Other Postretirement Benefits" for all pension and postretirement plans.

The Company's funding policy for domestic plans is to contribute annually, at a minimum, an amount which is deductible for Federal income tax purposes and that is sufficient to meet actuarially computed pension benefits. Contributions are intended to provide for benefits attributed to service to date and for benefits expected to be earned in the future. The assets of the pension plans are invested primarily in mutual funds, common stocks, investment grade bonds and U.S. Government obligations.

Certain foreign operations of domestic subsidiaries also have pension plans. In most cases, the plans are defined benefit in nature. Assets of the plans are comprised of insurance contracts. Benefit formulas are based generally on years of service and compensation. It is the policy of these subsidiaries to fund at least the minimum amounts required by local law and regulation.

The following table sets forth the plans' funded status, including the change in plan assets, and the amount recognized in the Company's Consolidated Balance Sheets.

May 31,	**2000**	1999
Change in benefit obligation:		
Benefit obligation at beginning of year	**$50,154**	$46,384
Service cost	**2,647**	2,315
Interest cost	**3,791**	3,334
Plan participants' contributions	**220**	171
Amendments	**1,231**	—
Net actuarial (gain) loss	**(2,556)**	(25)
Benefits paid	**(1,936)**	(1,850)
Other	**—**	(175)
Benefit obligation at end of year	**53,551**	50,154
Change in plan assets:		
Fair value of plan assets at beginning of year	**44,096**	42,286
Actual return on plan assets	**2,369**	2,725
Employer contributions	**1,600**	764
Plan participants' contributions	**220**	171
Benefits paid	**(1,936)**	(1,850)
Fair value of plan assets at end of year	**46,349**	44,096
Funded status	**(7,202)**	(6,058)
Unrecognized actuarial losses	**5,068**	6,904
Unrecognized prior service cost	**2,028**	966
Unrecognized transitional obligation	**417**	521
Prepaid pension costs	**$ 311**	$ 2,333

The projected benefit obligation for domestic plans is determined using an assumed weighted average discount rate of 8.25% at May 31, 2000 and 7.5% at May 31, 1999, and an assumed average compensation increase of 5.0%. The expected long-term rate of return on assets is 10.0% for fiscal 2000 and 1999. The unrecognized actuarial losses, prior service cost and transition obligation are amortized on a straight-line basis over the estimated average future service period.

The projected benefit obligation for nondomestic plans is determined using an assumed weighted average discount rate of 6.5% at May 31, 2000 and 5.5% at May 31, 1999, and an assumed average compensation increase of 4.0%. The expected long-term rate of return on assets is 6.5% for fiscal 2000 and 1999.

Pension expense charged to results of operations includes the following components:

May 31,	**2000**	1999	1998
Service cost	**$ 2,647**	$ 2,315	$ 1,643
Interest cost	**3,791**	3,334	3,011
Expected return on plan assets	**(3,881)**	(3,560)	(3,165)
Amortization of prior service cost	**169**	138	138
Recognized net actuarial loss	**411**	412	173
Transitional obligation	**90**	92	93
	$ 3,227	$ 2,731	$ 1,893

Defined Contribution Plan

The defined contribution plan is a profit sharing plan which is intended to qualify as a 401(k) plan under the Internal Revenue Code. Under the plan, employees may contribute up to 15.0% of their pretax compensation, subject to applicable regulatory limits. The Company may make matching contributions up to 6.0% of compensation. Participants vest on a pro-rata basis in Company contributions during the first three years of employment. Expense charged to results of operations was $1,634, $1,491 and $1,174 in fiscal 2000, 1999 and 1998, respectively.

Director, Executive and Key Employee Retirement Benefit and Profit Sharing Plans

The Company provides its outside directors with benefits upon retirement on or after age 65 provided they have completed at least five years of service as a director. Benefits are paid quarterly in cash in an amount equal to 25.0% of the annual retainer fee payable by the Company to active outside directors. Payment of benefits commences upon retirement and continues for a period equal to the total number of years of the retired director's service as a director to a maximum of ten years, or death, whichever occurs first.

