

FARMER BROTHERS CO
Form 10-Q
November 07, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)

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

For the quarterly period ended September 30, 2013
OR

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

For the transition period from _____ to _____
Commission file number: 001-34249

FARMER BROS. CO.
(Exact Name of Registrant as Specified in Its Charter)
Delaware
(State of Incorporation)

95-0725980
(I.R.S. Employer Identification No.)

20333 South Normandie Avenue, Torrance, California 90502
(Address of Principal Executive Offices; Zip Code)
310-787-5200
Registrant's telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act:

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 (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

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

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input checked="" type="checkbox"/>
Non-accelerated filer	<input checked="" type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company	<input type="checkbox"/>

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

As of November 6, 2013 the registrant had 16,454,212 shares outstanding of its common stock, par value \$1.00 per share, which is the registrant's only class of common stock.

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

FARMER BROS. CO.

CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)	September 30, 2013 (Unaudited)	June 30, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	\$4,930	\$2,678
Restricted cash	6,260	8,084
Short-term investments	20,425	20,546
Accounts and notes receivable, net	42,840	43,922
Inventories	68,682	60,867
Income tax receivable	226	409
Prepaid expenses	2,748	3,243
Total current assets	146,111	139,749
Property, plant and equipment, net	90,225	92,159
Intangible assets, net	6,061	6,277
Other assets	5,402	5,484
Deferred income taxes	467	467
Total assets	\$248,266	\$244,136
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$29,374	27,740
Accrued payroll expenses	19,871	19,757
Short-term borrowings under revolving credit facility	10,138	9,654
Short-term obligations under capital leases	3,430	3,409
Short-term derivative liability	9,350	9,896
Deferred income taxes	923	923
Other current liabilities	6,309	5,171
Total current liabilities	79,395	76,550
Long-term borrowings under revolving credit facility	10,000	10,000
Long-term derivative liability	687	1,129
Accrued postretirement benefits	16,267	16,076
Other long-term liabilities—capital leases	8,505	8,759
Accrued pension liabilities	43,797	43,800
Accrued workers' compensation liabilities	5,082	5,132
Deferred income taxes	888	852
Total liabilities	\$164,621	\$162,298
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, \$1.00 par value, 500,000 shares authorized and none issued	\$—	\$—
Common stock, \$1.00 par value, 25,000,000 shares authorized; 16,454,212 and 16,454,422 issued and outstanding at September 30, 2013 and June 30, 2013, respectively	16,454	16,454
Additional paid-in capital	35,561	34,654
Retained earnings	95,885	94,080
Unearned ESOP shares	(20,836	) (20,836
Less accumulated other comprehensive loss	(43,419) (42,514
Total stockholders' equity	\$83,645	\$81,838

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Total liabilities and stockholders' equity	\$248,266	\$244,136
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The accompanying notes are an integral part of these financial statements.

FARMER BROS. CO.
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except share and per share data)

	Three Months Ended September 30,	
	2013	2012
	(Unaudited)	
Net sales	\$128,561	\$119,153
Cost of goods sold	79,089	74,532
Gross profit	49,472	44,621
Selling expenses	37,335	37,271
General and administrative expenses	9,246	8,769
Operating expenses	46,581	46,040
Income (loss) from operations	2,891	(1,419)
Other (expense) income:		
Dividend income	268	259
Interest income	108	92
Interest expense	(372)	) (457)
Other, net	(783)	) 4,945
Total other (expense) income	(779)	) 4,839
Income before taxes	2,112	3,420
Income tax expense	306	441
Net income	\$1,806	\$2,979
Net income per common share—basic	\$0.11	\$0.19
Net income per common share—diluted	\$0.11	\$0.19
Weighted average common shares outstanding—basic	15,802,160	15,490,365
Weighted average common shares outstanding—diluted	15,860,365	15,490,365

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

FARMER BROS. CO.
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
 (In thousands)

	Three Months Ended September 30,	
	2013	2012
	(Unaudited)	
Net income	\$ 1,806	\$ 2,979
Other comprehensive income, net of tax:		
Deferred losses on derivatives designated as cash flow hedges	(3,125) —
Reclassification of deferred losses on derivatives designated as cash flow hedges to cost of goods sold	2,219	—
Total comprehensive income, net of tax	\$ 900	\$ 2,979

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

FARMER BROS. CO.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Three Months Ended September 30,	
	2013	2012
	(Unaudited)	
Cash flows from operating activities:		
Net income	\$ 1,806	\$2,979
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	7,424	8,340
Provision for (recovery of) doubtful accounts	73	(922)
Deferred income taxes	37	—
Net gains on sales of assets	(123)	(3,213)
ESOP and share-based compensation expense	904	823
Net losses (gains) on derivatives and investments	1,549	(802)
Change in operating assets and liabilities:		
Restricted cash	1,824	1,483
Short-term investments	(1,429)	52
Accounts and notes receivable	1,009	(1,481)
Inventories	(7,816)	(3,943)
Income tax receivable	183	393
Prepaid expenses and other assets	578	120
Accounts payable	1,907	2,268
Accrued payroll expenses and other liabilities	(199)	(1,542)
Accrued postretirement benefits	190	288
Other long-term liabilities	(644)	(1,191)
Net cash provided by operating activities	\$7,273	\$3,652
Cash flows from investing activities:		
Purchases of property, plant and equipment	(4,757)	(3,572)
Proceeds from sales of property, plant and equipment	292	3,786
Net cash (used in) provided by investing activities	\$(4,465)	\$214
Cash flows from financing activities:		
Proceeds from revolving credit facility	9,810	4,800
Repayments on revolving credit facility	(9,600)	(9,250)
Payments of capital lease obligations	(768)	(777)
Proceeds from stock option exercises	2	—
Net cash used in financing activities	\$(556)	\$(5,227)
Net increase (decrease) in cash and cash equivalents	\$2,252	\$(1,361)
Cash and cash equivalents at beginning of period	2,678	3,906
Cash and cash equivalents at end of period	\$4,930	\$2,545

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

FARMER BROS. CO.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies

Organization

Farmer Bros. Co., a Delaware corporation (including its consolidated subsidiaries unless the context otherwise requires, the "Company," or "Farmer Bros."), is a manufacturer, wholesaler and distributor of coffee, tea and culinary products. The Company is a direct distributor of coffee to restaurants, hotels, casinos, offices, quick service restaurants ("QSR's"), convenience stores, healthcare facilities and other foodservice providers, as well as private brand retailers in the QSR, grocery, drugstore, restaurant, convenience store and independent coffeehouse channels. The Company was founded in 1912, was incorporated in California in 1923, and reincorporated in Delaware in 2004. The Company operates in one business segment.

Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States ("GAAP") for complete consolidated financial statements. In the opinion of management, all adjustments (consisting only of normal recurring accruals, unless otherwise indicated) considered necessary for a fair presentation of the interim financial data have been included. Operating results for the three months ended September 30, 2013 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2014. Events occurring subsequent to September 30, 2013 have been evaluated for potential recognition or disclosure in the unaudited consolidated financial statements for the three months ended September 30, 2013.

