

KB HOME  
Form 10-Q  
April 09, 2012

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended February 29, 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 No. 001-09195

**KB HOME**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State of incorporation)

**95-3666267**  
(IRS employer identification number)

**10990 Wilshire Boulevard**

**Los Angeles, California 90024**

**(310) 231-4000**

(Address and telephone number of principal executive offices)

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

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

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  Accelerated filer  Non-accelerated filer  Smaller reporting company

(Do not check if a 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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of February 29, 2012.

There were 77,095,968 shares of the registrant's common stock, par value \$1.00 per share, outstanding on February 29, 2012. The registrant's grantor stock ownership trust held an additional 10,860,551 shares of the registrant's common stock on that date.

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**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****KB HOME****CONSOLIDATED STATEMENTS OF OPERATIONS**

(In Thousands, Except Per Share Amounts Unaudited)

	Three Months Ended	
	February 29, 2012	February 28, 2011
<b>Total revenues</b>	\$ 254,558	\$ 196,940
<b>Homebuilding:</b>		
Revenues	\$ 251,895	\$ 195,301
Construction and land costs	(227,358)	(170,796)
Selling, general and administrative expenses	(55,686)	(49,605)
Loss on loan guaranty		(22,758)
Operating loss	(31,149)	(47,858)
Interest income	135	383
Interest expense	(16,286)	(11,439)
Equity in loss of unconsolidated joint ventures	(72)	(55,837)
Homebuilding pretax loss	(47,372)	(114,751)
<b>Financial services:</b>		
Revenues	2,663	1,639
Expenses	(835)	(865)
Equity in income (loss) of unconsolidated joint venture	142	(149)
Financial services pretax income	1,970	625
<b>Total pretax loss</b>	(45,402)	(114,126)
Income tax expense	(400)	(400)
<b>Net loss</b>	\$ (45,802)	\$ (114,526)
<b>Basic and diluted loss per share</b>	\$ (.59)	\$ (1.49)
<b>Basic and diluted average shares outstanding</b>	77,090	76,974
<b>Cash dividends declared per common share</b>	\$ .0625	\$ .0625

See accompanying notes.

## KB HOME

## CONSOLIDATED BALANCE SHEETS

(In Thousands Unaudited)

	February 29, 2012	November 30, 2011
<b>Assets</b>		
<b>Homebuilding:</b>		
Cash and cash equivalents	\$ 304,171	\$ 415,050
Restricted cash	63,890	64,481
Receivables	72,442	66,179
Inventories	1,748,377	1,731,629
Investments in unconsolidated joint ventures	121,307	127,926
Other assets	87,948	75,104
	2,398,135	2,480,369
<b>Financial services</b>	7,938	32,173
<b>Total assets</b>	<b>\$ 2,406,073</b>	<b>\$ 2,512,542</b>
<b>Liabilities and stockholders' equity</b>		
<b>Homebuilding:</b>		
Accounts payable	\$ 80,900	\$ 104,414
Accrued expenses and other liabilities	337,786	374,406
Mortgages and notes payable	1,587,414	1,583,571
	2,006,100	2,062,391
<b>Financial services</b>	6,105	7,494
Common stock	115,171	115,171
Paid-in capital	885,765	884,190
Retained earnings	469,224	519,844
Accumulated other comprehensive loss	(26,152)	(26,152)
Grantor stock ownership trust, at cost	(117,803)	(118,059)
Treasury stock, at cost	(932,337)	(932,337)
<b>Total stockholders' equity</b>	<b>393,868</b>	<b>442,657</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 2,406,073</b>	<b>\$ 2,512,542</b>

See accompanying notes.

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## CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands Unaudited)

	Three Months Ended	
	February 29, 2012	February 28, 2011
<b>Cash flows from operating activities:</b>		
Net loss	\$ (45,802)	\$ (114,526)
Adjustments to reconcile net loss to net cash used by operating activities:		
Equity in (income) loss of unconsolidated joint ventures	(70)	55,987
Distributions of earnings from unconsolidated joint ventures		186
Loss on loan guaranty		22,758
Gain on sale of operating property		(8,825)
Amortization of discounts and issuance costs	579	552
Depreciation and amortization	392	596
Loss (gain) on early extinguishment of debt	2,003	(3,612)
Stock-based compensation expense	1,656	1,980
Inventory impairments and land option contract abandonments	6,572	1,754
Change in assets and liabilities:		
Receivables	18,293	4,627
Inventories	(25,856)	(64,940)
Accounts payable, accrued expenses and other liabilities	(60,621)	(55,472)
Other, net	(6,730)	(5,964)
<b>Net cash used by operating activities</b>	<b>(109,584)</b>	<b>(164,899)</b>
<b>Cash flows from investing activities:</b>		
Return of investment in (contributions to) unconsolidated joint ventures	6,547	(611)
Proceeds from sale of operating property		80,600
Purchases of property and equipment, net	(429)	(74)
<b>Net cash provided by investing activities</b>	<b>6,118</b>	<b>79,915</b>
<b>Cash flows from financing activities:</b>		
Change in restricted cash	591	(5,710)
Proceeds from issuance of senior notes	344,831	
Payment of senior notes issuance costs	(5,816)	
Repayment of senior notes	(340,481)	
Payments on mortgages and land contracts due to land sellers and other loans	(1,715)	(70,501)
Issuance of common stock under employee stock plans	175	69
Payments of cash dividends	(4,818)	(4,806)
<b>Net cash used by financing activities</b>	<b>(7,233)</b>	<b>(80,948)</b>
<b>Net decrease in cash and cash equivalents</b>	<b>(110,699)</b>	<b>(165,932)</b>
Cash and cash equivalents at beginning of period	418,074	908,430
Cash and cash equivalents at end of period	\$ 307,375	\$ 742,498

See accompanying notes.



**KB HOME****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

**1. Basis of Presentation and Significant Accounting Policies**

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and the rules and regulations of the Securities and Exchange Commission ( SEC ). Accordingly, certain information and footnote disclosures normally included in the annual financial statements prepared in accordance with U.S. generally accepted accounting principles ( GAAP ) have been condensed or omitted.

In the opinion of KB Home (the Company ), the accompanying unaudited consolidated financial statements contain all adjustments (consisting only of normal recurring accruals) necessary to present fairly the Company s consolidated financial position as of February 29, 2012, the results of its consolidated operations for the three months ended February 29, 2012 and February 28, 2011, and its consolidated cash flows for the three months ended February 29, 2012 and February 28, 2011. The results of consolidated operations for the three months ended February 29, 2012 are not necessarily indicative of the results to be expected for the full year, due to seasonal variations in operating results and other factors. The consolidated balance sheet at November 30, 2011 has been taken from the audited consolidated financial statements as of that date. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements for the year ended November 30, 2011, which are contained in the Company s Annual Report on Form 10-K for that period.

*Use of Estimates*

The accompanying unaudited consolidated financial statements have been prepared in conformity with GAAP and, therefore, include amounts based on informed estimates and judgments of management. Actual results could differ from these estimates.

*Cash and Cash Equivalents and Restricted Cash*

The Company considers all highly liquid short-term investments purchased with an original maturity of three months or less to be cash equivalents. The Company s cash equivalents totaled \$217.8 million at February 29, 2012 and \$212.8 million at November 30, 2011. The majority of the Company s cash and cash equivalents were invested in money market accounts and U.S. government securities.

Restricted cash of \$63.9 million at February 29, 2012 and \$64.5 million at November 30, 2011 consisted of cash deposited with various financial institutions that was required as collateral for the Company s cash-collateralized letter of credit facilities (the LOC Facilities ).

*Loss Per Share*

Basic and diluted loss per share were calculated as follows (in thousands, except per share amounts):

	Three Months Ended	
	February 29, 2012	February 28, 2011
<b>Numerator:</b>		
Net loss	\$ (45,802)	\$ (114,526)
<b>Denominator:</b>		
Basic and diluted average shares outstanding	77,090	76,974
<b>Basic and diluted loss per share</b>	<b>\$ (.59)</b>	<b>\$ (1.49)</b>

All outstanding stock options were excluded from the diluted loss per share calculations for the three months ended February 29, 2012 and February 28, 2011 because the effect of their inclusion would be antidilutive, or would decrease the reported loss per share.





