HORTON D R INC /DE/
Form 10-Q
July 27, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended June 30, 2012

OR

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

For the Transition Period From To

Commission file number 1-14122

D.R. Horton, Inc.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	75-2386963 (I.R.S. Employer Identification No.)
301 Commerce Street, Suite 500, Fort Worth, Texas (Address of principal executive offices)	76102 (Zip Code)

(817) 390-8200
(Registrant’s telephone number, including area code)

Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes ý No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer x	Accelerated filer ¨	Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes ¨ No ý

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date.

Common stock, $.01 par value – 319,295,759 shares as of July 23, 2012

D.R. HORTON, INC. AND SUBSIDIARIES
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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
D.R. HORTON, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	June 30, 2012	September 30, 2011
	(In millions)	
	(Unaudited)	
ASSETS		
Homebuilding:		
Cash and cash equivalents	$884.3	$715.5
Marketable securities, available-for-sale	283.7	297.6
Restricted cash	41.5	49.1
Inventories:		
Construction in progress and finished homes	1,573.2	1,369.2
Residential land and lots — developed and under development	1,600.0	1,370.7
Land held for development	688.4	709.8
	3,861.6	3,449.7
Income taxes receivable	12.9	12.4
Deferred income taxes, net of valuation allowance of $78.4 million and $848.5 million at June 30, 2012 and September 30, 2011, respectively	716.7	—
Property and equipment, net	66.7	57.6
Other assets	412.1	398.4
Goodwill	15.9	15.9
	6,295.4	4,996.2
Financial Services:		
Cash and cash equivalents	20.6	17.1
Mortgage loans held for sale	295.1	294.1
Other assets	45.9	51.0
	361.6	362.2
Total assets	$6,657.0	$5,358.4
LIABILITIES		
Homebuilding:		
Accounts payable	$186.3	$154.0
Accrued expenses and other liabilities	842.3	829.8
Notes payable	1,948.6	1,588.1
	2,977.2	2,571.9
Financial Services:		
Accounts payable and other liabilities	41.5	46.5
Mortgage repurchase facility	146.7	116.5
	188.2	163.0
Total liabilities	3,165.4	2,734.9
Commitments and contingencies (Note L)		
EQUITY		
Preferred stock, $.10 par value, 30,000,000 shares authorized, no shares issued	—	—
Common stock, $.01 par value, 1,000,000,000 shares authorized, 326,363,223 shares issued and 319,163,152 shares outstanding at June 30, 2012 and 323,243,170 shares issued and 316,043,099 shares outstanding at September 30, 2011	3.3	3.2

Additional paid-in capital	1,964.7	1,917.0
Retained earnings	1,655.0	834.6
Treasury stock, 7,200,071 shares at June 30, 2012 and September 30, 2011, at cost	(134.3)	(134.3)
Accumulated other comprehensive income	—	0.1
Total stockholders’ equity	3,488.7	2,620.6
Noncontrolling interests	2.9	2.9
Total equity	3,491.6	2,623.5
Total liabilities and equity	$6,657.0	$5,358.4

See accompanying notes to consolidated financial statements.

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D.R. HORTON, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2012	2011	2012	2011
	(In millions, except per share data) (Unaudited)			
Homebuilding:				
Revenues:				
Home sales	$1,115.2	$974.5	$2,930.1	$2,468.6
Land/lot sales	1.0	0.9	7.3	6.9
	1,116.2	975.4	2,937.4	2,475.5
Cost of sales:				
Home sales	914.6	813.5	2,417.3	2,069.9
Land/lot sales	0.8	0.7	4.0	6.7
Inventory impairments and land option cost write-offs	2.5	9.9	4.7	32.6
	917.9	824.1	2,426.0	2,109.2
Gross profit:				
Home sales	200.6	161.0	512.8	398.7
Land/lot sales	0.2	0.2	3.3	0.2
Inventory impairments and land option cost write-offs	(2.5)	(9.9)	(4.7)	(32.6)
	198.3	151.3	511.4	366.3
Selling, general and administrative expense	136.4	113.7	382.9	355.8
Interest expense	6.2	10.1	18.7	41.0
Loss (gain) on early retirement of debt, net	—	6.5	(0.1)	10.7
Other (income)	(2.6)	(1.2)	(8.1)	(6.8)
	58.3	22.2	118.0	(34.4)
Financial Services:				
Revenues, net of recourse and reinsurance expense	33.8	23.8	80.4	63.0
General and administrative expense	21.5	19.3	59.9	56.4
Interest expense	0.6	0.3	2.4	0.7
Interest and other (income)	(2.2)	(2.5)	(7.6)	(6.7)
	13.9	6.7	25.7	12.6
Income (loss) before income taxes	72.2	28.9	143.7	(21.8)
Income tax (benefit) expense	(715.6)	0.2	(712.5)	(57.8)
Net income	$787.8	$28.7	$856.2	$36.0
Other comprehensive income (loss), net of income tax:				
Unrealized loss related to available-for-sale securities	(0.1)	—	(0.1)	—
Comprehensive income	$787.7	$28.7	$856.1	$36.0
Basic net income per common share	$2.47	$0.09	$2.70	$0.11
Net income per common share assuming dilution	$2.22	$0.09	$2.47	$0.11
Cash dividends declared per common share	$0.0375	$0.0375	$0.1125	$0.1125

See accompanying notes to consolidated financial statements.

