TOLL BROTHERS INC
Form 10-Q
September 09, 2008

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

Form 10-Q

(Mark One)

þ	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the quarterly period ended July 31, 2008**
	or
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the transition period from to**

Commission file number 1-9186

TOLL BROTHERS, INC.
(Exact name of registrant as specified in its charter)

Delaware	**23-2416878**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
250 Gibraltar Road, Horsham, Pennsylvania	**19044**
(Address of principal executive offices)	*(Zip Code)*

(215) 938-8000
(Registrant s telephone number, including area code)

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

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

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. (Check one):

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

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes o   No þ

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

At September 2, 2008, there were approximately 158,881,000 shares of Common Stock, $.01 par value, outstanding.

TOLL BROTHERS, INC. AND SUBSIDIARIES

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Certification of Robert I. Toll pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
Certification of Joel H. Rassman pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
Certification of Robert I. Toll pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
Certification of Joel H. Rassman pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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STATEMENT ON FORWARD-LOOKING INFORMATION

Certain information included in this report or in other materials we have filed or will file with the Securities and Exchange Commission (the SEC) (as well as information included in oral statements or other written statements made or to be made by us) contains or may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended. You can identify these statements by the fact that they do not relate strictly to historical or current facts. They contain words such as anticipate, estimate, expect, project, intend, plan, bel can, could, might, should and other words or phrases of similar meaning in connection with any discussion of futur operating or financial performance. Such statements may include information relating to anticipated operating results (including changes in revenues, profitability and operating margins), financial resources, interest expense, inventory write-downs, changes in accounting treatment, effects of homebuyer cancellations, growth and expansion, anticipated income or loss to be realized from our investments in unconsolidated entities, the ability to acquire land, the ability to gain approvals and to open new communities, the ability to sell homes and properties, the ability to deliver homes from backlog, the ability to secure materials and subcontractors, the ability to produce the liquidity and capital necessary to expand and take advantage of opportunities in the future, industry trends, and stock market valuations. From time to time, forward-looking statements also are included in our Form 10-K and other periodic reports on Forms 10-Q and 8-K, in press releases, in presentations, on our web site and in other materials released to the public.

Any or all of the forward-looking statements included in this report and in any other reports or public statements made by us are not guarantees of future performance and may turn out to be inaccurate. This can occur as a result of incorrect assumptions or as a consequence of known or unknown risks and uncertainties. These risks and uncertainties include local, regional and national economic conditions, the demand for homes, domestic and international political events, uncertainties created by terrorist attacks, the effects of governmental regulation, the competitive environment in which the Company operates, fluctuations in interest rates, changes in home prices and sales activity in the markets where the Company builds homes, the availability and cost of land for future growth, adverse market conditions that could result in substantial inventory write-downs, the availability of capital, uncertainties and fluctuations in capital and securities markets, changes in tax laws and their interpretation, legal proceedings, the availability of adequate insurance at reasonable cost, the ability of customers to obtain adequate and affordable financing for the purchase of homes, the ability of home buyers to sell their existing homes, the ability of the participants in our various joint ventures to honor their commitments, the availability and cost of labor and building and construction materials, the cost of oil, gas and other raw materials, construction delays and weather conditions.

The factors mentioned in this report or in other reports or public statements made by us will be important in determining our future performance. Consequently, actual results may differ materially from those that might be anticipated from our forward-looking statements. If one or more of the assumptions underlying our forward-looking statements proves incorrect, then our actual results, performance or achievements could differ materially from those expressed in, or implied by the forward-looking statements contained in this report. Therefore, we caution you not to place undue reliance on our forward-looking statements. This statement is provided as permitted by the Private Securities Litigation Reform Act of 1995.

Additional information concerning potential factors that we believe could cause our actual results to differ materially from expected and historical results is included in Item 1A Risk Factors of our Annual Report on Form 10-K for the fiscal year ended October 31, 2007 and this Form 10-Q for the period ended July 31, 2008.

When this report uses the words we, us, our, and the Company, they refer to Toll Brothers, Inc. and its subsidiaries unless the context otherwise requires. The terms fiscal 2008, fiscal 2007, fiscal 2006, and fiscal 2005 refer to our fiscal year ending October 31, 2008, and our fiscal years ended October 31, 2007, October 31, 2006 and October 31,

2005, respectively.