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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Basis of Presentation and Significant Accounting Policies (continued)*Comprehensive Loss*

The Company's comprehensive loss was \$45.8 million for the three months ended February 29, 2012 and \$114.5 million for the three months ended February 28, 2011. The accumulated balances of other comprehensive loss in the consolidated balance sheets as of February 29, 2012 and November 30, 2011 were comprised solely of adjustments recorded directly to accumulated other comprehensive loss in accordance with Accounting Standards Codification Topic No. 715, Compensation - Retirement Benefits (ASC 715). ASC 715 requires an employer to recognize the funded status of defined postretirement benefit plans as an asset or liability on the balance sheet and requires any unrecognized prior service costs and actuarial gains/losses to be recognized in accumulated other comprehensive income (loss).

2. Stock-Based Compensation

The Company measures and recognizes compensation expense associated with its grant of equity-based awards in accordance with Accounting Standards Codification Topic No. 718, Compensation - Stock Compensation (ASC 718). ASC 718 requires that companies measure and recognize compensation expense at an amount equal to the fair value of share-based payments granted under compensation arrangements over the vesting period.

*Stock Options*

In accordance with ASC 718, the Company estimates the grant-date fair value of its stock options using the Black-Scholes option-pricing model, which takes into account assumptions regarding an expected dividend yield, a risk-free interest rate, an expected volatility factor for the market price of the Company's common stock and an expected term of the stock options. The following table summarizes the stock options outstanding and stock options exercisable as of February 29, 2012, as well as stock options activity during the three months then ended:

	Options	Weighted Average Exercise Price
Options outstanding at beginning of period	10,160,396	\$ 21.27
Granted	15,000	9.70
Exercised		
Cancelled	(6,000)	16.83
Options outstanding at end of period	10,169,396	21.26
Options exercisable at end of period	7,241,732	26.27

As of February 29, 2012, the weighted average remaining contractual life of stock options outstanding and stock options exercisable was 7.1 years and 6.3 years, respectively. There was \$4.6 million of total unrecognized compensation cost related to unvested stock option awards as of February 29, 2012. For the three months ended February 29, 2012 and February 28, 2011, stock-based compensation expense associated with stock options totaled \$1.2 million and \$1.4 million, respectively. The aggregate intrinsic value of stock options outstanding and stock options exercisable was \$9.0 million and \$.2 million, respectively, as of February 29, 2012. (The intrinsic value of a stock option is the amount by which the market value of a share of the underlying common stock exceeds the exercise price of the stock option.)

*Other Stock-Based Awards*

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From time to time, the Company grants restricted common stock, phantom shares and stock appreciation rights ( SARs ) to various employees. In some cases, the Company has granted phantom shares and SARs that can be

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

2. Stock-Based Compensation (continued)

settled only in cash and are therefore accounted for as liability awards. The Company recognized total compensation expense of \$.4 million in the three months ended February 29, 2012 and \$1.0 million in the three months ended February 28, 2011 related to restricted common stock, phantom shares and SARs awards.

3. Segment Information

As of February 29, 2012, the Company had identified five reporting segments, comprised of four homebuilding reporting segments and one financial services reporting segment, within its consolidated operations in accordance with Accounting Standards Codification Topic No. 280,

Segment Reporting. As of February 29, 2012, the Company's homebuilding reporting segments conducted ongoing operations in the following states:

West Coast: California

Southwest: Arizona and Nevada

Central: Colorado and Texas

Southeast: Florida, Maryland, North Carolina and Virginia

The Company's homebuilding reporting segments are engaged in the acquisition and development of land primarily for residential purposes and offer a wide variety of homes that are designed to appeal to first-time, move-up and active adult homebuyers.

The Company's homebuilding reporting segments were identified based primarily on similarities in economic and geographic characteristics, product types, regulatory environments, methods used to sell and construct homes and land acquisition characteristics. The Company evaluates segment performance primarily based on segment pretax results.

The Company's financial services reporting segment provides title and insurance services to the Company's homebuyers in the same markets as the Company's homebuilding reporting segments. In addition, since the third quarter of 2011, this segment has earned revenues pursuant to the terms of a marketing services agreement with a preferred mortgage lender that offers mortgage banking services, including residential consumer mortgage loan originations, to the Company's homebuyers who elect to use the lender. The Company's homebuyers are under no obligation to use the Company's preferred mortgage lender and may select any lender of their choice to obtain mortgage financing for the purchase of a home. The Company makes available to its homebuyers marketing materials and other information regarding its preferred mortgage lender's financing options and mortgage loan products, and is compensated solely for the fair market value of these services. Prior to late June 2011, this segment provided mortgage banking services to the Company's homebuyers indirectly through KBA Mortgage, LLC (KBA Mortgage), a former unconsolidated joint venture of a subsidiary of the Company and a subsidiary of Bank of America, N.A., with each partner having had a 50% interest in the joint venture.

The Company's reporting segments follow the same accounting policies used for the Company's consolidated financial statements. Operational results of each segment are not necessarily indicative of the results that would have occurred had the segment been an independent, stand-alone entity during the periods presented, nor are they indicative of the results to be expected in future periods.

The following tables present financial information relating to the Company's reporting segments (in thousands):



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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. Segment Information (continued)

	Three Months Ended	
	February 29, 2012	February 28, 2011
<b>Revenues:</b>		
West Coast	\$ 105,233	\$ 71,771
Southwest	31,584	23,300
Central	80,274	60,589
Southeast	34,804	39,641
Total homebuilding revenues	251,895	195,301
Financial services	2,663	1,639
Total	\$ 254,558	\$ 196,940
<b>Pretax income (loss):</b>		
West Coast	\$ (18,760)	\$ 8,865
Southwest	(5,043)	(80,329)
Central	(3,507)	(6,709)
Southeast	(4,259)	(14,028)
Corporate and other (a)	(15,803)	(22,550)
Total homebuilding loss	(47,372)	(114,751)
Financial services	1,970	625
Total	\$ (45,402)	\$ (114,126)
<b>Equity in income (loss) of unconsolidated joint ventures:</b>		
West Coast	\$ (45)	\$ 63
Southwest	(8)	(55,900)
Central		
Southeast	(19)	
Total	\$ (72)	\$ (55,837)
<b>Inventory impairments:</b>		
West Coast	\$ 6,572	\$
Southwest		391
Central		51
Southeast		550
Total	\$ 6,572	\$ 992
<b>Land option contract abandonments:</b>		
West Coast	\$	\$ 112

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Southwest			
Central			240
Southeast			410
Total		\$	\$ 762

(a) Corporate and other includes corporate general and administrative expenses.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. Segment Information (continued)

	Three Months Ended	
	February 29, 2012	February 28, 2011
Joint venture impairments:		
West Coast	\$	\$
Southwest		53,727
Central		
Southeast		
Total	\$	\$ 53,727
	February 29, 2012	November 30, 2011
Assets:		
West Coast	\$ 1,000,608	\$ 995,888
Southwest	319,642	338,586
Central	324,600	336,553
Southeast	332,566	317,308
Corporate and other	420,719	492,034
Total homebuilding assets	2,398,135	2,480,369
Financial services	7,938	32,173
Total	\$ 2,406,073	\$ 2,512,542
Investments in unconsolidated joint ventures:		
West Coast	\$ 38,360	\$ 38,405
Southwest	73,638	80,194
Central		
Southeast	9,309	9,327
Total	\$ 121,307	\$ 127,926

4. Financial Services

The following tables present financial information relating to the Company's financial services reporting segment (in thousands):

	Three Months Ended	
	February 29, 2012	February 28, 2011



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Revenues		
Insurance commissions	\$ 1,600	\$ 1,253
Title services	386	384
Marketing services fees	675	
Interest income	2	2
Total	2,663	1,639
Expenses		
General and administrative	(835)	(865)
Operating income	1,828	774
Equity in income (loss) of unconsolidated joint venture	142	(149)
Pretax income	\$ 1,970	\$ 625

## KB HOME

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

4. Financial Services (continued)

	February 29, 2012	November 30, 2011
<b>Assets</b>		
Cash and cash equivalents	\$ 3,204	\$ 3,024
Receivables (a)	939	25,495
Investment in unconsolidated joint venture	3,781	3,639
Other assets	14	15
<b>Total assets</b>	<b>\$ 7,938</b>	<b>\$ 32,173</b>
<b>Liabilities</b>		
Accounts payable and accrued expenses	\$ 6,105	\$ 7,494
<b>Total liabilities</b>	<b>\$ 6,105</b>	<b>\$ 7,494</b>

(a) In December 2011, the Company collected a \$23.5 million receivable it established in the fourth quarter of 2011 in connection with the wind down of KBA Mortgage's business operations.