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D.R. HORTON, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended June 30, 2012	2011
	(In millions) (Unaudited)	
OPERATING ACTIVITIES		
Net income	$856.2	$36.0
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation	14.4	14.9
Amortization of discounts and fees	29.9	27.6
Stock based compensation expense	14.3	9.9
Deferred income taxes	(716.7)	—
(Gain) loss on early retirement of debt, net	(0.1)	10.7
Gain on sale of marketable securities	(0.2)	(0.1)
Inventory impairments and land option cost write-offs	4.7	32.6
Changes in operating assets and liabilities:		
Increase in construction in progress and finished homes	(204.8)	(148.2)
(Increase) decrease in residential land and lots – developed, under development, and held for development	(207.7)	34.7
(Increase) decrease in other assets	(8.6)	39.3
(Increase) decrease in income taxes receivable	(0.5)	2.0
Increase in mortgage loans held for sale	(1.0)	(32.4)
Increase (decrease) in accounts payable, accrued expenses and other liabilities	42.9	(102.3)
Net cash used in operating activities	(177.2)	(75.3)
INVESTING ACTIVITIES		
Purchases of property and equipment	(23.8)	(12.8)
Purchases of marketable securities	(188.7)	(259.7)
Proceeds from the sale or maturity of marketable securities	196.8	254.7
Decrease in restricted cash	7.6	3.3
Net cash used in investing activities	(8.1)	(14.5)
FINANCING ACTIVITIES		
Proceeds from notes payable	377.6	29.8
Repayment of notes payable	(14.5)	(336.5)
Proceeds from stock associated with certain employee benefit plans	30.3	2.7
Cash dividends paid	(35.8)	(35.9)
Purchase of treasury stock	—	(38.6)
Net cash provided by (used in) financing activities	357.6	(378.5)
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	172.3	(468.3)
Cash and cash equivalents at beginning of period	732.6	1,309.3
Cash and cash equivalents at end of period	$904.9	$841.0

See accompanying notes to consolidated financial statements.

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D.R. HORTON, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
June 30, 2012

NOTE A – BASIS OF PRESENTATION

The accompanying unaudited, consolidated financial statements include the accounts of D.R. Horton, Inc. and all of its wholly-owned, majority-owned and controlled subsidiaries (which are referred to as the Company, unless the context otherwise requires). All significant intercompany accounts, transactions and balances have been eliminated in consolidation. The financial statements have been prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal, recurring accruals and the asset impairment charges, loss reserves and deferred tax asset valuation allowance discussed below) considered necessary for a fair presentation have been included. These financial statements do not include all of the information and notes required by GAAP for complete financial statements and should be read in conjunction with the consolidated financial statements and accompanying notes included in the Company's annual report on Form 10-K for the fiscal year ended September 30, 2011.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ materially from those estimates.

Business

The Company is a national homebuilder that is engaged in the construction and sale of single-family housing in 25 states and 73 markets in the United States as of June 30, 2012. The Company designs, builds and sells single-family detached homes on lots it develops and on finished lots purchased ready for home construction. To a lesser extent, the Company also builds and sells attached homes, such as town homes, duplexes, triplexes and condominiums (including some mid-rise buildings), which share common walls and roofs. Periodically, the Company sells land and lots to other developers and homebuilders where it has excess land and lot positions. The Company also provides mortgage financing and title agency services, primarily to its homebuilding customers. The Company generally does not retain or service originated mortgages; rather, it seeks to sell the mortgages and related servicing rights to third-party purchasers.

Seasonality

Historically, the homebuilding industry has experienced seasonal fluctuations; therefore, the operating results for the three and nine months ended June 30, 2012 are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2012 or subsequent periods.

NOTE B – MARKETABLE SECURITIES

The Company invests a portion of its cash on hand by purchasing marketable securities with maturities in excess of three months. These securities are held in the custody of a single financial institution. The Company considers its investment portfolio to be available-for-sale. Accordingly, these investments are recorded at fair value. The investment portfolio consisted of the following marketable securities at June 30, 2012 and September 30, 2011:

	June 30, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In millions)			
Type of security:				
U.S. Treasury securities	$60.8	$—	$(0.1)	$60.7
Obligations of U.S. government agencies	82.7	—	—	82.7
Corporate debt securities issued under the FDIC Temporary Liquidity Guarantee Program	39.3	—	—	39.3
Corporate debt securities	95.9	0.1	—	96.0
Total debt securities	278.7	0.1	(0.1)	278.7
Certificates of deposit	5.0	—	—	5.0
Total marketable securities, available-for-sale	$283.7	$0.1	$(0.1)	$283.7

	September 30, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In millions)			
Type of security:				
U.S. Treasury securities	$16.3	$—	$—	$16.3
Obligations of U.S. government agencies	73.7	0.1	—	73.8
Corporate debt securities issued under the FDIC Temporary Liquidity Guarantee Program	103.7	0.1	—	103.8
Corporate debt securities	98.8	—	(0.1)	98.7
Total debt securities	292.5	0.2	(0.1)	292.6
Certificates of deposit	5.0	—	—	5.0
Total marketable securities, available-for-sale	$297.5	$0.2	$(0.1)	$297.6

Of the $283.7 million in marketable securities at June 30, 2012, $207.7 million mature in the next twelve months and $76.0 million mature in one to two years. Gains and losses realized upon the sale of marketable securities are determined by specific identification and are included in homebuilding other income. The Company’s realized gains related to these sales were $0 and $0.2 million during the three and nine months ended June 30, 2012, respectively, compared to $0 and $0.1 million, respectively, in the same periods of 2011.

NOTE C – INVENTORY IMPAIRMENTS AND LAND OPTION COST WRITE-OFFS

At June 30, 2012, the Company performed its quarterly inventory impairment analysis by reviewing the performance and outlook for all of its communities, utilizing assumptions that reflected the Company's expectation of continued low overall new home demand and uncertainties in the homebuilding industry and in its markets. The Company evaluated communities with a combined carrying value of $367.4 million for impairment.