The accompanying unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2013, filed with the Securities and Exchange Commission (the "SEC") on October 9, 2013.

Use of Estimates

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. The Company reviews its estimates on an ongoing basis using currently available information. Changes in facts and circumstances may result in revised estimates and actual results may differ from those estimates.

Derivative Instruments

The Company purchases various derivative instruments as investments or to create economic hedges of its commodity price risk and interest rate risk. These derivative instruments consist primarily of futures and swaps. The Company reports the fair value of derivative instruments on its consolidated balance sheets in "Short-term investments," "Other assets," "Short-term derivative liability," or "Long-term derivative liability." The Company determines the current and noncurrent classification based on the timing of expected future cash flows of individual trades and reports these amounts on a gross basis. Additionally, the Company reports cash held on deposit in margin accounts for coffee-related derivative instruments on a gross basis.

The accounting for the changes in fair value of the Company's derivative instruments can be summarized as follows:

Derivative Treatment	Accounting Method
Normal purchases and normal sales exception	Accrual accounting
Designated in a qualifying hedging relationship	Hedge accounting
All other derivatives	Mark-to-market accounting

The Company enters into green coffee purchase commitments at a fixed price or at a price to be fixed ("PTF"). PTF contracts are purchase commitments whereby the quality, quantity, delivery period, price differential to the coffee "C" market price and other negotiated terms are agreed upon, but the price at which the base "C" market price will be fixed has not yet been established. The coffee "C" market price is fixed at some point after the purchase contract date and

before the futures market closes for the delivery month and may be fixed either at the direction of the Company to the vendor, or by the application of a derivative that was separately purchased as a hedge. For both fixed-price and PTF contracts, the Company expects to take

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Farmer Bros. Co.
Notes to Consolidated Financial Statements (continued)

delivery of and to utilize the coffee in a reasonable period of time and in the conduct of normal business. Accordingly, these purchase commitments qualify as normal purchases and are not recorded at fair value on the Company's consolidated balance sheets.

Prior to April 1, 2013, the Company had no derivative instruments that were designated as accounting hedges. Beginning April 1, 2013, the Company implemented procedures following the guidelines of ASC 815, "Derivatives and Hedging" ("ASC 815"), to enable it to account for certain coffee-related derivatives as accounting hedges in order to minimize the volatility created in the Company's quarterly results from utilizing these derivative contracts and to improve comparability between reporting periods. For a derivative to qualify for designation in a hedging relationship, it must meet specific criteria and the Company must maintain appropriate documentation. The Company establishes hedging relationships pursuant to its risk management policies. The hedging relationships are evaluated at the inception of the hedging relationship and on an ongoing basis to determine whether the hedging relationship is, and is expected to remain, highly effective in achieving offsetting changes in fair value or cash flows attributable to the underlying risk being hedged. The Company also regularly assesses whether the hedged forecasted transaction is probable of occurring. If a derivative ceases to be or is no longer expected to be highly effective, or if the Company believes the likelihood of occurrence of the hedged forecasted transaction is no longer probable, hedge accounting is discontinued prospectively, and future changes in the fair value of the derivative are recognized currently in "Other, net."

For commodity derivatives designated as cash flow hedges, the effective portion of the change in fair value of the derivative is reported as accumulated other comprehensive income ("AOCI") and subsequently reclassified into cost of goods sold in the period or periods when the hedged transaction affects earnings. Any ineffective portion of the derivative's change in fair value is recognized currently in "Other, net." Gains or losses deferred in AOCI associated with terminated derivatives, derivatives that cease to be highly effective hedges, derivatives for which the forecasted transaction is reasonably possible but no longer probable of occurring, and cash flow hedges that have been otherwise discontinued remain in AOCI until the hedged item affects earnings. If it becomes probable that the forecasted transaction designated as the hedged item in a cash flow hedge will not occur, any gain or loss deferred in AOCI is recognized in "Other, net" at that time. For derivative instruments that are not designated in a hedging relationship, and for which the normal purchases and normal sales exception has not been elected, the changes in fair value are reported in "Other, net."

The following gains and losses on derivative instruments are netted together and reported in "Other, net" in the Company's consolidated statement of operations:

- Gains and losses on all derivatives that are not designated as cash flow hedges and for which the normal purchases and normal sales exception has not been elected; and

- The ineffective portion of unrealized gains and losses on derivatives that are designated as cash flow hedges.

The fair value of derivative instruments is based upon broker quotes. At September 30, 2013, approximately 90% of the Company's outstanding coffee-related derivative instruments were designated as cash flow hedges (see Note 2). At September 30, 2012, no derivative instruments were designated as accounting hedges.

Coffee Brewing Equipment and Service

The Company classifies certain expenses related to coffee brewing equipment provided to customers as cost of goods sold. These costs include the cost of the equipment as well as the cost of servicing that equipment (including service employees' salaries, cost of transportation and the cost of supplies and parts) and are considered directly attributable to the generation of revenues from its customers. Accordingly, such costs included in cost of goods sold in the accompanying consolidated financial statements for the three months ended September 30, 2013 and 2012 are \$6.5 million and \$5.8 million, respectively.

The Company has capitalized coffee brewing equipment in the amounts of \$3.1 million and \$1.9 million in the three months ended September 30, 2013 and 2012, respectively. During the three months ended September 30, 2013 and

2012, the Company had depreciation expense related to the capitalized coffee brewing equipment reported as cost of goods sold in the amounts of \$2.9 million and \$3.3 million, respectively.

Revenue Recognition

Most product sales are made “off-truck” to the Company’s customers at their places of business by the Company’s sales representatives. Revenue is recognized at the time the Company’s sales representatives physically deliver products to customers and title passes or when it is accepted by the customer when shipped by third-party delivery.

The Company sells roast and ground coffee and tea to The J.M. Smucker Company ("J.M. Smucker") pursuant to a co-packing agreement. The Company recognizes revenue from the co-packing arrangement for the sale of tea on a net basis, net of

Farmer Bros. Co.

Notes to Consolidated Financial Statements (continued)

direct costs of revenue, since the Company acts as an agent of J.M. Smucker in such transactions. As of September 30, 2013 and June 30, 2013, the Company had \$0.4 million and \$0.3 million, respectively, of receivables relating to this arrangement which are included in "Other receivables" (see Note 6).

Earnings (Loss) Per Common Share

Basic earnings (loss) per share ("EPS") represents net earnings attributable to common stockholders divided by the weighted-average number of common shares outstanding for the period, excluding unallocated shares held by the Company's Employee Stock Ownership Plan ("ESOP"). Diluted EPS represents net earnings attributable to common stockholders divided by the weighted-average number of common shares outstanding, inclusive of the dilutive impact of common equivalent shares outstanding during the period. However, nonvested restricted stock awards (referred to as participating securities) are excluded from the dilutive impact of common equivalent shares outstanding in accordance with authoritative guidance under the two-class method. The nonvested restricted stockholders are entitled to participate in dividends declared on common stock as if the shares were fully vested and hence are deemed to be participating securities. Under the two-class method, earnings (loss) attributable to nonvested restricted stockholders are excluded from net earnings (loss) attributable to common stockholders for purposes of calculating basic and diluted EPS. Computation of EPS for the three months ended September 30, 2013 and 2012 includes the dilutive effect of 58,205 and 0 shares, respectively, issuable under stock options (see Note 12).