5. Inventories

Inventories consisted of the following (in thousands):

	February 29, 2012	November 30, 2011
Homes under construction	\$ 402,077	\$ 417,304
Land under development	608,695	587,582
Land held for future development	737,605	726,743
<b>Total</b>	<b>\$ 1,748,377</b>	<b>\$ 1,731,629</b>

The Company's interest costs are as follows (in thousands):

	Three Months Ended	
	February 29, 2012	February 28, 2011
Capitalized interest at beginning of period	\$ 233,461	\$ 249,966
Interest incurred (a)	30,411	25,937

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Interest expensed (a)	(16,286)	(11,439)
Interest amortized to construction and land costs	(12,669)	(11,424)
Capitalized interest at end of period (b)	\$ 234,917	\$ 253,040

- (a) Amounts for the three months ended February 29, 2012 include a \$2.0 million loss on early extinguishment of debt. Amounts for the three months ended February 28, 2011 include a \$3.6 million gain on the early extinguishment of secured debt.
- (b) Inventory impairment charges are recognized against all inventory costs of a community, such as land, land improvements, cost of home construction and capitalized interest. Capitalized interest amounts presented in the table reflect the gross amount of capitalized interest as impairment charges recognized are not generally allocated to specific components of inventory.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

**6. Inventory Impairments and Land Option Contract Abandonments**

Each land parcel or community in the Company's owned inventory is assessed to determine if indicators of potential impairment exist. Impairment indicators are assessed separately for each land parcel or community on a quarterly basis and include, but are not limited to: significant decreases in sales rates, average selling prices, volume of homes delivered, gross profit margins on homes delivered or projected gross profit margins on homes in backlog or future housing sales; significant increases in budgeted land development and construction costs or cancellation rates; or projected losses on expected future land sales. If indicators of potential impairment exist for a land parcel or community, the identified asset is evaluated for recoverability in accordance with Accounting Standards Codification Topic No. 360, Property, Plant, and Equipment (ASC 360). The Company evaluated 37 land parcels or communities for recoverability during the three months ended February 29, 2012, and evaluated 31 land parcels or communities for recoverability during the three months ended February 28, 2011.

When an indicator of potential impairment is identified for a land parcel or community, the Company tests the asset for recoverability by comparing the carrying value of the asset to the undiscounted future net cash flows expected to be generated by the asset. The undiscounted future net cash flows are impacted by then-current conditions and trends in the market in which the asset is located as well as factors known to the Company at the time the cash flows are calculated. The undiscounted future net cash flows consider recent trends in the Company's sales, backlog and cancellation rates. Also taken into account are the Company's future expectations related to the following: market supply and demand, including estimates concerning average selling prices; sales and cancellation rates; and anticipated land development, construction and overhead costs to be incurred. With respect to the three-month periods ended February 29, 2012 and February 28, 2011, these expectations reflected the Company's experience that market conditions for its assets in inventory where impairment indicators were identified have been generally stable in 2011 and into 2012, with no significant deterioration or improvement identified as to revenue and cost drivers. In the Company's assessments during the first quarter of 2012, the Company determined that the year-over-year decline in net orders in the period did not reflect a sustained change in market conditions preventing recoverability. Rather, the Company considered that the decline primarily reflected higher home purchase contract cancellation rates stemming from period-specific residential consumer mortgage loan funding issues, which the Company believes will be mitigated in future periods with a new preferred mortgage lender relationship it established in March 2012. In addition, with respect to recoverability, the impact of the decline in net orders was generally offset by a higher average selling price. Based on this experience, and taking into account the signs of stability in certain markets for new home sales, the Company's inventory assessments as of February 29, 2012 considered an expected steady, if slightly improved, overall sales pace for the remainder of 2012.

Given the inherent challenges and uncertainties in forecasting future results, the Company's inventory assessments at the time they are made generally assume the continuation of then-current market conditions, subject to identifying information suggesting a significant sustained deterioration or improvement, or other changes, in such conditions. Therefore, the Company's inventory assessments, at the time made, anticipate sales rates, average selling prices and costs to generally continue at or near then-current levels through the affected asset's estimated remaining life. Inventory assessments for the Company's land held for future development also incorporate highly subjective forecasts for future performance, including the timing and projected costs of development and construction, the product to be offered, and the sales rates and selling prices of the product when an associated community is anticipated to open for sales. The Company evaluates various factors to develop these forecasts, including the availability of and demand for homes and finished lots within the relevant marketplace; historical, current and future sales trends for the marketplace; and third-party data, if available. Based on these factors, the Company formulates assumptions for future performance that it believes are reasonable. These various estimates, trends and expectations used in the Company's inventory assessments are specific to each land parcel or community and may vary among land parcels or communities.

A real estate asset is considered impaired when its carrying value is greater than the undiscounted future net cash flows the asset is expected to generate. Impaired real estate assets are written down to fair value, which is primarily based on the estimated future cash flows discounted for inherent risk associated with each asset. The discount rate used in the Company's estimated discounted cash flows was 17% during the three-month periods ended February 29, 2012 and February 28, 2011. The discount rate used and related discounted cash flows are

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

6. Inventory Impairments and Land Option Contract Abandonments (continued)

impacted by the following: the risk-free rate of return; expected risk premium based on estimated land development, construction and delivery timelines; market risk from potential future price erosion; cost uncertainty due to development or construction cost increases; and other risks specific to the asset or conditions in the market in which the asset is located at the time the assessment is made. These factors are specific to each land parcel or community and may vary among land parcels or communities.

Based on the results of its evaluations, the Company recognized pretax, noncash inventory impairment charges of \$6.6 million in the three months ended February 29, 2012 associated with two communities with a post-impairment fair value of \$12.2 million. In the three months ended February 28, 2011, the Company recognized \$1.0 million of pretax, noncash inventory impairment charges associated with three land parcels or communities with a post-impairment fair value of \$1.2 million. As of February 29, 2012, the aggregate carrying value of the Company's inventory that had been impacted by pretax, noncash inventory impairment charges was \$341.7 million, representing 52 land parcels or communities. As of November 30, 2011, the aggregate carrying value of the Company's inventory that had been impacted by pretax, noncash inventory impairment charges was \$338.5 million, representing 53 land parcels or communities.

The Company's inventory controlled under land option contracts and other similar contracts is assessed to determine whether it continues to meet the Company's internal investment and marketing standards. Assessments are made separately for each optioned land parcel on a quarterly basis and are affected by the following factors, among others: current and/or anticipated sales rates, average selling prices and home delivery volume; estimated land development and construction costs; and projected profitability on expected future housing or land sales. When a decision is made not to exercise certain land option contracts and other similar contracts due to market conditions and/or changes in its marketing strategy, the Company writes off the related inventory costs, including non-refundable deposits and pre-acquisition costs. Based on the results of its assessments, the Company recognized no pretax, noncash land option contract abandonment charges in the three months ended February 29, 2012. In the three months ended February 28, 2011, the Company recognized \$.8 million of such charges corresponding to 141 lots. Inventory impairment and land option contract abandonment charges are included in construction and land costs in the Company's consolidated statements of operations.

The estimated remaining life of each land parcel or community in the Company's inventory depends on various factors, such as the total number of lots remaining; the expected timeline to acquire and entitle land and develop lots to build homes; the anticipated future sales and cancellation rates; and the expected timeline to build and deliver homes sold. While it is difficult to determine a precise timeframe for any particular inventory asset, the Company estimates its inventory assets' remaining operating lives under current and expected future market conditions to range generally from one year to in excess of 10 years. Based on current market conditions and expected delivery timelines, the Company expects to realize, on an overall basis, the majority of its current inventory balance within five years.

Due to the judgment and assumptions applied in the estimation process with respect to inventory impairments, land option contract abandonments, the remaining operating lives of the Company's inventory assets and the realization of its inventory balances, it is possible that actual results could differ substantially from those estimated.

7. Fair Value Disclosures

Accounting Standards Codification Topic No. 820, Fair Value Measurements and Disclosures, defines fair value, provides a framework for measuring the fair value of assets and liabilities under GAAP, and establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The fair value hierarchy can be summarized as follows:

Level 1 Fair value determined based on quoted prices in active markets for identical assets or liabilities.