The analysis of the majority of these communities assumed that sales prices in future periods will be equal to or lower than current sales order prices in each community, or in comparable communities, in order to generate an acceptable absorption rate. For a minority of communities that the Company does not intend to develop or operate in current market conditions, some increases over current sales prices were assumed. While it is difficult to determine a timeframe for a given community, the remaining lives of these communities were estimated to be in a range from six months to in excess of ten years. When a discounted cash flow analysis was prepared for a community, the Company utilized a range of discount rates of 12% to 15%. Through this evaluation process, it was determined that communities with a carrying value of $8.5 million as of June 30, 2012 were impaired. As a result, during the three months ended June 30, 2012, impairment charges of $1.9 million were recorded to reduce the carrying value of the impaired communities to their estimated fair value, as compared to $7.8 million of impairment charges in the same period of 2011. During the nine months ended June 30, 2012 and 2011, impairment charges totaled $2.6 million and $27.2 million, respectively.

The Company's estimate of undiscounted cash flows from communities analyzed may change and could result in a future need to record impairment charges to adjust the carrying value of these assets to their estimated fair value. There are several factors which could lead to changes in the estimates of undiscounted future cash flows for a given community. The most significant of these include pricing and incentive levels actually realized by the community, the rate at which the homes are sold and the costs incurred to develop the lots and construct the homes. If conditions in the broader economy, homebuilding industry or specific markets in which the Company operates worsen, and as the Company re-evaluates specific community pricing and incentives, construction and development plans, and its overall land sale strategies, it may be required to evaluate additional communities or re-evaluate previously impaired communities for potential impairment. These evaluations may result in additional impairment charges.

At June 30, 2012 and September 30, 2011, the Company had $26.0 million and $26.3 million, respectively, of land held for sale, consisting of land held for development and land under development that met the criteria of land held for sale.

During the three months ended June 30, 2012 and 2011, the Company wrote off $0.6 million and $2.1 million, respectively, of earnest money deposits and pre-acquisition costs related to land option contracts which are not expected to be acquired. During the nine months ended June 30, 2012 and 2011, the Company wrote off $2.1 million and $5.4 million, respectively, of these deposits and costs.

NOTE D – LAND AND LOT OPTION PURCHASE CONTRACTS

The Company enters into land and lot option purchase contracts to procure land or lots for the construction of homes. Under these contracts, the Company will fund a stated deposit in consideration for the right, but not the obligation, to purchase land or lots at a future point in time with predetermined terms. Under the terms of the option purchase contracts, many of the option deposits are not refundable at the Company's discretion.

Certain option purchase contracts result in the creation of a variable interest in the entity holding the land parcel under option. The current guidance for determining which entity is the primary beneficiary is based on the ability of an entity to control both (1) the activities of a variable interest entity that most significantly impact the entity's economic performance and (2) the obligation to absorb losses of the entity or the right to receive benefits from the entity. There were no variable interest entities reported as land inventory not owned in the consolidated balance sheets at June 30, 2012 and September 30, 2011 because the Company determined it did not control the activities that most significantly impact the variable interest entity's economic performance.

The maximum exposure to loss related to the Company's variable interest entities is generally limited to the amounts of the Company's option deposits. At June 30, 2012 and September 30, 2011, the amounts of option deposits related to these contracts totaled $18.1 million and $13.2 million, respectively, and are included in homebuilding other assets on the consolidated balance sheets.

D.R. HORTON, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) – (Continued)
June 30, 2012

NOTE E – NOTES PAYABLE

The Company’s notes payable at their principal amounts, net of any unamortized discounts, consist of the following:

	June 30, 2012	September 30, 2011
	(In millions)	
Homebuilding:		
Unsecured:		
6.875% senior notes due 2013	$171.7	$171.7
6.125% senior notes due 2014, net	145.4	145.2
2% convertible senior notes due 2014, net	439.5	418.1
5.625% senior notes due 2014, net	137.6	137.5
5.25% senior notes due 2015, net	157.3	157.3
5.625% senior notes due 2016, net	169.6	169.5
6.5% senior notes due 2016, net	372.4	383.1
4.75% senior notes due 2017	350.0	—
Other secured	5.1	5.7
	$1,948.6	$1,588.1
Financial Services:		
Mortgage repurchase facility, maturing 2013	$146.7	$116.5

Homebuilding:

On August 1, 2011, the Board of Directors authorized the repurchase of up to $500 million of the Company’s debt securities effective through July 31, 2012. At June 30, 2012, $412.1 million of the authorization was remaining, and no additional debt has been repurchased subsequent to June 30, 2012. On July 25, 2012, the Board of Directors authorized the repurchase of up to $500 million of the Company's debt securities effective through July 31, 2013.

During the nine months ended June 30, 2012, through unsolicited transactions, the Company repurchased $10.8 million principal amount of its 6.5% senior notes due 2016 for an aggregate purchase price of $10.6 million, plus accrued interest. These transactions resulted in a gain on early retirement of debt of $0.1 million, net of unamortized discounts and fees written off.

In May 2012, the Company issued $350 million principal amount of 4.75% senior notes due May 15, 2017, with interest payable semi-annually. The notes represent unsecured obligations of the Company. The annual effective interest rate of the notes, after giving effect to the amortization of deferred financing costs is 5.0%.

The indentures governing the Company’s senior notes impose restrictions on the creation of secured debt and liens. At June 30, 2012, the Company was in compliance with all of the limitations and restrictions that form a part of the public debt obligations.