Forward-looking statements speak only as of the date they are made. We undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise. However, any further disclosures made on related subjects in our subsequent reports on Forms 10-K, 10-Q and 8-K should be consulted. On September 4, 2008, we issued a press release and held a conference call to review the results of operations for the nine-month and three-month periods ended July 31, 2008 and to discuss the current state of our business. The information contained in this report is the same information given in the press release and on the conference call on September 4, 2008, and we are not reconfirming or updating that information in this Form 10-Q.

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PART I. FINANCIAL INFORMATION

ITEM 1. ***FINANCIAL STATEMENTS***

TOLL BROTHERS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS
(Amounts in thousands)

	July 31, 2008 (Unaudited)	October 31, 2007
ASSETS		
Cash and cash equivalents	$ 1,502,360	$ 900,337
Inventory	4,546,737	5,572,655
Property, construction and office equipment, net	86,841	84,265
Receivables, prepaid expenses and other assets	119,294	135,910
Contracts receivable	4,672	46,525
Mortgage loans receivable	49,717	93,189
Customer deposits held in escrow	21,417	34,367
Investments in and advances to unconsolidated entities	141,843	183,171
Deferred tax assets, net	363,150	169,897
	$ 6,836,031	$ 7,220,316
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities:		
Loans payable	$ 731,629	$ 696,814
Senior notes	1,143,160	1,142,306
Senior subordinated notes	350,000	350,000
Mortgage company warehouse loan	39,106	76,730
Customer deposits	171,175	260,155
Accounts payable	142,055	236,877
Accrued expenses	752,705	724,229
Income taxes payable	196,470	197,960
Total liabilities	3,526,300	3,685,071
Minority interest	8,014	8,011
Stockholders equity:		
Preferred stock, none issued		
Common stock, 158,798 and 157,028 shares issued at July 31, 2008 and October 31, 2007, respectively	1,588	1,570
Additional paid-in capital	269,138	227,561

Retained earnings	3,032,476	3,298,925
Treasury stock, at cost 3 and 20 shares at July 31, 2008 and October 31, 2007, respectively	(62)	(425)
Accumulated other comprehensive loss	(1,423)	(397)
Total stockholders equity	3,301,717	3,527,234
	$ 6,836,031	$ 7,220,316

See accompanying notes

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TOLL BROTHERS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Amounts in thousands, except per share data)

	Nine Months Ended July 31,		Three Months Ended July 31,	
	2008	2007	2008	2007
	(Unaudited)			
Revenues:				
Completed contract	$ 2,417,915	$ 3,356,895	$ 791,078	$ 1,178,500
Percentage of completion	39,122	110,890	5,633	29,368
Land sales	2,275	9,854	959	4,483
	2,459,312	3,477,639	797,670	1,212,351
Cost of revenues:				
Completed contract(1)	2,350,072	2,811,399	711,163	1,023,230
Percentage of completion	32,163	87,540	4,681	24,280
Land sales	1,910	6,441	816	3,677
Interest	67,294	76,258	23,170	27,121
	2,451,439	2,981,638	739,830	1,078,308
Selling, general and administrative	333,127	396,263	103,104	131,686
Goodwill impairment		8,973		
(Loss) income from operations	(325,254)	90,765	(45,264)	2,357
Other:				
(Loss) earnings from unconsolidated entities(2)	(135,756)	15,375	(30,113)	3,848
Interest and other	100,249	85,599	20,582	38,841
(Loss) income before income taxes	(360,761)	191,739	(54,795)	45,046
Income tax (benefit) provision	(141,772)	74,247	(25,500)	18,560
Net (loss) income	$ (218,989)	$ 117,492	$ (29,295)	$ 26,486
(Loss) earnings per share:				
Basic	$ (1.38)	$ 0.76	$ (0.18)	$ 0.17
Diluted	$ (1.38)	$ 0.72	$ (0.18)	$ 0.16
Weighted average number of shares:				
Basic	158,398	154,828	158,761	155,556
Diluted	158,398	164,239	158,761	164,375

(1) Includes inventory impairment charges and write-offs of $526.7 million and $363.9 million in the nine-month periods ended July 31, 2008 and 2007, respectively, and $106.0 million and $147.3 million in the three-month periods ended July 31, 2008 and 2007, respectively.