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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

7. Fair Value Disclosures (continued)

Level 2 Fair value determined using significant observable inputs, such as quoted prices for similar assets or liabilities or quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability, or inputs that are derived principally from or corroborated by observable market data, by correlation or other means.

Level 3 Fair value determined using significant unobservable inputs, such as pricing models, discounted cash flows, or similar techniques.

Fair value measurements are used for inventories on a nonrecurring basis when events and circumstances indicate the carrying value may not be recoverable. The following table presents the Company's assets measured at fair value on a nonrecurring basis during the three months ended February 29, 2012 and the year ended November 30, 2011 (in thousands):

Description	Hierarchy	Fair Value	
		February 29, 2012 (a)	November 30, 2011 (a)
Long-lived assets held and used	Level 2	\$	\$ 75
Long-lived assets held and used	Level 3	12,239	33,947
<b>Total</b>		<b>\$ 12,239</b>	<b>\$ 34,022</b>

(a) Amounts represent the aggregate fair values for land parcels or communities for which the Company recognized noncash inventory impairment charges during the period, as of the date that the fair value measurements were made. The carrying value for these land parcels and communities may have subsequently increased or decreased from the fair value reflected due to activity that has occurred since the measurement date.

In accordance with the provisions of ASC 360, long-lived assets held and used with a carrying value of \$18.8 million were written down to their fair value of \$12.2 million during the three months ended February 29, 2012, resulting in noncash inventory impairment charges of \$6.6 million. Long-lived assets held and used with a carrying value of \$56.7 million were written down to their fair value of \$34.0 million during the year ended November 30, 2011, resulting in noncash inventory impairment charges of \$22.7 million.

The fair values for the Company's long-lived assets held and used that were determined using Level 2 inputs were based on an executed contract. The fair values for the Company's long-lived assets held and used that were determined using Level 3 inputs were primarily based on the estimated future cash flows discounted for inherent risk associated with each asset. The discount rates used and related discounted cash flows were impacted by the following: the risk-free rate of return; expected risk premium based on estimated land development, construction and delivery timelines; market risk from potential future price erosion; cost uncertainty due to development or construction cost increases; and other risks specific to the asset or conditions in the market in which the asset is located at the time the assessment is made. These factors were specific to each land parcel or community and may have varied among land parcels or communities.

The Company's financial instruments consist of cash and cash equivalents, restricted cash, mortgages and notes receivable, senior notes, and mortgages and land contracts due to land sellers and other loans. Fair value measurements of financial instruments are determined by various market data and other valuation techniques as appropriate. When available, the Company uses quoted market prices in active markets to determine fair value.

The following table presents the carrying value and estimated fair values of the Company's financial instruments, except for those for which the carrying values approximate fair value (in thousands):





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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

7. Fair Value Disclosures (continued)

	February 29, 2012		November 30, 2011	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
<b>Financial Liabilities:</b>				
Senior notes due 2014 at 5 <sup>3</sup> / <sub>4</sub> %	\$ 193,452	\$ 195,633	\$ 249,647	\$ 232,500
Senior notes due 2015 at 5 <sup>7</sup> / <sub>8</sub> %	169,626	170,007	299,273	270,000
Senior notes due 2015 at 6 <sup>1</sup> / <sub>4</sub> %	296,171	297,038	449,795	401,625
Senior notes due 2017 at 9.10%	261,001	278,250	260,865	235,519
Senior notes due 2018 at 7 <sup>1</sup> / <sub>4</sub> %	299,037	297,000	299,007	251,625
Senior notes due 2020 at 8.00%	344,858	351,750		

The fair values of the Company's senior notes are estimated based on quoted market prices.

The carrying values reported for cash and cash equivalents, restricted cash, mortgages and notes receivable, and mortgages and land contracts due to land sellers and other loans approximate fair values.

8. Variable Interest Entities

The Company participates in joint ventures from time to time that conduct land acquisition, development and/or other homebuilding activities. Its investments in these joint ventures may create a variable interest in a variable interest entity ( VIE ), depending on the contractual terms of the arrangement. The Company analyzes its joint ventures in accordance with Accounting Standards Codification Topic No. 810, Consolidation ( ASC 810 ), to determine whether they are VIEs and, if so, whether the Company is the primary beneficiary. All of the Company's joint ventures at February 29, 2012 and November 30, 2011 were determined under the provisions of ASC 810 to be unconsolidated joint ventures and were accounted for under the equity method, either because they were not VIEs or, if they were VIEs, the Company was not the primary beneficiary of the VIEs.

In the ordinary course of its business, the Company enters into land option contracts and other similar contracts to procure rights to land parcels for the construction of homes. The use of such land option contracts and other similar contracts generally allows the Company to reduce the market risks associated with direct land ownership and development, and to reduce the Company's capital and financial commitments, including interest and other carrying costs. Under such contracts, the Company typically pays a specified option deposit or earnest money deposit in consideration for the right to purchase land in the future, usually at a predetermined price. Under the requirements of ASC 810, certain of these contracts may create a variable interest for the Company, with the land seller being identified as a VIE.

In compliance with ASC 810, the Company analyzes its land option contracts and other similar contracts to determine whether the corresponding land sellers are VIEs and, if so, whether the Company is the primary beneficiary. Although the Company does not have legal title to the underlying land, ASC 810 requires the Company to consolidate a VIE if the Company is determined to be the primary beneficiary. In determining whether it is the primary beneficiary, the Company considers, among other things, whether it has the power to direct the activities of the VIE that most significantly impact the VIE's economic performance. Such activities would include, among other things, determining or limiting the scope or purpose of the VIE, selling or transferring property owned or controlled by the VIE, or arranging financing for the VIE. The Company also considers whether it has the obligation to absorb losses of the VIE or the right to receive benefits from the VIE. As a result of its analyses, the Company determined that as of February 29, 2012 and November 30, 2011 it was not the primary beneficiary of any VIEs from which it is purchasing land under land option contracts and other similar contracts.

As of February 29, 2012, the Company had cash deposits totaling \$2.2 million associated with land option contracts and other similar contracts that the Company determined to be unconsolidated VIEs, having an aggregate purchase price of \$298.1 million, and had cash deposits totaling

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\$18.5 million associated with land option contracts and other similar contracts that the Company determined were not VIEs, having an aggregate

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

8. Variable Interest Entities (continued)

purchase price of \$298.9 million. As of November 30, 2011, the Company had cash deposits totaling \$8.1 million associated with land option contracts and other similar contracts that the Company determined to be unconsolidated VIEs, having an aggregate purchase price of \$122.1 million, and had cash deposits totaling \$12.8 million associated with land option contracts and other similar contracts that the Company determined were not VIEs, having an aggregate purchase price of \$223.0 million.

The Company's exposure to loss related to its land option contracts and other similar contracts with third parties and unconsolidated entities consisted of its deposits, which totaled \$20.7 million at February 29, 2012 and \$20.9 million at November 30, 2011, and are included in inventories in the Company's consolidated balance sheets. In addition, the Company had outstanding letters of credit of \$.2 million at February 29, 2012 and \$1.7 million at November 30, 2011 in lieu of cash deposits under certain land option contracts or other similar contracts.

The Company also evaluates its land option contracts and other similar contracts for financing arrangements in accordance with Accounting Standards Codification Topic No. 470, Debt (ASC 470), and, as a result of its evaluations, increased inventories, with a corresponding increase to accrued expenses and other liabilities, in its consolidated balance sheets by \$21.4 million at February 29, 2012 and \$23.9 million at November 30, 2011.

9. Investments in Unconsolidated Joint Ventures

The Company has investments in unconsolidated joint ventures that conduct land acquisition, development and/or other homebuilding activities in various markets where the Company's homebuilding operations are located. The Company's partners in these unconsolidated joint ventures are unrelated homebuilders, and/or land developers and other real estate entities, or commercial enterprises. These investments are designed primarily to reduce market and development risks and to increase the number of homesites owned and controlled by the Company. In some instances, participating in unconsolidated joint ventures has enabled the Company to acquire and develop land that it might not otherwise have had access to due to a project's size, financing needs, duration of development or other circumstances. While the Company considers its participation in unconsolidated joint ventures as potentially beneficial to its homebuilding activities, it does not view such participation as essential and has unwound its participation in a number of unconsolidated joint ventures in the past few years.