Dividends Declared

Although historically the Company has paid a dividend to stockholders, in light of the Company's current financial position, the Company's Board of Directors has omitted the payment of a quarterly dividend since the third quarter of fiscal 2011. The amount, if any, of dividends to be paid in the future will depend upon the Company's then available cash, anticipated cash needs, overall financial condition, loan agreement restrictions, future prospects for earnings and cash flows, as well as other relevant factors.

Impairment of Indefinite-lived Intangible Assets

The Company performs its annual impairment test of goodwill and/or other indefinite-lived intangible assets as of June 30. Goodwill and other indefinite-lived intangible assets are not amortized but instead are reviewed for impairment annually and on an interim basis if events or changes in circumstances between annual tests indicate that an asset might be impaired. Indefinite-lived intangible assets are tested for impairment by comparing their fair values to their carrying values.

In addition to an annual test, indefinite-lived intangible assets must also be tested on an interim basis if events or circumstances indicate that the estimated fair value of such assets has decreased below their carrying value. There were no such events or circumstances during the three months ended September 30, 2013.

Long-Lived Assets, Excluding Indefinite-lived Intangible Assets

The Company reviews the recoverability of its long-lived assets whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Long-lived assets evaluated for impairment are grouped with other assets to the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. The estimated future cash flows are based upon, among other things, assumptions about expected future operating performance, and may differ from actual cash flows. If the sum of the projected undiscounted cash flows (excluding interest) is less than the carrying value of the assets, the assets will be written down to the estimated fair value in the period in which the determination is made. There were no such events or circumstances during the three months ended September 30, 2013.

Recently Adopted Accounting Standards

In February 2013, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") No. 2013-02, "Reporting Amounts Reclassified Out of Accumulated Other Comprehensive Income" ("ASU 2013-02"), an update to the authoritative guidance related to the reporting of amounts reclassified out of accumulated other comprehensive income. This new requirement about presenting information about amounts reclassified out of accumulated other comprehensive income and their corresponding effect on net income will

present, in one place, information about significant amounts reclassified and, in some cases, cross-references to related footnote disclosures. The disclosure amendments in this update are effective prospectively for fiscal years (and interim periods within those years) beginning after December 15, 2012 and early adoption is permitted. The Company adopted ASU 2013-02 beginning July 1, 2013. Adoption of ASU 2013-02 did not have a material effect on the results of operations, financial position or cash flows of the Company.

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Farmer Bros. Co.

Notes to Consolidated Financial Statements (continued)

In February 2013, the FASB issued ASU No. 2013-01, "Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities" ("ASU 2013-01"). The amendments limit the scope of ASU No. 2011-11, "Disclosures about Offsetting Assets and Liabilities" ("ASU 2011-11"), to certain derivative instruments (including bifurcated embedded derivatives), repurchase agreements and reverse repurchase agreements, and securities borrowing and lending arrangements that are either (1) offset on the balance sheet or (2) subject to an enforceable master netting arrangement or similar agreement. The requirements as initially written in ASU 2011-11 would have applied more broadly than intended. The disclosure amendments in this update are effective prospectively for fiscal years (and interim periods within those years) beginning after January 1, 2013. The amendments will be applied retrospectively for all comparative periods presented on the balance sheet. The Company adopted ASU 2013-01 beginning July 1, 2013. Adoption of ASU 2013-01 did not have a material effect on the results of operations, financial position or cash flows of the Company.

In July 2012, the FASB issued ASU No. 2012-02, "Testing Indefinite-Lived Intangible Assets for Impairment" ("ASU 2012-02"), an update to the authoritative guidance related to the impairment testing of indefinite-lived intangible assets. Similar to the guidance for goodwill impairment testing, companies will have the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of the indefinite-lived intangible asset is less than its carrying value. The guidance provides companies with a revised list of examples of events and circumstances to consider, in their totality, to determine whether it is more likely than not that the fair value of the asset is less than its carrying amount. If a company concludes that this is the case, the company is required to perform the quantitative impairment test by comparing the fair value with the carrying value. Otherwise, a company can skip the quantitative test. Companies are not required to perform the qualitative assessment and are permitted to skip the qualitative assessment for any indefinite-lived asset in any period and proceed directly to the quantitative impairment test. The company may resume performing the qualitative assessment in any subsequent period. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted. The Company adopted ASU 2012-02 beginning July 1, 2013. Adoption of ASU 2012-02 did not to have a material effect on the results of operations, financial position or cash flows of the Company.

New Accounting Pronouncements

In July 2013, the FASB issued ASU No. 2013-11, "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists" ("ASU 2013-11"). An entity is required to present unrecognized tax benefits as a decrease in net operating loss, similar tax loss or tax credit carryforward if certain criteria are met. The determination of whether a deferred tax asset is available is based on the unrecognized tax benefit and the deferred tax asset that exists at the reporting date and presumes disallowance of the tax position at the reporting date. The guidance will eliminate the diversity in practice in the presentation of unrecognized tax benefits but will not alter the way in which entities assess deferred tax assets for realizability. This update is effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2013 and will be effective for the Company beginning July 1, 2014. Adoption of ASU 2013-11 is not expected to have a material effect on the results of operations, financial position or cash flows of the Company.

Note 2. Derivative Instruments

Derivative Instruments Held

Coffee-Related Derivative Instruments

The Company is exposed to commodity price risk associated with its PTF green coffee purchase contracts, which are described further in Note 1. The Company utilizes futures contracts and options to manage exposure to the variability in expected future cash flows from forecasted purchases of green coffee attributable to commodity price risk, in some instances, as much as 18 months prior to the actual delivery date. Certain of these coffee-related derivative instruments utilized for risk management purposes have been designated as cash flow hedges, while other

coffee-related derivative instruments have not been designated as cash flow hedges or do not qualify for hedge accounting despite hedging the Company's future cash flows on an economic basis.

At September 30, 2013, approximately 90% of the Company's outstanding coffee-related derivative instruments, representing 47.9 million pounds of forecasted green coffee purchases, were designated as cash flow hedges. At September 30, 2012 no coffee-related derivative instruments were designated as accounting hedges.

Farmer Bros. Co.
Notes to Consolidated Financial Statements (continued)

For the three months ended September 30, 2013, the Company recorded coffee-related net derivative losses in OCI in the amount of \$3.1 million. No coffee-related net derivative gains or losses were recorded in OCI for the three months ended September 30, 2012.