Financial Services:

The Company’s mortgage subsidiary, DHI Mortgage, has a mortgage repurchase facility that is accounted for as a secured financing. The mortgage repurchase facility provides financing and liquidity to DHI Mortgage by facilitating purchase transactions in which DHI Mortgage transfers eligible loans to the counterparties against the transfer of funds by the counterparties, thereby becoming purchased loans. DHI Mortgage then has the right and obligation to repurchase the purchased loans upon their sale to third-party purchasers in the secondary market or within specified time frames from 45 to 120 days in accordance with the terms of the mortgage repurchase facility. In March 2012, the mortgage repurchase facility was renewed and amended. The committed capacity of the facility remains at $180 million; however, the capacity can be increased to $225 million. Increases in borrowing capacity in excess of $180 million are provided on an uncommitted basis and at a higher borrowing cost than committed borrowings. Additionally, the term of the facility was extended to March 3, 2013.

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As of June 30, 2012, $251.7 million of mortgage loans held for sale were pledged under the mortgage repurchase facility. These mortgage loans had a collateral value of $238.0 million. DHI Mortgage has the option to fund a portion of its repurchase obligations in advance. As a result of advance paydowns totaling $91.3 million, DHI Mortgage had an obligation of $146.7 million outstanding under the mortgage repurchase facility at June 30, 2012 at a 2.8% annual interest rate.

The mortgage repurchase facility is not guaranteed by either D.R. Horton, Inc. or any of the subsidiaries that guarantee the Company's homebuilding debt. The facility contains financial covenants as to the mortgage subsidiary's minimum required tangible net worth, its maximum allowable ratio of debt to tangible net worth and its minimum required liquidity. At June 30, 2012, DHI Mortgage was in compliance with all of the conditions and covenants of the mortgage repurchase facility.

NOTE F – HOMEBUILDING INTEREST

The Company capitalizes homebuilding interest to inventory during active development and construction. Capitalized interest is charged to cost of sales as the related inventory is delivered to the buyer. Additionally, the Company writes off a portion of the capitalized interest related to communities for which inventory impairments are recorded. The Company's inventory under active development and construction was lower than its debt level at June 30, 2012 and 2011; therefore, a portion of the interest incurred is reflected as interest expense.

The following table summarizes the Company's homebuilding interest costs incurred, capitalized, expensed as interest expense, charged to cost of sales and written off during the three and nine months ended June 30, 2012 and 2011:

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2012	2011	2012	2011
	(In millions)			
Capitalized interest, beginning of period	$81.1	$88.6	$79.2	$91.5
Interest incurred	31.1	31.4	87.2	100.5
Interest expensed:				
Directly to interest expense	(6.2)	(10.1)	(18.7)	(41.0)
Amortized to cost of sales	(24.7)	(25.3)	(66.4)	(65.7)
Written off with inventory impairments	(0.1)	(0.2)	(0.1)	(0.9)
Capitalized interest, end of period	$81.2	$84.4	$81.2	$84.4

NOTE G – MORTGAGE LOANS

To manage the interest rate risk inherent in its mortgage operations, the Company hedges its risk using various derivative instruments, which include forward sales of mortgage-backed securities (MBS), Eurodollar Futures Contracts (EDFC) and put options on both MBS and EDFC. Use of the term "hedging instruments" in the following discussion refers to these securities collectively, or in any combination. The Company does not enter into or hold derivatives for trading or speculative purposes.

Mortgage Loans Held for Sale

Mortgage loans held for sale consist primarily of single-family residential loans collateralized by the underlying property. At June 30, 2012, mortgage loans held for sale had an aggregate fair value of $295.1 million and an aggregate outstanding principal balance of $286.5 million. At September 30, 2011, mortgage loans held for sale had an aggregate fair value of $294.1 million and an aggregate outstanding principal balance of $284.6 million. During the three months ended June 30, 2012 and 2011, the Company had net gains on sales of loans of $20.7 million and $11.1 million, respectively, which includes the effect of recording recourse expense of $2.0 million and $3.5 million, respectively, as discussed below in “Other Mortgage Loans and Loss Reserves.” During the nine months ended June 30, 2012 and 2011, the Company had net gains on sales of loans of $45.8 million and $30.9 million, respectively, which includes the effect of recording recourse expense of $4.7 million and $7.7 million, respectively. Net gains on sales of loans is included in financial services revenues on the consolidated statement of operations.

Approximately 73% of the mortgage loans sold by DHI Mortgage during the nine months ended June 30, 2012 were sold to one major financial institution that provided the best price and execution. On an ongoing basis, the Company is negotiating with other institutions to establish additional loan purchase options. If the Company is unable to sell mortgage loans to additional purchasers on attractive terms, the Company's ability to originate and sell mortgage loans at competitive prices could be limited which would negatively affect profitability.

Newly originated loans that have been closed but not committed to third-party purchasers are hedged to mitigate the risk of changes in their fair value. Hedged loans are committed to third-party purchasers typically within three days after origination. The notional amounts of the hedging instruments used to hedge mortgage loans held for sale vary in relationship to the underlying loan amounts, depending on the movements in the value of each hedging instrument relative to the value of the underlying mortgage loans. The fair value change related to the hedging instruments generally offsets the fair value change in the mortgage loans held for sale, which for the three and nine months ended June 30, 2012 and 2011 was not significant, and is recognized in current earnings. As of June 30, 2012, the Company had a notional amount of $80.6 million in mortgage loans held for sale not committed to third-party purchasers and the notional amounts of the hedging instruments related to those loans totaled $81.0 million.