(2) Includes write-downs of the Company s investments in unconsolidated entities and its pro-rata share of impairment charges recognized by unconsolidated entities in which it has investments of $146.3 million and $33.4 million in the nine-month and three-month periods ended July 31, 2008, respectively. No impairment charges were recognized in the fiscal 2007 periods.

See accompanying notes

TOLL BROTHERS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Amounts in thousands)

	Nine Months Ended July 31,	
	2008	2007
	(Unaudited)	
Cash flow from operating activities:		
Net (loss) income	$ (218,989)	$ 117,492
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	21,062	22,833
Amortization of initial benefit obligation		1,088
Stock-based compensation	19,884	22,956
Excess tax benefits from stock-based compensation	(8,543)	(14,736)
Loss (earnings) from unconsolidated entities	135,756	(15,375)
Distributions of earnings from unconsolidated entities	41,669	16,501
Deferred tax benefit	(193,253)	(137,350)
Inventory write-offs	526,729	363,904
Goodwill impairment charge		8,973
Gain on sale of ancillary business		(24,643)
Changes in operating assets and liabilities:		
Decrease (increase) in inventory	499,515	(183,710)
Origination of mortgage loans	(720,917)	(1,064,537)
Sale of mortgage loans	764,389	1,054,717
Decrease in contracts receivable	41,853	122,038
Decrease in receivables, prepaid expenses and other assets	23,040	26,285
Decrease in customer deposits	(76,030)	(53,237)
Decrease in accounts payable and accrued expenses	(158,665)	(82,151)
Decrease in current income taxes payable	(36,638)	(79,548)
Net cash provided by operating activities	660,862	101,500
Cash flow from investing activities:		
Purchase of property and equipment	(3,554)	(13,717)
Proceeds from sale of ancillary businesses		32,299
Purchases of marketable securities	(1,468,440)	(3,840,620)
Sale of marketable securities	1,458,887	3,840,620
Investments in and advances to unconsolidated entities	(46,900)	(21,194)
Distributions of investments in unconsolidated entities	2,623	35,953
Net cash (used in) provided by investing activities	(57,384)	33,341
Cash flow from financing activities:		

Proceeds from loans payable	801,558	1,133,892
Principal payments of loans payable	(823,127)	(1,162,973)
Proceeds from stock-based benefit plans	13,044	17,994
Proceeds from restricted stock award		1,800
Excess tax benefits from stock-based compensation	8,543	14,736
Purchase of treasury stock	(1,476)	(1,395)
Change in minority interest	3	302
Net cash (used in) provided by financing activities	(1,455)	4,356
Net increase in cash and cash equivalents	602,023	139,197
Cash and cash equivalents, beginning of period	900,337	632,524
Cash and cash equivalents, end of period	$ 1,502,360	$ 771,721

See accompanying notes

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TOLL BROTHERS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

1. Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of Toll Brothers, Inc. (the Company), a Delaware corporation, and its majority-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated. Investments in 50% or less owned partnerships and affiliates are accounted for using the equity method unless it is determined that the Company has effective control of the entity, in which case the entity would be consolidated.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (SEC) for interim financial information. The October 31, 2007 balance sheet amounts and disclosures included herein have been derived from our October 31, 2007 audited financial statements. Since the accompanying condensed consolidated financial statements do not include all the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements, the Company suggests that they be read in conjunction with the consolidated financial statements and notes thereto included in its Annual Report on Form 10-K for the fiscal year ended October 31, 2007. In the opinion of management, the accompanying unaudited condensed consolidated financial statements include all adjustments, which are of a normal recurring nature, necessary to present fairly the Company s financial position as of July 31, 2008, the results of its operations for the nine months and three months ended July 31, 2008 and 2007 and its cash flows for the nine months ended July 31, 2008 and 2007. The results of operations for such interim periods are not necessarily indicative of the results to be expected for the full year.