Interest Rate Swap

Effective December 1, 2012, the Company entered into an interest rate swap transaction utilizing a notional amount of \$10.0 million and a maturity date of March 1, 2015. The Company entered into the swap transaction to effectively fix the future interest rate during the applicable period on a portion of its borrowings under the revolving credit facility. The swap transaction is intended to manage the Company's interest rate risk related to its revolving credit facility and requires the Company to pay a fixed rate of 0.48% per annum in exchange for a variable interest rate based on 1-month USD LIBOR-BBA. The interest rate swap is not designated as an accounting hedge.

Effect of Derivative Instruments on the Financial Statements

Balance Sheet

Fair values of derivative instruments on the consolidated balance sheets (in thousands):

	Derivatives Designated as Cash Flow Hedges		Derivatives Not Designated as Accounting Hedges	
	September 30, 2013 (Unaudited)	June 30, 2013	September 30, 2013 (Unaudited)	June 30, 2013
Financial Statement Location:				
Short-term investments:				
Coffee-related derivatives	\$—	\$—	\$—	\$4
Short-term derivative liability:				
Coffee futures	\$8,718	\$9,331	\$632	\$565
Other current liabilities:				
Interest rate swap	\$—	\$—	\$32	\$25
Long-term derivative liability:				
Coffee futures	\$687	\$1,129	\$—	\$—

Statement of Operations

For the three months ended September 30, 2013, the Company recognized \$0.5 million in losses on coffee-related derivative instruments designated as cash flow hedges for ineffectiveness and 10% of the total coffee-related derivative instruments were excluded from the effectiveness assessment since they were not designated as cash flow hedges. Cash flow hedge contracts outstanding as of September 30, 2013 will expire within 26 months.

The following table presents pretax net gains and losses for the Company's coffee-related derivative instruments designated as cash flow hedges, as recognized in "Cost of goods sold," "Accumulated other comprehensive income" ("AOCI") and "Other, net" (in thousands):

(Unaudited)	Three Months Ended September 30,		Financial Statement Classification
	2013	2012	
Net losses recognized in earnings (effective portion)	\$ (2,219)	) \$—	Cost of goods sold
Net losses recognized in other comprehensive income (loss) (effective portion)	\$ (3,125)	) \$—	AOCI
Net losses recognized in earnings (ineffective portion)	\$ (507)	) \$—	Other, net

Farmer Bros. Co.

Notes to Consolidated Financial Statements (continued)

For the three months ended September 30, 2013, there were no gains or losses recognized in income as a result of excluding amounts from the assessment of hedge effectiveness or as a result of reclassifications to earnings following the discontinuance of any cash flow hedges.

Gains and losses on derivatives not designated as accounting hedges are included in "Other, net" in the Company's consolidated statements of operations and in "Net losses (gains) on derivatives and investments" in the Company's consolidated statements of cash flow.

Net gains and losses recorded in "Other, net" are as follows:

(In thousands)	Three Months Ended September 30, 2013		2012
	(Unaudited)		
Net (losses) gains from coffee-related derivatives	\$(848	)	\$703
Net (losses) gains from investments	(694	)	99
Net losses from interest rate swap	(7)	—
Net (losses) gains on derivatives and investments	(1,549	)	802
Net gains from sales of assets	123		3,213
Other gains, net	643		930
Other, net	\$(783	)	\$4,945

Offsetting of Derivative Assets and Liabilities

The Company has agreements in place that allow for the financial right of offset for derivative assets and liabilities at settlement or in the event of default under the agreements. Additionally, the Company maintains accounts with its brokers to facilitate financial derivative transactions in support of its risk management activities. Based on the value of the Company's positions in these accounts and the associated margin requirements, the Company may be required to deposit cash into these broker accounts.

Farmer Bros. Co.
Notes to Consolidated Financial Statements (continued)

The following tables present the Company's net exposure from its offsetting derivative asset and liability positions, as well as cash margins on deposit with each of its counterparties as of the reporting dates indicated:

Counterparty A		Gross Amount Reported on Balance Sheet	Netting Adjustments	Cash Collateral Posted (Received)	Net Exposure
At September 30, 2013 (Unaudited)	Derivative Assets	\$—	\$—	\$—	\$—
	Derivative Liabilities	\$ 10,037	\$—	\$ 6,260	\$ 3,777
At June 30, 2013	Derivative Assets	\$ 4	\$ (4) \$—	\$—
	Derivative Liabilities	\$ 11,025	\$ (4	) \$ 8,084	\$ 2,937
Counterparty B		Gross Amount Reported on Balance Sheet	Netting Adjustments	Cash Collateral Posted (Received)	Net Exposure
At September 30, 2013 (Unaudited)	Derivative Assets	\$—	\$—	\$—	\$—
	Derivative Liabilities	\$ 32	\$—	\$—	\$ 32
At June 30, 2013	Derivative Assets	\$—	\$—	\$—	\$—
	Derivative Liabilities	\$ 25	\$—	\$—	\$ 25

Credit-Risk-Related Features

The Company does not have any credit-risk-related contingent features that would require it, in certain circumstances, to post additional collateral in support of its net derivative liability positions. The Company had \$6.3 million and \$8.1 million, respectively, in restricted cash representing cash held on deposit in margin accounts for coffee-related derivative instruments at September 30, 2013 and June 30, 2013 (see Note 5). Changes in commodity prices and the number of coffee-related derivative instruments held could have a significant impact on cash deposit requirements under the Company's broker and counterparty agreements.

Cash Flow Hedges

Changes in the fair value of the Company's coffee-related derivative instruments designated as cash flow hedges, to the extent effective, are deferred in AOCI and reclassified into earnings in the same period or periods in which the hedged forecasted purchases affect earnings, or when it is probable that the hedged forecasted transaction will not occur by the end of the originally specified time period. Based on recorded values at September 30, 2013, \$8.2 million of net losses are expected to be reclassified into earnings within the next twelve months. These recorded values are based on market prices of the commodities as of September 30, 2013. Due to the volatile nature of commodity prices, actual gains or losses realized within the next twelve months will likely differ from these values. These gains or losses are expected to substantially offset net losses or gains that will be realized in earnings from previous unfavorable or favorable market movements associated with underlying hedged transactions.

Note 3. Investments

Preferred stock investments as of September 30, 2013 consisted of securities with a fair value of \$10.7 million in an unrealized loss position and securities with a fair value of \$9.7 million in an unrealized gain position. Preferred stock

investments as of June 30, 2013 consisted of securities with a fair value of \$7.3 million in an unrealized loss position and \$13.2 million in an unrealized gain position.