The Company typically has obtained rights to purchase portions of the land held by the unconsolidated joint ventures in which it currently participates. When an unconsolidated joint venture sells land to the Company's homebuilding operations, the Company defers recognition of its share of such unconsolidated joint venture's earnings until a home sale is closed and title passes to a homebuyer, at which time the Company accounts for those earnings as a reduction of the cost of purchasing the land from the unconsolidated joint venture.

The Company and its unconsolidated joint venture partners make initial and/or ongoing capital contributions to these unconsolidated joint ventures, typically on a pro rata basis equal to their respective equity interests. The obligations to make capital contributions are governed by each unconsolidated joint venture's respective operating agreement and related governing documents.

Each unconsolidated joint venture is obligated to maintain financial statements in accordance with GAAP. The Company shares in profits and losses of these unconsolidated joint ventures generally in accordance with its respective equity interests. In some instances, the Company recognizes profits and losses related to its investment in an unconsolidated joint venture that differ from its equity interest in the unconsolidated joint venture. This may arise from impairments recognized by the Company related to its investment that differ from the recognition of impairments by the unconsolidated joint venture with respect to the unconsolidated joint venture's assets; differences between the Company's basis in assets it has transferred to an unconsolidated joint venture and the unconsolidated joint venture's basis in those assets; the deferral of unconsolidated joint venture profits from land sales to the Company; or other items.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

9. Investments in Unconsolidated Joint Ventures (continued)

With respect to the Company's investments in unconsolidated joint ventures, its equity in loss of unconsolidated joint ventures included no pretax, noncash impairment charges for the three months ended February 29, 2012 and \$53.7 million of such charges for the three months ended February 28, 2011. The impairment charges for the three months ended February 28, 2011 reflected the write off of the Company's remaining investment in South Edge, LLC (South Edge). South Edge was a residential development joint venture in the Company's Southwest reporting segment. The Company wrote off its remaining investment in South Edge based on the Company's determination that South Edge was no longer able to perform its activities as originally intended following a court decision in the first quarter of 2011 to enter an order for relief on a Chapter 11 involuntary bankruptcy petition filed against the joint venture.

The following table presents information from the combined condensed statements of operations of the Company's unconsolidated joint ventures (in thousands):

	Three Months Ended	
	February 29, 2012	February 28, 2011
Revenues	\$	\$ 230
Construction and land costs	6	(222)
Other expenses, net	(461)	(4,367)
Loss	\$ (455)	\$ (4,359)

The following table presents combined condensed balance sheet information for the Company's unconsolidated joint ventures (in thousands):

	February 29, 2012	November 30, 2011
<b>Assets</b>		
Cash	\$ 21,614	\$ 8,923
Receivables	14,125	19,503
Inventories	353,522	368,306
Other assets	151	151
Total assets	\$ 389,412	\$ 396,883
<b>Liabilities and equity</b>		
Accounts payable and other liabilities	\$ 91,825	\$ 96,981
Equity	297,587	299,902
Total liabilities and equity	\$ 389,412	\$ 396,883

The following table presents information relating to the Company's investments in unconsolidated joint ventures as of the dates specified (dollars in thousands):

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	February 29, 2012	November 30, 2011
Number of investments in unconsolidated joint ventures (a)	8	8
Investments in unconsolidated joint ventures (a)	\$ 121,307	\$ 127,926

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

9. Investments in Unconsolidated Joint Ventures (continued)

- (a) The Company's investments in unconsolidated joint ventures as of February 29, 2012 and November 30, 2011 include Inspirada Builders, LLC, an unconsolidated joint venture that was formed in 2011 in connection with the South Edge Plan (as defined below) and in which a wholly owned subsidiary of the Company is a member. As part of the South Edge Plan, land previously owned by South Edge was transferred to Inspirada Builders, LLC in November 2011. The Company anticipates that it will acquire its share of the land from Inspirada Builders, LLC through a future distribution.

The Company's unconsolidated joint ventures finance land and inventory investments for a project through a variety of arrangements. To finance their respective land acquisition and development activities, certain of the Company's unconsolidated joint ventures have obtained loans from third-party lenders that are secured by the underlying property and related project assets. None of the Company's unconsolidated joint ventures had outstanding debt at February 29, 2012 or November 30, 2011.

In certain instances, the Company and/or its partner(s) in an unconsolidated joint venture have provided completion and/or carve-out guarantees to the unconsolidated joint venture's lenders. A completion guaranty refers to the physical completion of improvements for a project and/or the obligation to contribute capital to an unconsolidated joint venture to enable it to fund its completion obligations. The Company's potential responsibility under its completion guarantees, if triggered, is highly dependent on the facts of a particular case. A carve-out guaranty refers to the payment of losses a lender suffers due to certain bad acts or omissions by an unconsolidated joint venture or its partners, such as fraud or misappropriation, or due to environmental liabilities arising with respect to the relevant project. The Company does not believe it currently has exposure with respect to any of its completion or carve-out guarantees.

In the first quarter of 2011, as a result of recording a probable obligation related to a limited several repayment guaranty (the Springing Guaranty) that the Company had provided to the administrative agent for the lenders to South Edge, and taking into account accruals it had previously established with respect to its investment in South Edge, the Company recognized a charge of \$22.8 million that was reflected as a loss on loan guaranty in its consolidated statements of operations. This charge was in addition to the joint venture impairment charge of \$53.7 million to write off the Company's remaining investment in South Edge. South Edge underwent and completed a bankruptcy reorganization in 2011. In connection with a consensual plan of reorganization for South Edge that was confirmed by a bankruptcy court in November 2011 (the South Edge Plan) and the resolution of other matters concerning South Edge, the Company's obligations under the Springing Guaranty were eliminated in the fourth quarter of 2011.

10. Other Assets

Other assets consisted of the following (in thousands):

	February 29, 2012	November 30, 2011
Cash surrender value of insurance contracts	\$ 63,069	\$ 59,718
Debt issuance costs	10,295	4,219
Property and equipment, net	7,839	7,801
Prepaid expenses	5,593	2,214
Net deferred tax assets	1,152	1,152
Total	\$ 87,948	\$ 75,104

11. Accrued Expenses and Other Liabilities

Accrued expenses and other liabilities consisted of the following (in thousands):

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

11. Accrued Expenses and Other Liabilities (continued)

	February 29, 2012	November 30, 2011
Construction defect and other litigation liabilities	\$ 99,610	\$ 101,017
Employee compensation and related benefits	72,327	76,960
Warranty liability	64,607	67,693
Accrued interest payable	28,080	43,129
Liabilities related to inventory not owned	21,368	23,903
Real estate and business taxes	4,850	10,770
Other	46,944	50,934
<b>Total</b>	<b>\$ 337,786</b>	<b>\$ 374,406</b>

12. Mortgages and Notes Payable

Mortgages and notes payable consisted of the following (in thousands):

	February 29, 2012	November 30, 2011
Mortgages and land contracts due to land sellers and other loans	\$ 23,269	\$ 24,984
Senior notes due 2014 at 5 <sup>3</sup> / <sub>4</sub> %	193,452	249,647
Senior notes due 2015 at 5 <sup>7</sup> / <sub>8</sub> %	169,626	299,273
Senior notes due 2015 at 6 <sup>1</sup> / <sub>4</sub> %	296,171	449,795
Senior notes due 2017 at 9.10%	261,001	260,865
Senior notes due 2018 at 7 <sup>1</sup> / <sub>4</sub> %	299,037	299,007
Senior notes due 2020 at 8.00%	344,858	
<b>Total</b>	<b>\$ 1,587,414</b>	<b>\$ 1,583,571</b>

The Company maintains the LOC Facilities to provide letters of credit in the ordinary course of operating its business. As of February 29, 2012 and November 30, 2011, \$61.8 million and \$63.8 million, respectively, of letters of credit were outstanding under the LOC Facilities. The LOC Facilities require the Company to deposit and maintain cash with the issuing financial institutions as collateral for its letters of credit outstanding. The Company may maintain, revise or, if necessary or desirable, enter into additional or expanded letter of credit facilities, or other similar facility arrangements, with the same or other financial institutions.