The Company also provides supplemental retirement and profit sharing benefits for current and former executives and key employees to supplement benefits provided by the Company's other benefit plans. The plans are not fully funded and may require funding in the event of a change in control of the Company as determined by the Company's Board of Directors. Expense charged to results of operations for these plans was $345, $1,162 and $1,231 in fiscal 2000, 1999 and 1998, respectively.

Postretirement Benefits Other Than Pensions

The Company provides health and life insurance benefits for certain eligible employees and retirees under a variety of plans. Generally these benefits are contributory with retiree contributions adjusted annually. The postretirement plans are unfunded, and the Company has the right to modify or terminate any of these plans in the future, in certain cases, subject to union bargaining agreements. In fiscal 1995, the Company completed termination of postretirement healthcare and life insurance benefits attributable to future services of collective bargaining and other domestic employees.

Postretirement benefit cost for the years ended May 31, 2000, 1999 and 1998 included the following components:

May 31,	**2000**	1999	1998
Service cost	**$ —**	$—	$—
Interest cost	**104**	96	89
	$104	$96	$89

The funded status of the plans at May 31, 2000 and 1999 was as follows:

May 31,	**2000**	1999
Change in benefit obligations:		
Benefit obligations at beginning of year	**$ 1,463**	$ 1,354
Interest cost	**104**	96
Benefits paid	**(153)**	(240)
Unrecognized actuarial loss	**(57)**	108
Plan participants' contributions	**—**	145
Benefit obligation at end of year	**1,357**	1,463
Change in plan assets:		
Fair value of plan assets at beginning of year	**—**	—
Company contributions	**153**	95
Benefits paid	**(153)**	(240)
Plan participants' contributions	**—**	145
Fair value of plan assets at end of year	**—**	—
Funded status	**(1,357)**	(1,463)
Unrecognized actuarial (gains) losses	**(3)**	53
Unrecognized prior service cost	**160**	210
Accrued postretirement costs	**$(1,200)**	$(1,200)

The assumed discount rate used to measure the accumulated postretirement benefit obligation was 8.25% at May 31, 2000 and 7.5% at May 31, 1999. The assumed rate of future increases in healthcare costs was 6.8% and 7.5% in fiscal 2000 and 1999, respectively, declining to 5.25% by the year 2004 and remaining at that rate thereafter. A one percent increase in the assumed healthcare cost trend rate would increase the accumulated postretirement benefit obligation by approximately $44 as of May 31, 2000 and would not result in a significant change to the annual postretirement benefit expense.

7. COMMITMENTS AND CONTINGENCIES

The Company leases certain facilities and equipment under agreements which are accounted for as operating leases that expire at various dates through 2011. The Company also leases certain aviation equipment which are accounted for as operating leases. The terms of these arrangements are one to five years with options to renew annually at the election of the Company. If the Company elects to not renew the lease, the Company is required to purchase the aviation equipment at its stipulated lease value. The Company may also sublease the aviation equipment to a customer on a short- or long-term basis. Future minimum payments under leases with initial or remaining terms of one year or more at May 31, 2000 are as follows:

Year	Facilities and Equipment	Aviation Equipment
2001	$5,682	$ 2,787
2002	4,343	2,787
2003	3,621	2,787
2004	3,243	2,787
2005 and thereafter	3,639	20,117

Rental expense during the past three fiscal years was as follows:

May 31,	**2000**	1999	1998
Facilities and Equipment	**$9,663**	$8,339	$6,991
Aviation Equipment	**8,344**	4,242	422

The Company routinely issues letters of credit, performance bonds or credit guarantees in the ordinary course of its business. These instruments are typically issued in conjunction with insurance contracts or other business requirements. The total of these instruments outstanding at May 31, 2000 was approximately $51,500.

The Company is involved in various claims and legal actions, including environmental matters, arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the Company's consolidated financial condition or results of operations.

8. INVESTMENT IN LEVERAGED LEASES

From time to time, the Company acquires aircraft under lease that qualify for leveraged lease accounting treatment. Typically, these are long-term leases of late-model aircraft operated by major carriers where the Company is an equity participant of at least 20% and there is a third-party provider of nonrecourse debt of the remaining equipment cost.