Farmer Bros. Co.
Notes to Consolidated Financial Statements (continued)

The following tables show gross unrealized losses (although such losses have been recognized in the consolidated statements of operations) and fair value for those investments that were in an unrealized loss position as of September 30, 2013 and June 30, 2013, aggregated by the length of time those investments have been in a continuous loss position:

(In thousands)	September 30, 2013 (Unaudited)			
	Less than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Preferred stock	\$5,861	\$(342)	\$10,706	\$(524)

(In thousands)	June 30, 2013			
	Less than 12 Months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Preferred stock	\$5,391	\$(161)	\$7,318	\$(228)

Note 4. Fair Value Measurements

The Company groups its assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

- Level 1—Valuation is based upon quoted prices for identical instruments traded in active markets.
- Level 2—Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level 3—Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

Farmer Bros. Co.
Notes to Consolidated Financial Statements (continued)

Assets and liabilities measured and recorded at fair value on a recurring basis were as follows (in thousands):

September 30, 2013 (Unaudited)	Total	Level 1	Level 2	Level 3
Preferred stock(1)	\$20,425	\$15,744	\$4,681	\$—
Futures, options and other derivative assets	\$—	\$—	\$—	\$—
Derivatives designated as cash flow hedges:				
Coffee-related derivative liabilities	\$9,405	\$9,405	\$—	\$—
Derivatives not designated as accounting hedges:				
Coffee-related derivative liabilities	\$632	\$632	\$—	\$—
Derivative liabilities — interest rate swap	\$32	\$—	\$32	\$—
June 30, 2013	Total	Level 1	Level 2	Level 3
Preferred stock(1)	\$20,542	\$15,738	\$4,804	\$—
Futures, options and other derivative assets(1)	\$4	\$—	\$4	\$—
Derivatives designated as cash flow hedges:				
Coffee-related derivative liabilities	\$10,460	\$10,460	\$—	\$—
Derivatives not designated as accounting hedges:				
Coffee-related derivative liabilities	\$565	\$565	\$—	\$—
Derivative liabilities — interest rate swap	\$25	\$—	\$25	\$—

(1)Included in "Short-term investments" on the consolidated balance sheets.

There were no significant transfers of securities between Level 1 and Level 2.

Effective December 1, 2012, the Company entered into an interest rate swap transaction utilizing a notional amount of \$10.0 million and a maturity date of March 1, 2015. The Company entered into the swap transaction to effectively fix the future interest rate during the applicable period on a portion of its borrowings under the revolving credit facility. The swap transaction is intended to manage the Company's interest rate risk related to its revolving credit facility and requires the Company to pay a fixed rate of 0.48% per annum in exchange for a variable interest rate based on 1-month USD LIBOR-BBA.

The Company values its interest rate swap using widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of the interest rate swap. This analysis reflects the contractual terms of the interest rate swap, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities.

Valuation of the interest rate swap transaction is based on proprietary curves that take into account both Level 1 and Level 2 inputs. The fair value of the interest rate swap is determined using the market standard methodology of netting the discounted future fixed cash payments and the discounted expected variable cash receipts. The variable cash receipts are based on an expectation of future interest rates (forward curves). These forward curves are market-based, utilizing observable market data. Discount curves for present value purposes are constructed using rates representing estimated costs of funding swap positions for early terminations based on an appropriate observable discount rate.

Note 5. Restricted Cash

The Company had \$6.3 million and \$8.1 million, respectively, in restricted cash representing cash held on deposit in margin accounts for coffee-related derivative instruments at September 30, 2013 and June 30, 2013. Changes in commodity prices and the number of coffee-related derivative instruments held could have a significant impact on cash deposit requirements under the Company's broker and counterparty agreements.

Farmer Bros. Co.
Notes to Consolidated Financial Statements (continued)

Note 6. Accounts and Notes Receivable, Net

(In thousands)	September 30, 2013 (Unaudited)	June 30, 2013
Trade receivables	43,142	\$43,965
Other receivables	886	1,072
Allowance for doubtful accounts	(1,188	) (1,115
	\$42,840	\$43,922

Note 7. Inventories

	Processed (In thousands)	Unprocessed	Total
September 30, 2013 (Unaudited)			
Coffee	\$15,580	\$13,292	\$28,872
Tea and culinary products	24,921	4,470	29,391
Coffee brewing equipment	5,672	4,747	10,419
	\$46,173	\$22,509	\$68,682

	Processed (In thousands)	Unprocessed	Total
June 30, 2013			
Coffee	\$12,553	\$12,796	\$25,349
Tea and culinary products	21,406	4,194	25,600
Coffee brewing equipment	5,144	4,774	9,918
	\$39,103	\$21,764	\$60,867

Inventories are valued at the lower of cost or market. The Company accounts for coffee, tea and culinary products on the last in, first out ("LIFO") basis and coffee brewing equipment manufactured on the first in, first out ("FIFO") basis. The Company regularly evaluates these inventories to determine whether market conditions are correctly reflected in the recorded carrying value. At the end of each quarter, the Company records the expected beneficial effect of the liquidation of LIFO inventory quantities, if any, and records the actual impact at fiscal year-end. An actual valuation of inventory under the LIFO method is made only at the end of each fiscal year based on the inventory levels and costs at that time. If inventory quantities decline at the end of the fiscal year compared to the beginning of the fiscal year, the reduction results in the liquidation of LIFO inventory quantities carried at the cost prevailing in prior years. This LIFO inventory liquidation may result in a decrease or increase in cost of goods sold depending on whether the cost prevailing in prior years was lower or higher, respectively, than the current year cost. Accordingly, interim LIFO calculations must necessarily be based on management's estimates of expected fiscal year-end inventory levels and costs. Because these estimates are subject to many forces beyond management's control, interim results are subject to the final fiscal year-end LIFO inventory valuation. The Company anticipates its inventory levels at June 30, 2014 will be same as of June 30, 2013 and, therefore, did not record an adjustment to cost of goods sold for the three months ended September 30, 2013. No adjustment to cost of goods sold was recorded for the three months ended September 30, 2012.

In the three months ended September 30, 2013 the Company recorded a reduction to inventory reserve for slow-moving and obsolete inventory in the amount of \$0.2 million compared to an increase in inventory reserve for slow-moving and obsolete inventory in the amount of \$0.3 million in the three months ended September 30, 2012.

Note 8. Employee Benefit Plans

The Company provides pension plans for most full time employees. Generally the plans provide benefits based on years of service and/or a combination of years of service and earnings. The Company sponsors a postretirement

defined benefit plan that covers qualified non-union retirees and certain qualified union retirees and provides retiree medical coverage and, depending on the age of the retiree, dental and vision coverage. The Company also provides a postretirement death benefit to certain of its employees and retirees.

Farmer Bros. Co.
Notes to Consolidated Financial Statements (continued)

The Company is required to recognize the funded status of a benefit plan in its consolidated balance sheet. The Company is also required to recognize in OCI certain gains and losses that arise during the period but are deferred under pension accounting rules.

Single Employer Pension Plans

The Company has a defined benefit pension plan, the Farmer Bros. Salaried Employees Pension Plan (the "Farmer Bros. Plan"), for the majority of its employees who are not covered under a collective bargaining agreement. The Company amended the Farmer Bros. Plan, freezing the benefit for all participants effective June 30, 2011. After the plan freeze, participants do not accrue any benefits under the plan, and new hires are not eligible to participate in the plan.