On February 7, 2012, pursuant to its universal shelf registration statement filed with the SEC on September 20, 2011 (the 2011 Shelf Registration), the Company issued \$350.0 million in aggregate principal amount of 8.00% senior notes due 2020 (the \$350 Million Senior Notes). The \$350 Million Senior Notes, which are due on March 15, 2020, with interest payable semi-annually, represent senior unsecured obligations of the Company and rank equally in right of payment with all of the Company's existing and future senior unsecured indebtedness. The \$350 Million Senior Notes may be redeemed, in whole at any time or from time to time in part, at a price equal to the greater of (a) 100% of their principal amount and (b) the sum of the present values of the remaining scheduled payments of principal and interest discounted to the date of redemption at a defined rate, plus, in each case, accrued and unpaid interest to the applicable redemption date. If a change in control occurs as defined in the instruments governing the \$350 Million Senior Notes, the Company would be required to offer to purchase the \$350 Million Senior Notes at 101% of their principal amount, together with all accrued and unpaid interest, if any. The \$350 Million Senior Notes are



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unconditionally guaranteed jointly and severally by certain of the Company's subsidiaries (the "Guarantor Subsidiaries") on a senior unsecured basis. The Company used substantially all of the net proceeds from the issuance of the \$350 Million Senior Notes to purchase, pursuant to the terms of tender offers that were initially made on January 19, 2012 (the "Tender Offers"), \$56.3 million in

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

12. Mortgages and Notes Payable (continued)

aggregate principal amount of its 5 <sup>3</sup>/<sub>4</sub>% senior notes due 2014, \$130.0 million in aggregate principal amount of its 5 <sup>7</sup>/<sub>8</sub>% senior notes due 2015 and \$153.7 million in aggregate principal amount of its 6 <sup>1</sup>/<sub>4</sub>% senior notes due 2015. The applicable Tender Offers expired on February 15, 2012. The total amount paid to purchase these senior notes was \$340.5 million. The Company incurred a loss of \$2.0 million in the first quarter of 2012 related to the early redemption of debt due to a premium paid under the applicable Tender Offers and the unamortized original issue discount.

The indenture governing the Company's senior notes does not contain any financial maintenance covenants. Subject to specified exceptions, the indenture contains certain restrictive covenants that, among other things, limit the Company's ability to incur secured indebtedness, or engage in sale-leaseback transactions involving property or assets above a certain specified value. Unlike the Company's other senior notes, the terms governing both the Company's \$265.0 million in aggregate principal amount of 9.10% senior notes due 2017 (the \$265 Million Senior Notes) and the \$350 Million Senior Notes contain certain limitations related to mergers, consolidations, and sales of assets.

As of February 29, 2012, the Company was in compliance with the applicable terms of all of its covenants under the Company's senior notes, the indenture, and mortgages and land contracts due to land sellers and other loans. The Company's ability to secure future debt financing may depend in part on its ability to remain in such compliance.

Principal payments on senior notes, mortgages and land contracts due to land sellers and other loans are due as follows: 2012 \$23.3 million; 2013 \$0; 2014 \$193.4 million; 2015 \$465.8 million; 2016 \$0; and thereafter \$904.9 million.

13. Commitments and Contingencies

Commitments and contingencies include typical obligations of homebuilders for the completion of contracts and those incurred in the ordinary course of business.

*Warranty.* The Company provides a limited warranty on all of its homes. The specific terms and conditions of these limited warranties vary depending upon the market in which the Company does business. The Company generally provides a structural warranty of 10 years, a warranty on electrical, heating, cooling, plumbing and other building systems each varying from two to five years based on geographic market and state law, and a warranty of one year for other components of the home. The Company estimates the costs that may be incurred under each limited warranty and records a liability in the amount of such costs at the time the revenue associated with the sale of each home is recognized. Factors that affect the Company's warranty liability include the number of homes delivered, historical and anticipated rates of warranty claims, and cost per claim. The Company's primary assumption in estimating the amounts it accrues for warranty costs is that historical claims experience is a strong indicator of future claims experience. The Company periodically assesses the adequacy of its recorded warranty liabilities, which are included in accrued expenses and other liabilities in the consolidated balance sheets, and adjusts the amounts as necessary based on its assessment. The Company's assessment includes the review of its actual warranty costs incurred to identify trends and changes in its warranty claims experience, and considers the Company's construction quality and customer service initiatives and outside events. While the Company believes the warranty liability reflected in its consolidated balance sheets to be adequate, unanticipated changes in the legal environment, local weather, land or environmental conditions, quality of materials or methods used in the construction of homes, or customer service practices could have a significant impact on its actual warranty costs in the future and such amounts could differ from the Company's current estimates.

The changes in the Company's warranty liability are as follows (in thousands):

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

13. Commitments and Contingencies (continued)

	Three Months Ended	
	February 29, 2012	February 28, 2011
Balance at beginning of period	\$ 67,693	\$ 93,988
Warranties issued	1,317	848
Payments	(4,436)	(7,809)
Adjustments	33	34
Balance at end of period	\$ 64,607	\$ 87,061

The Company's overall warranty liability of \$64.6 million at February 29, 2012 included \$3.9 million for estimated remaining repair costs associated with 73 homes that have been identified as containing or suspected of containing allegedly defective drywall manufactured in China. These homes are located in Florida and were primarily delivered in 2006 and 2007. The Company's overall warranty liability of \$67.7 million at November 30, 2011 included \$4.8 million for the estimated remaining repair costs associated with 87 such identified affected homes. The decrease in the liability for estimated repair costs associated with identified affected homes during the three months ended February 29, 2012 reflected the lower number of identified affected homes with unresolved repairs at February 29, 2012 compared to November 30, 2011. During the three months ended February 29, 2012, repairs were resolved on 15 identified affected homes, and the Company identified one additional affected home. For these purposes, the Company considers repairs for identified affected homes to be resolved when all repairs are complete and all repair costs are fully paid. Repairs for identified affected homes are considered unresolved if repairs are not complete and/or there are repair costs remaining to be paid.

During the three months ended February 29, 2012 and February 28, 2011, the Company paid \$1.3 million and \$5.4 million, respectively, to repair identified affected homes, and estimated its additional repair costs with respect to the identified affected homes to be \$.4 million and \$3.7 million, respectively. Since first identifying affected homes in 2009, the Company has identified a total of 468 affected homes and has resolved repairs on 395 of those homes through February 29, 2012. As of February 29, 2012, the Company has paid \$41.8 million of the total estimated repair costs of \$45.7 million associated with the identified affected homes. The Company believes that it has identified substantially all potentially affected homes and anticipates it will receive only nominal additional claims in future periods.

In assessing its overall warranty liability, the Company evaluates the costs related to identified homes affected by the allegedly defective drywall material and other home warranty-related items on a combined basis. Based on its assessments, the Company determined that its overall warranty liability at each reporting date was sufficient with respect to the Company's then-estimated remaining repair costs associated with identified affected homes and its overall warranty obligations on homes delivered. In light of these assessments, the Company did not incur charges in its consolidated statements of operations for the three months ended February 29, 2012 or February 28, 2011 with respect to repair costs associated with the identified affected homes. The overall warranty liability has decreased in part because of the payments the Company has made to resolve repairs on identified affected homes and in part due to the decrease in the number of homes the Company has delivered over the past several years.

As of February 29, 2012, the Company has been named as a defendant in 11 lawsuits relating to the allegedly defective drywall material, and it may in the future be subject to other similar litigation or claims that could cause the Company to incur significant costs. Given the preliminary stages of the proceedings, the Company has not concluded whether the outcome of any of these lawsuits will be material to its consolidated financial statements.

The Company intends to seek and is undertaking efforts, including legal proceedings, to obtain reimbursement from various sources, including suppliers and insurers, for the costs it has incurred or expects to incur to investigate and complete repairs and to defend itself in litigation associated with this drywall material. Given



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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

13. Commitments and Contingencies (continued)

uncertainties in the potential outcomes of these efforts, some of which may involve pursuing claims in international forums, the Company has not recorded any amounts for potential future recoveries as of February 29, 2012.

*Guarantees.* In the normal course of its business, the Company issues certain representations, warranties and guarantees related to its home sales and land sales that may be affected by Accounting Standards Codification Topic No. 460, Guarantees. Based on historical evidence, the Company does not believe any of these representations, warranties or guarantees would be material to its consolidated financial statements.