During the lease term the Company is required, in accordance with SFAS No. 13, to adjust the elements of the investment in leveraged leases to reflect changes in important economic assumptions, such as the renegotiating of the interest rate on the nonrecourse debt or changes in income tax rates. In addition, the Company may sell options or other rights to the residual proceeds over the book value at the end of the lease term.

The Company's net investment in leveraged leases is comprised of the following elements:

for the year ended May 31,	**2000**	1999
Rentals receivable (net of principal and interest on the nonrecourse debt)	**$ 15,488**	$ 15,681
Estimated residual value of leased assets	**32,952**	32,952
Unearned and deferred income	**(13,953)**	(14,580)
	34,487	34,053
Deferred taxes	**(27,120)**	(27,440)
Net investment in leveraged leases	**$ 7,367**	$ 6,613

Pretax income from leveraged leases was $695, $702 and $1,329 in fiscal 2000, 1999 and 1998, respectively.

9. OTHER NONCURRENT ASSETS

At May 31, 2000 and 1999, other noncurrent assets consisted of the following:

May 31,	**2000**	1999
Investment in joint ventures	**$22,811**	$18,509
Notes receivable	**7,822**	7,130
Prepaid pension costs	**311**	2,333
Cash surrender value of life insurance	**2,719**	1,884
Debt issuance costs	**818**	1,028
Other	**11,920**	9,402
	$46,401	$40,286

10. ACQUISITIONS

On October 19, 1998, the Company acquired substantially all of the assets and assumed certain liabilities of Tempco Hydraulics Inc. (Tempco), a regional aircraft landing gear repair and overhaul business. The purchase price of approximately $7.5 million was paid with a combination of cash and a note. The transaction was recorded under the purchase method of accounting. The Company has included in its consolidated financial statements the results of operations of Tempco since the date of acquisition.

On December 31, 1997, the Company acquired substantially all of the assets and assumed certain liabilities of AVSCO Aviation Service Corporation (AVSCO), a distributor of factory-new parts and accessories to the commercial, regional/commuter and general aviation markets. The purchase price of approximately $18.4 million was paid with a combination of cash and a note, and the transaction was recorded under the purchase method of accounting. The Company has included in its consolidated financial statements the results of operations of AVSCO since the date of acquisition.

On October 24, 1997, the Company purchased the stock of ATR International, Inc. (ATR), a company which engineers and manufactures composite parts and structures for the aviation/aerospace industry. The Company acquired ATR for approximately $19 million cash, and the transaction was recorded under the purchase method of accounting. The Company has included in its consolidated financial statements the results of operations of ATR since the date of acquisition.

On June 2, 1997, the Company acquired substantially all of the assets and assumed certain liabilities of Cooper Aviation Industries, Inc. (Cooper), a distributor of factory-new aviation parts and accessories to the commercial, regional/commuter and general aviation markets. The purchase price was paid by issuing 140 thousand common shares (adjusted for the three-for-two stock split) and was recorded under the purchase method of accounting. In addition, the Company assumed short-term debt which was paid off by the Company during the first quarter of fiscal 1998. The Company has included in its consolidated financial statements the results of operations of Cooper since the date of acquisition.

The historical operating results of the acquisitions for the periods preceding the acquisitions are not material when compared to the operating results of the Company.

11. BUSINESS SEGMENT INFORMATION

The carrying value of long-lived assets in Company facilities located in foreign countries, and sales from these facilities in total, are not material to the consolidated financial statements.

Export sales from the Company's U.S. operations to unaffiliated customers, the majority of which are located in Europe, the Middle East, Canada, Mexico, South America and Asia (including sales through foreign sales offices of domestic subsidiaries), were approximately $184,718 (18.0% of total sales), $209,712 (20.0% of total sales) and $202,481 (23.6% of total sales) in fiscal 2000, 1999 and 1998, respectively.

Sales to the U.S. Government, its agencies and its contractors were approximately $132,048 (12.9% of total sales), $98,954 (9.4% of total sales) and $83,114 (9.7% of total sales) in fiscal 2000, 1999 and 1998, respectively. Sales to the Company's largest customer, excluding pass through sales, were $114,000 and $135,100 during fiscal 2000 and 1999, respectively. Including pass through sales, sales to the largest customer were $180,800 and $267,000 during fiscal 2000 and 1999, respectively. No assurances can be given that sales to this customer will continue at historical levels in the future.