The Company also has two defined benefit pension plans for certain hourly employees covered under collective bargaining agreements (the "Brewmatic Plan" and the "Hourly Employees' Plan"). In the fourth quarter of fiscal 2013, the Company determined that it would shut down its equipment refurbishment operations in Los Angeles, California and move them to its Oklahoma City distribution center effective August 30, 2013. Due to this shut down, all hourly employees responsible for these operations in Los Angeles were terminated and their pension benefits in the Brewmatic Plan were frozen effective August 30, 2013. As a result, the Company recorded a pension curtailment expense of \$34,000 in the fourth quarter of fiscal 2013.

The net periodic benefit cost for the defined benefit pension plans is as follows:

(In thousands)	Three Months Ended	
	September 30,	
	2013	2012
	(Unaudited)	
Service cost	\$ 100	\$ 119
Interest cost	1,452	1,449
Expected return on plan assets	(1,705	) (1,660
Amortization of net (gain) loss*	336	387
Amortization of prior service cost (credit)*	—	5
Net periodic benefit cost	\$ 183	\$ 300

* These amounts represent the estimated portion of the net (gain) loss and net prior service cost (credit) remaining in AOCI that is expected to be recognized as a component of net periodic benefit cost over the current fiscal year.

Weighted-average assumptions used to determine net periodic benefit cost

	Fiscal	
	2014	2013
Discount rate	4.50%	4.55%
Expected long-term rate of return on plan assets	8.00%	8.00%
Rate of compensation increase	N/A	N/A

Basis used to determine expected long-term return on plan assets

Historical and future projected returns of multiple asset classes were analyzed to develop a risk-free real rate of return and risk premiums for each asset class. The overall rate for each asset class was developed by combining a long-term inflation component, the risk-free real rate of return, and the associated risk premium. A weighted-average rate of return was developed based on those overall rates and the target asset allocation of the plans.

Multiemployer Pension Plans

The Company participates in a multiemployer defined benefit pension plan, the Western Conference of Teamsters Pension Plan ("WCTPP"), that is union sponsored and collectively bargained for the benefit of certain employees

subject to collective bargaining agreements. The Company makes contributions to WCTPP generally based on the number of hours worked by the participants in accordance with the provisions of negotiated labor contracts.

Farmer Bros. Co.
Notes to Consolidated Financial Statements (continued)

The risks of participating in multiemployer pension plans are different from single-employer plans in that: (i) assets contributed to a multiemployer plan by one employer may be used to provide benefits to employees of other participating employers; (ii) if a participating employer stops contributing to the plan, the unfunded obligations of the plan may be borne by the remaining participating employers; and (iii) if the Company stops participating in the multiemployer plan, the Company may be required to pay the plan an amount based on the underfunded status of the plan, referred to as a withdrawal liability.

Effective October 2011, the Company withdrew from the defined benefit pension plan, United Teamsters Pension Fund, and replaced it with the defined contribution pension plan, "United Teamsters Annuity Fund" ("Annuity Fund"), for its employees covered by a certain collective bargaining agreement with a term expiring in 2014. The Company incurred no withdrawal liability related to the withdrawal from the United Teamsters Pension Fund. The Company's contributions to the Annuity Fund are based on the number of compensable hours worked by the Company's employees who participate in the Annuity Fund.

In fiscal 2012, the Company withdrew from the Labor Management Pension Fund and recorded a charge of \$4.3 million associated with withdrawal from this plan, representing the present value of the estimated withdrawal liability expected to be paid in quarterly installments of \$0.1 million over 80 quarters. Installment payments will commence once the final determination of the amount of withdrawal liability is established, which determination may take up to 24 months from the date of withdrawal from the pension plan. Upon withdrawal, the employees covered under this multiemployer pension plan were included in the Company's 401(k) plan (the "401(k) Plan").

Future collective bargaining negotiations may result in the Company withdrawing from the remaining multiemployer pension plans in which it participates and, if successful, the Company may incur a withdrawal liability, the amount of which could be material to the Company's results of operations and cash flows.

Multiemployer Plans Other Than Pension Plans

The Company participates in eight defined contribution multiemployer plans other than pension plans that provide medical, vision, dental and disability benefits for active, union-represented employees subject to collective bargaining agreements. The plans are subject to the provisions of the Employee Retirement Income Security Act of 1974, and provide that participating employers make monthly contributions to the plans in an amount as specified in the collective bargaining agreements. Also, the plans provide that participants make self-payments to the plans, the amounts of which are negotiated through the collective bargaining process. The Company's participation in these plans is governed by the collective bargaining agreements which expire on or before June 30, 2017.

401(k) Plan

The Company's 401(k) Plan is available to all eligible employees who have worked more than 1,000 hours during a calendar year and were employed at the end of the calendar year. Participants in the 401(k) Plan may choose to contribute a percentage of their annual pay subject to the maximum contribution allowed by the Internal Revenue Service. The Company's matching contribution is discretionary based on approval by the Company's Board of Directors. For the calendar years 2011, 2012 and 2013, the Company's Board of Directors approved a Company matching contribution of 50% of an employee's annual contribution to the 401(k) Plan, up to 6% of the employee's eligible income. The matching contributions (and any earnings thereon) vest at the rate of 20% for each of the participant's first 5 years of vesting service, so that a participant is fully vested in his or her matching contribution account after 5 years of vesting service. A participant is automatically vested in the event of death, disability or attainment of age 65 while employed by the Company. Employees are 100% vested in their contributions. For employees subject to a collective bargaining agreement, the match is only available if so provided in the labor agreement.

The Company recorded matching contributions of \$0.4 million and \$0.5 million in operating expenses for the three months ended September 30, 2013 and 2012, respectively.

Farmer Bros. Co.
Notes to Consolidated Financial Statements (continued)

Postretirement Benefits

The Company sponsors a postretirement defined benefit plan that covers qualified non-union retirees and certain qualified union retirees. The plan provides medical, dental and vision coverage for retirees under age 65 and medical coverage only for retirees age 65 and above. Under this postretirement plan, the Company's contributions toward premiums for retiree medical, dental and vision coverage for participants and dependents are scaled based on length of service, with greater Company contributions for retirees with greater length of service, but subject to a maximum monthly Company contribution.

The Company also provides a postretirement death benefit to certain of its employees and retirees, subject, in the case of current employees, to continued employment with the Company until retirement, and certain other conditions related to the manner of employment termination and manner of death. The Company records the actuarially determined liability for the present value of the postretirement death benefit. The Company has purchased life insurance policies to fund the postretirement death benefit wherein the Company owns the policy but the postretirement death benefit is paid to the employee's or retiree's beneficiary. The Company records an asset for the fair value of the life insurance policies which equates to the cash surrender value of the policies.

The following table shows the components of total net periodic postretirement benefit cost for the three months ended September 30, 2013 and 2012 for the postretirement medical and death benefits. Net periodic postretirement benefit cost for the three months ended September 30, 2013 was based on employee census information as of July 1, 2013 and asset information as of June 30, 2013.