*Insurance.* The Company has, and requires the majority of its subcontractors to maintain, general liability insurance (including construction defect and bodily injury coverage) and workers' compensation insurance. These insurance policies protect the Company against a portion of its risk of loss from claims related to its homebuilding activities, subject to certain self-insured retentions, deductibles and other coverage limits. In Arizona, California, Colorado and Nevada, the Company's general liability insurance takes the form of a wrap-up policy, where eligible subcontractors are enrolled as insureds on each project. The Company self-insures a portion of its overall risk through the use of a captive insurance subsidiary. The Company records expenses and liabilities based on the estimated costs required to cover its self-insured retention and deductible amounts under its insurance policies, and the estimated costs of potential claims and claim adjustment expenses that are above its coverage limits or that are not covered by its policies. These estimated costs are based on an analysis of the Company's historical claims and include an estimate of construction defect claims incurred but not yet reported. The Company's estimated liabilities for such items were \$92.1 million at February 29, 2012 and \$94.9 million at November 30, 2011. These amounts are included in accrued expenses and other liabilities in the Company's consolidated balance sheets. The Company's expenses associated with self-insurance totaled \$2.3 million for each of the three-month periods ended February 29, 2012 and February 28, 2011. These expenses were largely offset by contributions from subcontractors participating in the wrap-up policy.

*Performance Bonds and Letters of Credit.* The Company is often required to provide to various municipalities and other government agencies performance bonds and/or letters of credit to secure the completion of its projects

and/or in support of obligations to build community improvements such as roads, sewers, water systems and other utilities, and to support similar development activities by certain of its unconsolidated joint ventures. At February 29, 2012, the Company had \$330.0 million of performance bonds and \$61.8 million of letters of credit outstanding. At November 30, 2011, the Company had \$361.6 million of performance bonds and \$63.8 million of letters of credit outstanding. If any such performance bonds or letters of credit are called, the Company would be obligated to reimburse the issuer of the performance bond or letter of credit. The Company does not believe that a material amount of any currently outstanding performance bonds or letters of credit will be called. Performance bonds do not have stated expiration dates. Rather, the Company is released from the performance bonds as the underlying performance is completed. The expiration dates of some letters of credit issued in connection with community improvements coincide with the expected completion dates of the related projects or obligations. Most letters of credit, however, are issued with an initial term of one year and are typically extended on a year-to-year basis until the related performance obligations are completed.

*Land Option Contracts.* In the ordinary course of business, the Company enters into land option contracts and other similar contracts to procure rights to land parcels for the construction of homes. At February 29, 2012, the Company had total deposits of \$20.9 million, comprised of \$20.7 million of cash deposits and \$.2 million of letters of credit, to purchase land having an aggregate purchase price of \$597.0 million. The Company's land option contracts and other similar contracts generally do not contain provisions requiring the Company's specific performance.

14. Legal Matters

*Nevada Development Contract Litigation*

On November 4, 2011, the Eighth Judicial District Court, Clark County, Nevada set for trial a consolidated



**KB HOME****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

14. Legal Matters (continued)

action against KB HOME Nevada Inc., a wholly owned subsidiary of the Company ( KB Nevada ), in a case entitled *Las Vegas Development Associates, LLC, Essex Real Estate Partners, LLC, et. al. v. KB HOME Nevada Inc.* In 2007, Las Vegas Development Associates, LLC ( LVDA ) agreed to purchase from KB Nevada approximately 83 acres of land located near Las Vegas, Nevada. LVDA subsequently assigned its rights to Essex Real Estate Partners, LLC ( Essex ). KB Nevada and Essex entered into a development agreement relating to certain major infrastructure improvements. LVDA s and Essex s complaint, initially filed in 2008, alleges that KB Nevada breached the development agreement, and also alleges that KB Nevada fraudulently induced them to enter into the purchase and development agreements. LVDA s and Essex s lenders subsequently filed related actions that were consolidated into the LVDA/Essex matter. The consolidated plaintiffs seek rescission of the agreements or a rescissory measure of damages or, in the alternative, compensatory damages of \$55 million plus unspecified punitive damages and other damages (the Claimed Damages ). KB Nevada denies the allegations, and believes it has meritorious defenses to the consolidated plaintiffs claims. While the ultimate outcome is uncertain the Company believes it is reasonably possible that the loss in this matter could range from zero to the amount of the Claimed Damages and could be material to the Company s consolidated financial statements KB Nevada believes it will be successful in defending against the plaintiffs claims and that the plaintiffs will not be awarded rescission or damages. The trial is currently set for September 2012.

*Southern California Project Development Case*

On December 27, 2011, the jury in a case entitled *KB HOME Coastal Inc. et al. v. Estancia Coastal*, returned a verdict against KB HOME Coastal Inc., a wholly owned subsidiary, and the Company for \$9.8 million, excluding legal fees and interest. The case related to a land option contract and a construction agreement between KB HOME Coastal Inc. and the plaintiff. Based on pre-trial analysis, the verdict was not expected, and KB HOME Coastal Inc. and the Company intend to file a motion for judgment notwithstanding the verdict and a motion for a new trial, ahead of a possible appeal of what they believe was an incorrect result. While the ultimate outcome is uncertain, KB HOME Coastal Inc. and the Company believe they will be successful in resolving the matter for an amount less than the jury s verdict. The ultimate loss for this matter is estimated to range from \$2.9 million to \$13 million, including legal fees and interest. In accordance with Accounting Standards Codification Topic No. 450, Contingencies, as no amount in that range appears to be a better estimate than any other amount, the Company s consolidated financial statements at February 29, 2012 included an accrual of \$2.9 million for this matter. However, it is reasonably possible that the loss could exceed the amount accrued within the estimated range described above.

*Other Matters*

In addition to the specific proceedings described above, the Company is involved in other litigation and regulatory proceedings incidental to its business that are in various procedural stages. The Company believes that the accruals it has recorded for probable and reasonably estimable losses with respect to these proceedings are adequate and that, as of February 29, 2012, it was not reasonably possible that an additional material loss had been incurred in an amount in excess of the estimated amounts already recognized on the Company s consolidated financial statements. The Company evaluates its accruals for litigation and regulatory proceedings at least quarterly and, as appropriate, adjusts them to reflect (i) the facts and circumstances known to the Company at the time, including information regarding negotiations, settlements, rulings and other relevant events and developments; (ii) the advice and analyses of counsel; and (iii) the assumptions and judgment of management. Similar factors and considerations are used in establishing new accruals for proceedings as to which losses have become probable and reasonably estimable at the time an evaluation is made. Based on its experience, the Company believes that the amounts that may be claimed or alleged against it in these proceedings are not a meaningful indicator of its potential liability. The outcome of any of these proceedings, including the defense and other litigation-related costs and expenses the Company may incur, however, is inherently uncertain and could differ significantly from the estimate reflected in a related accrual, if made. Therefore, it is possible that the ultimate outcome of any proceeding, if in excess of a related accrual or if no accrual had been made, could be material to the Company s consolidated financial statements.

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**KB HOME**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

**15. Stockholders' Equity**

As of February 29, 2012, the Company was authorized to repurchase four million shares of its common stock under a board-approved share repurchase program. The Company did not repurchase any of its common stock under this program in the three months ended February 29, 2012. The Company has not repurchased common shares pursuant to a common stock repurchase plan for the past several years and any resumption of such stock repurchases will be at the discretion of the Company's board of directors.

During the three months ended February 29, 2012, the Company's board of directors declared a cash dividend of \$.0625 per share of common stock, which was paid on February 16, 2012 to stockholders of record on February 7, 2012. A cash dividend of \$.0625 per share of common stock was also declared and paid during the three months ended February 28, 2011.

**16. Recent Accounting Pronouncements**

In May 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in GAAP and IFRS (ASU 2011-04), which changes the wording used to describe the requirements in GAAP for measuring fair value and for disclosing information about fair value measurements in order to improve consistency in the application and description of fair value between GAAP and International Financial Reporting Standards. ASU 2011-04 clarifies how the concepts of highest and best use and valuation premise in a fair value measurement are relevant only when measuring the fair value of nonfinancial assets and are not relevant when measuring the fair value of financial assets or liabilities. In addition, the guidance expanded the disclosures for the unobservable inputs for Level 3 fair value measurements, requiring quantitative information to be disclosed related to (1) the valuation processes used, (2) the sensitivity of the fair value measurement to changes in unobservable inputs and the interrelationships between those unobservable inputs, and (3) use of a nonfinancial asset in a way that differs from the asset's highest and best use. The revised guidance is effective for interim and annual periods beginning after December 15, 2011 and early application by public entities is prohibited. The Company believes the adoption of this guidance will not have a material impact on its consolidated financial position or results of operations.