12. ALLOWANCE FOR DOUBTFUL ACCOUNTS

for the year ended May 31,	**2000**	1999	1998
Balance, beginning of year	**$ 4,830**	$ 3,157	$ 1,965
Provision charged to operations	**5,470**	2,902	1,261
Reserves acquired	**—**	—	1,679
Deductions for accounts written off, net of recoveries	**(220)**	(1,229)	(1,748)
Balance, end of year	**$10,080**	$ 4,830	$ 3,157

Independent Auditors' Report

TO THE STOCKHOLDERS AND BOARD OF DIRECTORS OF AAR CORP.:

We have audited the accompanying consolidated balance sheets of AAR CORP. and subsidiaries as of May 31, 2000 and 1999, and the related consolidated statements of income, stockholders' equity and cash flows for each of the years in the three-year period ended May 31, 2000. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of AAR CORP. and subsidiaries as of May 31, 2000 and 1999, and the results of their operations and their cash flows for each of the years in the three-year period ended May 31, 2000 in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

Chicago, Illinois

June 27, 2000

Stockholder Information

CORPORATE HEADQUARTERS

One AAR Place
1100 North Wood Dale Road
Wood Dale, Illinois 60191
Telephone: (630) 227-2000
Facsimile: (630) 227-2019
www.aarcorp.com

TRANSFER AGENTS AND REGISTRARS

First Chicago Trust Company of New York
Jersey City, New Jersey

ANNUAL MEETING OF STOCKHOLDERS

The annual meeting of stockholders will be held October 11, 2000 at 3:00 p.m. (CDT) at Bank of America Illinois Shareholders Room (21st Floor), 231 South LaSalle Street, Chicago, Illinois 60604.

The number of holders of common stock, including participants in security positions listings as of June 30, 2000, was approximately 11,000.

STOCKHOLDERS' DIVIDEND REINVESTMENT SERVICE PLAN

AAR CORP. provides its stockholders the opportunity to purchase additional shares of common stock of the Company by automatic reinvestment of dividends and optional additional investments. Stockholders may obtain information regarding this plan by writing the Secretary, AAR CORP., One AAR Place, 1100 North Wood Dale Road, Wood Dale, Illinois 60191.

SPECIAL COUNSEL

Schiff Hardin & Waite
Chicago, Illinois

TICKER SYMBOL

AAR stock is traded on the New York and Chicago Stock Exchanges. Ticker symbol AIR.

Board Committees

AUDIT

Joel D. Spungin
Chairman

A. Robert Abboud
Howard B. Bernick
Erwin E. Schulze

COMPENSATION

Erwin E. Schulze
Chairman

A. Robert Abboud
Edgar D. Jannotta
Lee B. Stern

EXECUTIVE

Ira A. Eichner
Chairman

Edgar D. Jannotta
Erwin E. Schulze
David P. Storch

NOMINATING

David P. Storch
Chairman

Ira A. Eichner
Lee B. Stern
Richard D. Tabery

Corporate Officers

David P. Storch
President and Chief Executive Officer

Philip C. Slapke
Executive Vice President, Asset Management & Services Group

Michael K. Carr
Vice President, Tax

Peter K. Chapman
Vice President, Marketing and Business Development

James J. Clark
Vice President, Component Repair & Service

A. Lee Hall
Vice President, Strategic Planning and Acquisitions

Douglas S. Hara
Vice President, Purchasing and Facilities

John C. Mache
Vice President, Electronic Commerce

J. Steven McConnell
Vice President, Asset Management & Trading

Roberta R. McQuade
Vice President, Human Resources

David E. Prusiecki
Vice President, Defense Programs

Howard A. Pulsifer
Vice President, General Counsel and Secretary

Timothy J. Romenesko
Vice President and Chief Financial Officer

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

James N. Vincent
Vice President, Aircraft Turbine Center

1100 North Wood Dale Road
Wood Dale, Illinois 60191