	Three Months Ended September 30,	
	2013	2012
	(Unaudited)	
Components of Net Periodic Postretirement Benefit Cost:		
Service cost	\$493	\$493
Interest cost	242	242
Expected return on plan assets	—	—
Amortization of net gain	4	4
Amortization of unrecognized transition (asset) obligation	—	—
Amortization of prior service cost (credit)	(439	) (439
Net periodic postretirement benefit cost	\$300	\$300
Weighted-average assumptions used to determine net periodic postretirement benefit cost		
	Fiscal	
	2014	2013
Postretirement medical benefit discount rate	4.20%	4.20%
Postretirement death benefit discount rate	4.39%	4.39%

Note 9. Bank Loan

On September 12, 2011, the Company entered into an Amended and Restated Loan and Security Agreement (the "Loan Agreement") among the Company and Coffee Bean International, Inc. ("CBI"), as Borrowers, certain of the Company's other subsidiaries, as Guarantors, the Lenders party thereto, and Wells Fargo Bank, National Association ("Wells Fargo"), as Agent.

On January 9, 2012, the Loan Agreement was amended in connection with JPMorgan Chase Bank, N.A. ("JPMorgan Chase"), becoming an additional Lender thereunder. On March 18, 2013, the Loan Agreement was amended further ("Amendment No. 2") to amend the definition of "Maximum Credit" available thereunder to \$75.0 million from \$85.0 million. Pursuant to Amendment No. 2, Wells Fargo will provide a commitment of \$53.0 million and JPMorgan Chase will provide a commitment of \$22.0 million.

The Loan Agreement provides for a senior secured revolving credit facility of up to \$75.0 million, with a letter of credit sublimit of \$20.0 million. The revolving credit facility provides for advances of 85% of eligible accounts receivable and 75% of eligible inventory (subject to a \$60.0 million inventory loan limit), as defined. The Loan Agreement provides for interest rates

Farmer Bros. Co.
Notes to Consolidated Financial Statements (continued)

based on modified Monthly Average Excess Availability levels with a range of PRIME + 0.25% to PRIME + 0.75% or Adjusted Eurodollar Rate + 2.0% to Adjusted Eurodollar Rate + 2.5%. The Loan Agreement has an amendment fee of 0.375% and an unused line fee of 0.25%. Outstanding obligations under the Loan Agreement are collateralized by all of the Borrowers' assets, including the Company's preferred stock portfolio. The Loan Agreement expires on March 2, 2015.

The Loan Agreement contains a variety of affirmative and negative covenants of types customary in an asset-based lending facility, including those relating to reporting requirements, maintenance of records, properties and corporate existence, compliance with laws, incurrence of other indebtedness and liens, limitations on certain payments, including the payment of dividends and capital expenditures, and transactions and extraordinary corporate events. The Loan Agreement allows the Company to pay dividends, provided, among other things, certain liquidity requirements are met, the aggregate amount of all such payments in any fiscal year shall not exceed \$7.0 million (\$1.75 million in any fiscal quarter), and no event of default exists or has occurred and is continuing as of the date of any such payment and after giving effect thereto. The Loan Agreement also contains financial covenants requiring the Borrowers to maintain minimum Excess Availability and Total Liquidity levels. The Loan Agreement allows the Lenders to establish reserve requirements, which may reduce the amount of credit otherwise available to the Company, to reflect events, conditions, or risks that would have a reasonable likelihood of adversely affecting the Lender's collateral or the Company's assets, including the Company's green coffee inventory.

Effective December 1, 2012, the Company entered into an interest rate swap transaction utilizing a notional amount of \$10.0 million and a maturity date of March 1, 2015. The Company entered into the swap transaction to effectively fix the future interest rate during the applicable period on a portion of its borrowings under the revolving credit facility. The swap transaction is intended to manage the Company's interest rate risk related to its revolving credit facility and requires the Company to pay a fixed rate of 0.48% per annum in exchange for a variable interest rate based on 1-month USD LIBOR-BBA. As of September 30, 2013, the variable interest rate based on 1-month USD LIBOR-BBA was 0.18%.

The Company has not designated its interest rate swap as an accounting hedge. The Company records the interest rate swap on its consolidated balance sheet at fair value with the changes in fair value recorded as gain or loss in "Other, net" in its consolidated statements of operations. In the three months ended September 30, 2013, the Company recorded a loss of \$7,000 for the change in fair value of its interest rate swap. No such gain or loss was recorded in fiscal 2012 (see Note 2).

On September 30, 2013, the Company was eligible to borrow up to a total of \$64.9 million under the credit facility. As of September 30, 2013, the Company had outstanding borrowings of \$20.2 million, including loan extension fees of \$0.1 million, utilized \$11.2 million of the letters of credit sublimit, and had excess availability under the credit facility of \$33.5 million. In connection with entering into the interest rate swap agreement on December 1, 2012, the Company reclassified \$10.0 million of its borrowings under the revolving credit facility as long-term because the Company intends to repay the borrowings in accordance with the termination date of the swap agreement which extends beyond one year. At September 30, 2013, the weighted average interest rate on the Company's outstanding borrowings under the credit facility was 1.61%.

As of September 30, 2013, the Company was in compliance with all restrictive covenants under the credit facility. On October 3, 2013, the Company and Wells Fargo, as Agent, and the Lenders entered into a Letter Agreement regarding Waiver of Event of Default (the "Waiver Agreement") pursuant to which Wells Fargo agreed to waive the event of default arising under the Loan Agreement as a result of the Company's failure to furnish, in a timely manner, its audited consolidated financial statements and unaudited consolidating financial statements, and the accompanying notes thereto, together with the unqualified opinion of independent certified public accountants with respect to the audited consolidated financial statements, for the fiscal year ended June 30, 2013; provided that the Company furnish to Agent such financial information by October 15, 2013. The Company furnished the required financial information on October 9, 2013. There can be no assurance that the Lenders will issue a waiver or grant an amendment to the

covenants in future periods, if the Company required one.

Note 10. Share-based Compensation

On August 23, 2007, the Company's Board of Directors approved the Farmer Bros. Co. 2007 Omnibus Plan (the "Omnibus Plan"), which was approved by stockholders on December 6, 2007. On December 6, 2012, the stockholders approved an amendment to increase the maximum number of shares of common stock available for issuance under the Omnibus Plan to 1,125,000 from 1,000,000, subject to adjustment as provided in the Omnibus Plan. Prior to adoption of the Omnibus Plan the Company had no share-based compensation plan. Awards issued under the Omnibus Plan may take the form of stock options, stock appreciation rights, restricted stock, restricted stock units, dividend equivalents, performance-based awards, stock payments, cash-based awards or other incentives payable in cash or shares of stock, or any combination thereof.

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Farmer Bros. Co.
Notes to Consolidated Financial Statements (continued)

Each award will be set forth in a separate agreement with the person receiving the award and will indicate the type, terms and conditions of the award. The Company has placed a proposal on the ballot for its upcoming Annual Meeting of Stockholders requesting stockholder approval of the Farmer Bros. Co. Amended and Restated 2007 Long-Term Incentive Plan (the "Amended Equity Plan"), which is an amendment and restatement of, and successor to, the Omnibus Plan. If approved by stockholders, the Amended Equity Plan would implement certain material changes to the Omnibus Plan, including, without limitation, an increase in the number of shares of common stock authorized for issuance of awards by 250,000 from 1,125,000 to 1,375,000.