Other Mortgage Loans and Loss Reserves

Mortgage loans are sold with limited recourse provisions which include industry-standard representations and warranties, primarily involving the absence of misrepresentations by the borrower or other parties, insurability if applicable and, depending on the agreement, may include requiring a minimum number of payments to be made by the borrower. The Company generally does not retain any other continuing interest related to mortgage loans sold in the secondary market. Other mortgage loans generally consist of loans repurchased due to these limited recourse obligations. Typically, these loans are impaired and often become real estate owned through the foreclosure process. At June 30, 2012 and September 30, 2011, the Company's total other mortgage loans and real estate owned, before loss reserves were as follows:

	June 30, 2012	September 30, 2011
	(In millions)	
Other mortgage loans	$37.6	$42.8
Real estate owned	1.1	0.9
	$38.7	$43.7

Based on historical performance and current housing and credit market conditions, the Company has recorded reserves for estimated losses on other mortgage loans, real estate owned and future loan repurchase obligations due to the limited recourse provisions, all of which are recorded as reductions of financial services revenue. The reserve balances at June 30, 2012 and September 30, 2011 were as follows:

	June 30, 2012	September 30, 2011
	(In millions)	
Loss reserves related to:		
Other mortgage loans	$6.9	$6.2
Real estate owned	0.3	0.4
Loan repurchase and settlement obligations – known and expected	24.4	26.4
	$31.6	$33.0

Other mortgage loans and real estate owned and the related loss reserves are included in financial services other assets, while loan repurchase obligations are included in financial services accounts payable and other liabilities in the accompanying consolidated balance sheets.

A subsidiary of the Company reinsured a portion of the private mortgage insurance written on loans originated by DHI Mortgage in prior years. At June 30, 2012 and September 30, 2011, reserves for expected future losses under the reinsurance program totaled $1.9 million and $0.9 million, respectively, and are included in financial services accounts payable and other liabilities in the accompanying consolidated balance sheets.

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D.R. HORTON, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) – (Continued)
June 30, 2012

Loan Commitments and Related Derivatives

The Company is party to interest rate lock commitments (IRLCs) which are extended to borrowers who have applied for loan funding and meet defined credit and underwriting criteria. At June 30, 2012, the notional amount of IRLCs, which are accounted for as derivative instruments recorded at fair value, totaled $282.6 million.

The Company manages interest rate risk related to its IRLCs through the use of best-efforts whole loan delivery commitments and hedging instruments. These instruments are considered derivatives in an economic hedge and are accounted for at fair value with gains and losses recognized in current earnings. As of June 30, 2012, the Company had a notional amount of approximately $21.2 million of best-efforts whole loan delivery commitments and a notional amount of $236.0 million of hedging instruments related to IRLCs not yet committed to purchasers.

NOTE H – FAIR VALUE MEASUREMENTS

Fair value measurements are used for the Company’s marketable securities, mortgage loans held for sale, IRLCs and other derivative instruments on a recurring basis, and are used for inventories, other mortgage loans and real estate owned on a nonrecurring basis, when events and circumstances indicate that the carrying value may not be recoverable. The fair value hierarchy and its application to the Company’s assets and liabilities, is as follows:

- Level 1 – Valuation is based on quoted prices in active markets for identical assets and liabilities. The Company’s U.S. Treasury securities are measured at fair value using Level 1 inputs.
- Level 2 – Valuation is determined from quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar instruments in markets that are not active, or by model-based techniques in which all significant inputs are observable in the market. The Company’s assets/liabilities measured at fair value using Level 2 inputs are as follows:
  government agency securities, corporate debt securities, foreign government securities and certificates of deposit;
  mortgage loans held for sale;
  over-the-counter derivatives such as forward sales of MBS, put options on MBS and best-efforts and mandatory commitments; and
  IRLCs.
- Level 3 – Valuation is derived from model-based techniques in which at least one significant input is unobservable and based on the Company’s own estimates about the assumptions that market participants would use to value the asset or liability. The Company’s assets measured at fair value using Level 3 inputs, which are typically reported at the lower of carrying value or fair value on a nonrecurring basis, are as follows:
  inventory held and used;
  certain mortgage loans; and
  real estate owned.

The following tables summarize the Company’s assets and liabilities at June 30, 2012 and September 30, 2011 measured at fair value on a recurring basis:

	Balance Sheet Location	Fair Value at June 30, 2012		
		Level 1	Level 2	Total
		(In millions)		
Homebuilding:				
Marketable securities, available-for-sale	Marketable securities	$60.7	$223.0	$283.7
Financial Services:				
Mortgage loans held for sale (a)	Mortgage loans held for sale	—	295.1	295.1
Derivatives not designated as hedging instruments (b):				
Interest rate lock commitments	Other assets	—	3.8	3.8
Forward sales of MBS	Other liabilities	—	(2.6)	(2.6)
Best-efforts and mandatory commitments	Other liabilities	—	(0.3)	(0.3)

	Balance Sheet Location	Fair Value at September 30, 2011		
		Level 1	Level 2	Total
		(In millions)		
Homebuilding:				
Marketable securities, available-for-sale	Marketable securities	$16.3	$281.3	$297.6
Financial Services:				
Mortgage loans held for sale (a)	Mortgage loans held for sale	—	294.1	294.1
Derivatives not designated as hedging instruments (b):				
Interest rate lock commitments	Other assets	—	3.9	3.9
Forward sales of MBS	Other liabilities	—	(4.0)	(4.0)
Best-efforts and mandatory commitments	Other liabilities	—	(0.9)	(0.9)

(a) Mortgage loans held for sale are reflected at fair value. Interest income earned on mortgage loans held for sale is based on contractual interest rates and included in financial services interest and other income.