In June 2011, the FASB issued Accounting Standards Update No. 2011-05, Presentation of Comprehensive Income (ASU 2011-05), which allows an entity the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both instances, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments in ASU 2011-05 do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. However, in December 2011, the FASB issued Accounting Standards Update No. 2011-12, Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05 (ASU 2011-12), which deferred the guidance on whether to require entities to present reclassification adjustments out of accumulated other comprehensive income by component in both the statement where net income is presented and the statement where other comprehensive income is presented for both interim and annual financial statements. ASU 2011-12 reinstated the requirements for the presentation of reclassifications that were in place prior to the issuance of ASU 2011-05 and did not change the effective date for ASU 2011-05. For public entities, the amendments in ASU 2011-05 and ASU 2011-12 are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, and should be applied retrospectively. The adoption of this guidance concerns disclosure only and will not have an impact on the Company's consolidated financial position or results of operations.



## KB HOME

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

17. Income Taxes

The Company's income tax expense totaled \$.4 million for each of the three-month periods ended February 29, 2012 and February 28, 2011. Due to the effects of its deferred tax asset valuation allowances and changes in its unrecognized tax benefits, the Company's effective tax rates for the three months ended February 29, 2012 and February 28, 2011 are not meaningful items as the Company's income tax amounts are not directly correlated to the amount of its pretax losses for those periods.

In accordance with Accounting Standards Codification Topic No. 740, Income Taxes (ASC 740), the Company evaluates its deferred tax assets quarterly to determine if adjustments to the valuation allowance are required. ASC 740 requires that companies assess whether a valuation allowance should be established based on the consideration of all available evidence using a "more likely than not" standard with respect to whether deferred tax assets will be realized. The realization of deferred tax assets depends primarily on the Company's ability to generate sustained profitability. During the three months ended February 29, 2012, the Company recorded a valuation allowance of \$18.3 million against net deferred tax assets generated from the loss for the period. During the three months ended February 28, 2011, the Company recorded a similar valuation allowance of \$45.1 million against net deferred tax assets. The Company's net deferred tax assets totaled \$1.1 million at both February 29, 2012 and November 30, 2011. The deferred tax asset valuation allowance increased to \$866.1 million at February 29, 2012 from \$847.8 million at November 30, 2011. This increase reflected the impact of the \$18.3 million valuation allowance recorded during the three months ended February 29, 2012.

During the three months ended February 29, 2012, the Company had no additions to its total gross unrecognized tax benefits as a result of the current status of federal and state audits. The total amount of unrecognized tax benefits, including interest and penalties, that would affect the effective tax rate was \$1.9 million as of February 29, 2012. The Company anticipates that total unrecognized tax benefits will decrease by approximately \$.5 million during the 12 months from this reporting date due to various state filings associated with the resolution of the federal audit.

The benefits of the Company's net operating losses (NOLs), built-in losses and tax credits would be reduced or potentially eliminated if the Company experienced an ownership change under Internal Revenue Code Section 382 (Section 382). Based on the Company's analysis performed as of February 29, 2012, the Company does not believe it has experienced an ownership change as defined by Section 382, and, therefore, the NOLs, built-in losses and tax credits the Company has generated should not be subject to a Section 382 limitation as of this reporting date.

18. Supplemental Disclosure to Consolidated Statements of Cash Flows

The following are supplemental disclosures to the consolidated statements of cash flows (in thousands):

	Three Months Ended	
	February 29, 2012	February 28, 2011
<b>Summary of cash and cash equivalents at end of period:</b>		
Homebuilding	\$ 304,171	\$ 735,766
Financial services	3,204	6,732
Total	\$ 307,375	\$ 742,498
<b>Supplemental disclosure of cash flow information:</b>		
Interest paid, net of amounts capitalized	\$ 31,334	\$ 26,430
Income taxes paid	174	67
Income taxes refunded	58	

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Supplemental disclosure of noncash activities:

Increase (decrease) in consolidated inventories not owned	\$ (2,536)	\$ 14,493
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**KB HOME**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

19. Supplemental Guarantor Information

The Company's obligations to pay principal, premium, if any, and interest under its senior notes are guaranteed on a joint and several basis by the Guarantor Subsidiaries. The guarantees are full and unconditional and the Guarantor Subsidiaries are 100% owned by the Company. The Company has determined that separate, full financial statements of the Guarantor Subsidiaries would not be material to investors and, accordingly, supplemental financial information for the Guarantor Subsidiaries is presented.

The supplemental financial information for the periods presented below reflects the relevant subsidiaries of the Company that were Guarantor Subsidiaries as of and for the respective periods then ended. Accordingly, information for any period presented does not reflect subsequent changes, if any, in the subsidiaries of the Company considered to be Guarantor Subsidiaries.

## KB HOME

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

19. Supplemental Guarantor Information (continued)

Condensed Consolidated Statements of Operations

Three Months Ended February 29, 2012 (in thousands)

	KB Home Corporate	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Total
Revenues	\$	\$ 146,489	\$ 108,069	\$	\$ 254,558
Homebuilding:					
Revenues	\$	\$ 146,489	\$ 105,406	\$	\$ 251,895
Construction and land costs		(134,982)	(92,376)		(227,358)
Selling, general and administrative expenses	(14,000)	(21,172)	(20,514)		(55,686)
Operating loss	(14,000)	(9,665)	(7,484)		(31,149)
Interest income	125	1	9		135
Interest expense	14,120	(23,882)	(6,524)		(16,286)
Equity in loss of unconsolidated joint ventures		(51)	(21)		(72)
Homebuilding pretax income (loss)	245	(33,597)	(14,020)		(47,372)
Financial services pretax income			1,970		1,970
Total pretax income (loss)	245	(33,597)	(12,050)		(45,402)
Income tax expense		(300)	(100)		(400)
Equity in net loss of subsidiaries	(46,047)			46,047	
Net loss	\$ (45,802)	\$ (33,897)	\$ (12,150)	\$ 46,047	\$ (45,802)

Three Months Ended February 28, 2011 (in thousands)

	KB Home Corporate	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Total
Revenues	\$	\$ 49,207	\$ 147,733	\$	\$ 196,940
Homebuilding:					
Revenues	\$	\$ 49,207	\$ 146,094	\$	\$ 195,301
Construction and land costs		(46,577)	(124,219)		(170,796)
Selling, general and administrative expenses	(18,670)	1,125	(32,060)		(49,605)
Loss on loan guaranty			(22,758)		(22,758)
Operating income (loss)	(18,670)	3,755	(32,943)		(47,858)
Interest income	313	4	66		383
Interest expense	9,850	(8,307)	(12,982)		(11,439)
Equity in loss of unconsolidated joint ventures		(43)	(55,794)		(55,837)

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Homebuilding pretax loss	(8,507)	(4,591)	(101,653)	(114,751)
Financial services pretax income			625	625
Total pretax loss	(8,507)	(4,591)	(101,028)	(114,126)
Income tax expense			(400)	(400)
Equity in net loss of subsidiaries	(106,019)			106,019
Net loss	\$ (114,526)	\$ (4,591)	\$ (101,428)	\$ 106,019
				\$ (114,526)

**KB HOME****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

19. Supplemental Guarantor Information (continued)

## Condensed Consolidated Balance Sheets

February 29, 2012 (in thousands)

	KB Home Corporate	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Total
<b>Assets</b>					
<b>Homebuilding:</b>					
Cash and cash equivalents	\$ 259,419	\$ 24,385	\$ 20,367	\$	\$ 304,171
Restricted cash	63,884	6			63,890
Receivables	820	31,369	40,253		72,442
Inventories		1,260,358	488,019		1,748,377
Investments in unconsolidated joint ventures		107,321	13,986		121,307
Other assets	79,414	690	7,844		87,948
	403,537	1,424,129	570,469		2,398,135
Financial services			7,938		7,938
Investments in subsidiaries	(35,592)			35,592	
<b>Total assets</b>	<b>\$ 367,945</b>	<b>\$ 1,424,129</b>	<b>\$ 578,407</b>	<b>\$ 35,592</b>	<b>\$ 2,406,073</b>
<b>Liabilities and stockholders' equity</b>					
<b>Homebuilding:</b>					
Accounts payable, accrued expenses and other liabilities	\$ 113,316	\$ 147,364	\$		