The Company measures and recognizes compensation expense for all share-based payment awards made under the Omnibus Plan based on estimated fair values. No stock options were granted during the three months ended September 30, 2013 or 2012.

Stock Options

The Company estimates the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service period in the Company's consolidated statements of operations.

Share-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Compensation expense recognized for all stock option awards granted is recognized using the straight-line method over the vesting period. The options generally vest ratably over a period of 3 years, however, fiscal 2012 grants included nonqualified stock option awards to executive officers with different vesting periods, in each case, subject to certain events of acceleration as provided in the applicable employment agreement or award agreement with the executive officer.

The share-based compensation expense recognized in the Company's consolidated statements of operations for the three months ended September 30, 2013 and 2012 is based on awards ultimately expected to vest. Currently, management estimates an annual forfeiture rate of 6.5% based on actual forfeiture experience from the inception of the Omnibus Plan. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

The Company uses the Black-Scholes option valuation model, which requires management to make certain assumptions for estimating the fair value of stock options at the date of the grant. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimates, in management's opinion the existing models may not necessarily provide a reliable single measure of the fair value of the Company's stock options. Although the fair value of stock options is determined using an option valuation model that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

The Company's assumption regarding expected stock price volatility is based on the historical volatility of the Company's stock price. The risk-free interest rate is based on U.S. Treasury zero-coupon issues at the date of grant with a remaining term equal to the expected life of the stock options. The average expected life is based on the midpoint between the vesting date and the end of the contractual term of the award.

Farmer Bros. Co.
Notes to Consolidated Financial Statements (continued)

The following table summarizes stock option activity for the three months ended September 30, 2013 (unaudited):

Outstanding Stock Options:	Number of Stock Options	Weighted Average Exercise Price (\$)	Weighted Average Grant Date Fair Value (\$)	Weighted Average Remaining Life (Years)	Aggregate Intrinsic Value (Dollars in thousands)
Outstanding at June 30, 2013	557,427	12.81	5.44	5.1	1,620
Granted	—	—	—	—	—
Exercised	(346)	) 7.42	3.64	—	3
Cancelled/Forfeited	(11,681)	) 19.00	6.65	—	—
Outstanding at September 30, 2013	545,400	12.68	5.41	5.0	1,996
Vested and exercisable, September 30, 2013	231,663	15.22	5.81	3.8	604
Vested and expected to vest, September 30, 2013	522,652	12.76	5.42	3.8	1,899

The aggregate intrinsic values in the table above represent the total pretax intrinsic value, based on the Company's closing stock price of \$15.06 at September 30, 2013, representing the last trading day of the fiscal quarter ended September 30, 2013, which would have been received by award holders had all award holders exercised their awards that were in-the-money as of that date. Total fair value of options vested during the three months ended September 30, 2013 was \$0.

As of September 30, 2013 and 2012, there was approximately \$1.2 million and \$1.1 million, respectively, of unrecognized compensation cost related to stock options. Compensation expense recognized in general and administrative expenses in each of the three months ended September 30, 2013 and 2012 was \$0.2 million.

Restricted Stock

No shares of restricted stock were awarded during the three months ended September 30, 2013. During the three months ended September 30, 2012, the Company granted a total of 6,830 shares of restricted stock with a weighted average grant date fair value of \$9.06. Shares of restricted stock generally vest at the end of three years for eligible employees and officers who are employees. The fiscal 2012 grants included awards to executive officers with different vesting periods, in each case, subject to accelerated vesting as provided in the applicable employment agreement or award agreement with the executive officer. Shares of restricted stock generally vest ratably over a period of three years for directors.

Compensation expense is recognized on a straight-line basis over the service period based on the estimated fair value of the restricted stock. Compensation expense recognized in general and administrative expenses for the three months ended September 30, 2013 and 2012 was \$0.1 million and \$0.2 million, respectively. As of September 30, 2013 and 2012, there was approximately \$0.8 million and \$1.1 million, respectively, of unrecognized compensation cost related to restricted stock.

The following table summarizes restricted stock activity for the three months ended September 30, 2013 (unaudited):

Outstanding and Nonvested Restricted Stock Awards:	Shares Awarded	Weighted Average Grant Date Fair Value (\$)	Weighted Average Remaining Life (Years)	Aggregate Intrinsic Value (\$ in thousands)
Outstanding at June 30, 2013	139,360	9.87	1.9	1,959
Granted	—	—	—	—
Exercised/Released	—	—	—	—
Cancelled/Forfeited	(556)) 8.84	—	—

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Outstanding at September 30, 2013	138,804	9.87	1.7	2,090
Expected to vest, September 30, 2013	116,645	9.85	1.7	1,757

Note 11. Income Taxes

The Company adjusts its effective tax rate each quarter based on its current estimated annual effective tax rate. The Company also records the tax impact of certain discrete items, unusual or infrequently occurring tax events and the effects of

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changes in tax laws or rates, in the interim period in which they occur. In addition, the Company evaluates its deferred tax assets quarterly to determine if a valuation allowance is required.

The Company considered whether a valuation allowance should be recorded against deferred tax assets based on the likelihood that the benefits of the deferred tax assets would or would not ultimately be realized in future periods. In making this assessment, significant weight was given to evidence that could be objectively verified such as recent operating results and less consideration was given to less objective indicators such as future earnings projections. After consideration of positive and negative evidence, including the recent history of losses, the Company cannot conclude that it is more likely than not that it will generate future earnings sufficient to realize the Company's deferred tax assets as of September 30, 2013. Accordingly, the Company decreased its valuation allowance by \$0.7 million in the three months ended September 30, 2013 to \$81.8 million. The valuation allowance at June 30, 2013 was \$82.5 million.

A summary of the income tax expense recorded for the three months ended September 30, 2013 and 2012 is as follows:

(In thousands)	Three Months Ended September 30, 2013 2012 (Unaudited)	
Income before taxes	\$2,112	\$3,420
Income tax expense at statutory rate	718	1,163
State income tax (net of federal tax benefit)	212	462
Valuation allowance	(735	) (1,501
Other permanent items	111	317
Income tax expense	\$306	\$441

As of September 30, 2013 and June 30, 2013 the Company had not recognized the following tax benefits in its consolidated financial statements:

(In thousands)	As of September 30, 2013 (Unaudited)	June 30, 2013
Total unrecognized tax benefits*	\$3,211	\$3,211
Unrecognized tax benefits that, if recognized, would affect the Company's effective tax rate, subject to the valuation allowance*	\$3,064	\$3,064

* Excluding interest and penalties

The Company believes it is reasonably possible that none of its total unrecognized tax benefits could be released in the next 12 months.

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Note 12. Earnings (Loss) Per Common Share