(b) Fair value measurements of these derivatives represent changes in fair value since inception. These changes are reflected in the balance sheet and included in financial services revenues on the consolidated statement of operations.

The following table summarizes the Company’s assets at June 30, 2012 and September 30, 2011 measured at fair value on a nonrecurring basis:

	Balance Sheet Location	Fair Value at June 30, 2012	Fair Value at September 30, 2011
		Level 3	Level 3
		(In millions)	
Homebuilding:			
Inventory held and used (a)	Inventories	$6.6	$26.9
Financial Services:			
Other mortgage loans (a) (b)	Other assets	27.4	28.9

Real estate owned (a) (b)	Other assets	0.8	0.5

(a) The fair values included in the table above represent only those assets whose carrying values were adjusted to fair value in the current quarter.

(b) The fair values for other mortgage loans and real estate owned are determined based on the value of the underlying collateral.

The fair values of cash and cash equivalents approximate their carrying amounts due to their short-term nature. The Company determines the fair values of its senior and convertible senior notes based on quoted market prices of recent transactions, which is classified as Level 2 within the fair value hierarchy. The aggregate fair value of these notes at June 30, 2012 and September 30, 2011 was $2,333.2 million and $1,668.1 million, respectively, compared to an aggregate carrying value of $1,943.5 million and $1,582.4 million, respectively. The aggregate fair value of the Company’s senior notes includes fair values for the 2% convertible senior notes of $744.1 million and $511.9 million at June 30, 2012 and September 30, 2011, respectively, compared to their carrying values of $439.5 million and $418.1 million, respectively. For other secured notes and balances due under the mortgage repurchase facility, the fair values approximate their carrying amounts due to their short maturity or floating interest rate terms, as applicable.

NOTE I – INCOME TAXES

The Company’s income tax benefit for the three and nine months ended June 30, 2012 was $715.6 million and $712.5 million, respectively, compared to income tax expense of $0.2 million for the three months ended June 30, 2011 and income tax benefit of $57.8 million for the nine months ended June 30, 2011. The income tax benefit in the current year periods is due primarily to a $716.7 million reduction of the Company's deferred tax asset valuation allowance in the current quarter. The benefit from income taxes in the prior year nine-month period was due to the Company receiving a favorable result from the Internal Revenue Service (IRS) on a ruling request concerning capitalization of inventory costs.

At June 30, 2012 and September 30, 2011, the Company had net deferred tax assets of $795.1 million and $848.5 million, respectively, offset by valuation allowances of $78.4 million and $848.5 million, respectively. The realization of the Company's deferred tax assets depends upon the existence of sufficient taxable income in future periods. During the three months ended June 30, 2012, the Company evaluated both positive and negative evidence and determined it was more likely than not that the substantial majority of the Company's deferred tax assets will be realized, which resulted in the reduction of $716.7 million of the valuation allowance on its deferred tax assets.

In the Company's evaluation of the need for and level of a valuation allowance on its deferred tax assets, the most significant piece of evidence considered was the objective, direct positive evidence related to its recent financial results. The Company has generated pre-tax income in each of the five immediately preceding consecutive quarters totaling $206.4 million, and it generated more pre-tax income in the current quarter than in any of the four previous quarters. The Company closed 4,957 homes and earned $72.2 million of pre-tax income during the three months ended June 30, 2012 and closed 13,315 homes and earned $143.7 million of pre-tax income during the nine months ended June 30, 2012. A significant contributor to the Company's increased profitability is its reduced debt and interest costs. The value of the Company’s net sales orders for the current quarter and the value of the sales order backlog at June 30, 2012 increased 32% and 40%, respectively, compared to the prior year. Based on a sales order backlog of 7,311 homes at June 30, 2012, the Company expects to close more homes and generate more pre-tax income in the fourth quarter of fiscal 2012 than it did in the current quarter. Additionally, the Company believes it will increase its pre-tax income in future years, as the Company is utilizing its balance sheet and liquidity position to invest in opportunities to sustain and grow its operations. If industry conditions weaken from current levels, the Company expects to be able to adjust its operations to maintain long-term profitability. While the Company's expectations are that annual pre-tax income will grow, if annual pre-tax income in future years remains flat with the current level, the Company estimates that it will realize all of its current federal net operating losses in less than five years and will be able to absorb all federal deductible temporary differences as they reverse in future years.

In prior periods, a significant part of the negative evidence the Company considered was its three-year cumulative pre-tax loss position. At June 30, 2012 the Company had cumulative pre-tax income for the last three years of $26.1 million, so this piece of negative evidence was no longer considered to be as significant. Other negative evidence the Company considered was its previous losses incurred during the housing market decline, the current overall weakness in the economy and the housing market, the restrictive mortgage lending environment and the Company's gross margins, which are currently lower than historical levels before the housing downturn. Based on its evaluation of both positive and negative evidence, the Company concluded that the objective, direct positive evidence related to its operating results achieved during the recent challenging economic and housing market conditions and the sustainability of current pre-tax income levels outweighed the negative evidence and that it is more likely than not that the substantial majority of the Company's deferred tax assets will be realized.

The Company has a valuation allowance of $78.4 million because it is more likely than not that a portion of its state net operating loss carryforwards will not be realized due to the more limited carryforward periods that exist in certain states, and also because when a change in a valuation allowance is recognized in an interim period, a portion of the valuation allowance to be reversed is allocated to the remaining interim periods. Therefore, the Company expects a portion of the remaining $78.4 million valuation allowance to reverse in the fourth quarter of fiscal 2012.

The Company had income taxes receivable of $12.9 million and $12.4 million at June 30, 2012 and September 30, 2011, respectively, that relates to a federal tax refund the Company expects to receive. During the second quarter of 2012, after concluding its audit of the Company's fiscal year ended 2006 and 2007 tax returns, the IRS submitted its report to the U.S. Congressional Joint Committee on Taxation (Committee). The Company expects the review and approval from the Committee will be completed during the current fiscal year at which time it will receive the $12.9 million income taxes receivable.

A reduction of $3.3 million in the amount of unrecognized tax benefits and accrued interest is reasonably possible within the current fiscal year, which would be reflected as a benefit from income taxes.

NOTE J – EARNINGS PER SHARE

The following table sets forth the numerators and denominators used in the computation of basic and diluted earnings per share. Options to purchase 4.0 million and 9.6 million shares of common stock were excluded from the computation of diluted earnings per share for the fiscal 2012 and fiscal 2011 periods, respectively, because the exercise price was greater than the average market price of the common shares and, therefore, their effect would have been antidilutive. Additionally, the convertible senior notes were excluded from the computation of diluted earnings per share for 2011 periods because their effect would have been antidilutive.

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2012	2011	2012	2011
	(In millions)			
Numerator:				
Net income	$787.8	$28.7	$856.2	$36.0
Effect of dilutive securities:				
Interest expense and amortization of issuance costs associated with convertible senior notes	9.5	—	27.1	—
Numerator for diluted earnings per share after assumed conversions	$797.3	$28.7	$883.3	$36.0
Denominator:				
Denominator for basic earnings per share— weighted average common shares	318.8	318.7	317.6	319.0
Effect of dilutive securities:				
Employee stock awards	2.9	0.3	1.8	0.3
Convertible senior notes	38.3	—	38.3	—
Denominator for diluted earnings per share— adjusted weighted average common shares	360.0	319.0	357.7	319.3

NOTE K – STOCKHOLDERS' EQUITY

The Company has an automatically effective universal shelf registration statement filed with the SEC in September 2009, registering debt and equity securities that it may issue from time to time in amounts to be determined. The Company anticipates filing a new universal shelf registration statement that will register debt and equity securities prior to the expiration of its current universal shelf registration statement in September 2012.

On August 1, 2011, the Board of Directors authorized the repurchase of up to $100 million of the Company’s common stock effective through July 31, 2012. All of the $100 million authorization was remaining at June 30, 2012, and no common stock has been repurchased subsequent to June 30, 2012. On July 25, 2012, the Board of Directors authorized the repurchase of up to $100 million of the Company's common stock effective through July 31, 2013.

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During the three months ended June 30, 2012, the Board of Directors approved a quarterly cash dividend of $0.0375 per common share, which was paid on May 22, 2012 to stockholders of record on May 8, 2012. In July 2012, the Board of Directors approved a quarterly cash dividend of $0.0375 per common share, payable on August 24, 2012 to stockholders of record on August 13, 2012. Quarterly cash dividends of $0.0375 per common share were declared in the comparable quarters of fiscal 2011.

NOTE L – COMMITMENTS AND CONTINGENCIES

Warranty Claims

The Company typically provides its homebuyers with a ten-year limited warranty for major defects in structural elements such as framing components and foundation systems, a two-year limited warranty on major mechanical systems, and a one-year limited warranty on other construction components. The Company’s warranty liability is based upon historical warranty cost experience in each market in which it operates, and is adjusted as appropriate to reflect qualitative risks associated with the types of homes built and the geographic areas in which they are built.

At June 30, 2012, the Company had liabilities of $0.6 million for the remaining repair costs of homes which contain or are suspected to contain allegedly defective drywall manufactured in China (Chinese Drywall) that may be responsible for accelerated corrosion of certain metals in the home. During the nine months ended June 30, 2012, the Company received a payment of $2.4 million from a third-party for the reimbursement of costs paid to repair homes with Chinese Drywall and recorded the reimbursement as a reduction of warranty expense, which is a component of home sales cost of sales. While the Company continues to seek additional reimbursements for these remediation costs from various sources, it has not recorded a receivable for potential additional recoveries as of June 30, 2012.

The Company is named as a defendant in four Chinese Drywall lawsuits filed in federal court, involving claims from fewer than ten of the Company’s homeowners. These lawsuits are purported class action complaints involving hundreds of plaintiffs who are suing the homebuilders, suppliers, installers, importers and manufacturers of the defective Chinese Drywall. The Company is also named as a defendant in a single plaintiff Chinese Drywall lawsuit pending in state court in Florida. A mediator appointed by the federal court judge overseeing the multi-district Chinese Drywall litigation is working to facilitate a global nationwide settlement that will resolve all current claims against the Company and bar any future claims against all defendants, including the Company, related to defective Chinese Drywall. If the global nationwide settlement is accepted by all parties in its current form, any amounts owed by the Company are expected to be immaterial to its consolidated financial position, results of operations and cash flows.

Changes in the Company’s warranty liability during the three and nine months ended June 30, 2012 and 2011 were as follows:

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2012	2011	2012	2011
	(In millions)			
Warranty liability, beginning of period	$48.9	$43.8	$46.2	$46.2
Warranties issued	4.8	4.3	13.1	10.9
Changes in liability for pre-existing warranties	3.2	0.7	6.6	3.7
Settlements made	(8.1)	(7.8)	(17.1)	(19.8)

Warranty liability, end of period	$48.8	$41.0	$48.8	$41.0

Legal Claims and Insurance

The Company is named as a defendant in various claims, complaints and other legal actions in the ordinary course of business. At any point in time, the Company is managing several hundred individual claims related to construction defect matters, personal injury claims, employment matters, land development issues and contract disputes. The Company has established reserves for these contingencies based on the estimated costs of pending claims and the estimated costs of anticipated future claims related to previously closed homes. The estimated liabilities for these contingencies were $539.9 million and $529.6 million at June 30, 2012 and September 30, 2011, respectively, and are included in homebuilding accrued expenses and other liabilities in the consolidated balance sheets. At both June 30, 2012 and September 30, 2011, 99% of these reserves related to construction defect matters. Expenses related to the Company’s legal contingencies were approximately $29.5 million and $18.7 million in the nine months ended June 30, 2012 and 2011, respectively.

The Company’s reserves for construction defect claims include the estimated costs of both known claims and anticipated future claims. As of June 30, 2012, no individual existing claim was material to the Company’s financial statements, and the majority of the Company’s total construction defect reserves consisted of the estimated exposure to future claims on previously closed homes. The Company has closed a significant number of homes during recent years, and as a result the Company may be subject to future construction defect claims on these homes. Although regulations vary from state to state, construction defect issues can generally be reported for up to ten years after the home has closed in many states in which the Company operates. Historical data and trends regarding the frequency of claims incurred and the costs to resolve claims relative to the types of products and markets where the Company operates are used to estimate the construction defect liabilities for both existing and anticipated future claims. These estimates are subject to ongoing revision as the circumstances of individual pending claims and historical data and trends change. Adjustments to estimated reserves are recorded in the accounting period in which the change in estimate occurs.

Historical trends in construction defect claims have been inconsistent, and the Company believes they may continue to fluctuate over the next several years. Housing market conditions have been volatile across most of the Company's markets over the past ten years, and the Company believes such conditions can affect the frequency and cost of construction defect claims. The Company closed a significant number of homes during its peak operating years from 2003 to 2007. If the ultimate resolution of construction defect claims resulting from closings in the Company's peak operating years varies from current expectations, it could significantly change the Company's estimates regarding the frequency and timing of claims incurred and the costs to resolve existing and anticipated future claims, which would impact the construction defect reserves in the future. If the frequency of claims incurred or costs of existing and future legal claims significantly exceed the Company's current estimates, they will have a significant negative impact on its future earnings and liquidity.

The Company's reserves for legal claims increased from $529.6 million at September 30, 2011 to $539.9 million at June 30, 2012 primarily due to an increase in the number of closed homes that are subject to possible future construction defect claims and a slight increase in the estimated frequency of claims incurred. These increases were partially offset by payments made for legal claims. Following is a rollforward of the balance of the reserves for the nine months ended June 30, 2012:

	Nine Months Ended June 30, 2012 (In millions)
Reserves for legal claims, beginning of period	$529.6
Payments	(23.1)
Increase in reserves	33.4
Reserves for legal claims, end of period	$539.9

The Company estimates and records receivables under applicable insurance policies related to its estimated contingencies for known claims and anticipated future construction defect claims on previously closed homes and other legal claims and lawsuits incurred in the ordinary course of business when recovery is probable. Additionally, the Company may have the ability to recover a portion of its losses from its subcontractors and their insurance carriers when the Company has been named as an additional insured on their insurance policies. The Company's receivables related to its estimates of insurance recoveries from estimated losses from pending legal claims and anticipated future claims related to previously closed homes totaled $220.8 million and $218.3 million at June 30, 2012 and September 30, 2011, respectively, and are included in homebuilding other assets in the consolidated balance sheets.

The estimation of losses related to these reserves and the related estimates of recoveries from insurance policies are subject to a high degree of variability due to uncertainties such as trends in construction defect claims relative to the Company's markets and the types of products built, claim frequency, claim settlement costs and patterns, insurance industry practices and legal interpretations, among others. Due to the high degree of judgment required in establishing reserves for these contingencies, actual future costs and recoveries from insurance could differ significantly from current estimated amounts and it is not possible for the Company to make a reasonable estimate of the possible loss or range of loss in excess of its reserves.

Land and Lot Option Purchase Contracts

The Company enters into land and lot option purchase contracts to acquire land or lots for the construction of homes. At June 30, 2012, the Company had total deposits of $20.4 million, consisting of cash deposits of $18.9 million and promissory notes and surety bonds of $1.5 million, to purchase land and lots with a total remaining purchase price of $1.3 billion. Within the land and lot option purchase contracts at June 30, 2012, there were a limited number of contracts, representing $9.5 million of remaining purchase price, subject to specific performance clauses which may require the Company to purchase the land or lots upon the land sellers meeting their obligations. The majority of land and lots under contract are currently expected to be purchased within three years.

Other Commitments

To secure performance under various contracts, the Company had outstanding letters of credit of $39.5 million and surety bonds of $534.5 million at June 30, 2012. The Company has secured letter of credit agreements that require it to deposit cash, in an amount approximating the balance of letters of credit outstanding, as collateral with the issuing banks. At June 30, 2012 and September 30, 2011, the amount of cash restricted for this purpose totaled $39.6 million and $47.5 million, respectively, and is included in homebuilding restricted cash on the Company's consolidated balance sheets.

NOTE M – OTHER ASSETS AND ACCRUED EXPENSES AND OTHER LIABILITIES

The Company's homebuilding other assets were as follows:

	June 30, 2012	September 30, 2011
	(In millions)	
Insurance receivables	$220.8	$218.3
Earnest money and refundable deposits	65.4	59.1
Accounts and notes receivable	19.4	19.1
Prepaid assets	22.9	24.7
Other assets	83.6	77.2
	$412.1	$398.4