Income Taxes

On November 1, 2007, the Company adopted the provisions of the Financial Accounting Standards Board (the FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). See Note 6, Income Taxes , for information concerning the adoption of FIN 48.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an Amendment of FASB Statements No. 87, 88, 106, and 132(R) (SFAS 158). SFAS 158 requires the Company to (a) recognize in its statement of financial position the overfunded or underfunded status of a defined benefit postretirement plan, measured as the difference between the fair value of plan assets and the benefit obligation, (b) recognize as a component of other comprehensive income, net of tax, the actuarial gains and losses and the prior service costs and credits that arise during the period, (c) measure defined benefit plan assets and defined benefit plan obligations as of the date of the Company s statement of financial position, and (d) disclose additional information about certain effects on net periodic benefit costs in the upcoming fiscal year that arise from the delayed recognition of the actuarial gains and losses and the prior service costs and credits. The Company adopted SFAS 158 effective October 31, 2007 related to its recognition of accumulated other comprehensive income, net of tax. The Company s adoption of SFAS 158 did not have a material effect on its financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157). SFAS 157 provides guidance for using fair value to measure assets and liabilities. SFAS 157 also responds to investors requests for expanded information about the extent to which a company measures assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. SFAS 157 will be effective for the Company s fiscal year beginning November 1, 2008. The Company is currently reviewing the effect SFAS 157 will have on its financial statements; however, it is not expected that it will have a material impact on the Company s consolidated financial position, results of operations or cash flows.

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TOLL BROTHERS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, Including an Amendment of FASB Statement No. 115 (SFAS 159). SFAS 159 permits entities to choose to measure certain financial assets and liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. SFAS 159 will be effective for the Company s fiscal year beginning November 1, 2008. The Company is currently reviewing the effect SFAS 159 will have on its financial statements; however, it is not expected that it will have a material impact on the Company s consolidated financial position, results of operations or cash flows.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an Amendment to ARB No. 51 (SFAS 160). Under the provisions of SFAS 160, a noncontrolling interest in a subsidiary, or minority interest, must be classified as equity and the amount of consolidated net income specifically attributable to the minority interest must be clearly identified in the consolidated statement of operations. SFAS 160 also requires consistency in the manner of reporting changes in the parent s ownership interest and requires fair value measurement of any noncontrolling interest retained in a deconsolidation. SFAS 160 will be effective for the Company s fiscal year beginning November 1, 2009. The Company is currently evaluating the impact of the adoption of SFAS 160; however, it is not expected that it will have a material impact on the Company s consolidated financial position, results of operations or cash flows.

Reclassification

The presentation of certain prior period amounts have been reclassified to conform to the fiscal 2008 presentation.

2. Inventory

Inventory at July 31, 2008 and October 31, 2007 consisted of the following (amounts in thousands):

	July 31, 2008	October 31, 2007
Land and land development costs	$ 1,372,651	$ 1,749,652
Construction in progress completed contract	2,497,784	3,109,243
Construction in progress percentage of completion	51,887	62,677
Sample homes and sales offices	386,767	357,322
Land deposits and costs of future development	219,453	274,799
Other	18,195	18,962
	$ 4,546,737	$ 5,572,655

Construction in progress includes the cost of homes under construction, land and land development costs and the carrying cost of home sites that have been substantially improved.

The Company capitalizes certain interest costs to inventory during the development and construction period. Capitalized interest is charged to cost of revenues when the related inventory is delivered for homes accounted for under the completed contract accounting method or when the related inventory is charged to cost of revenues under the percentage of completion accounting method.

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TOLL BROTHERS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Interest incurred, capitalized and expensed for the nine months and three months ended July 31, 2008 and 2007, was as follows (amounts in thousands):

	Nine Months Ended July 31,		Three Months Ended July 31,	
	2008	**2007**	**2008**	**2007**
Interest capitalized, beginning of period	$ 215,571	$ 181,465	$ 235,094	$ 200,560
Interest incurred	93,205	102,702	29,524	34,430
Interest expensed to cost of revenues	(67,294)	(76,258)	(23,170)	(27,121)
Write-off to other	(46)	(40)	(12)	
Interest capitalized, end of period	$ 241,436	$ 207,869	$ 241,436	$ 207,869

Inventory impairment charges are recognized against all inventory costs of a community, such as land, land improvements, cost of home construction and capitalized interest. The amounts included in the above table reflect the gross amount of capitalized interest; impairment charges recognized are not generally allocated to specific components of inventory.

Interest expense by source of revenue included in cost of revenues for the nine months and three months ended July 31, 2008 and 2007, was as follows (amounts in thousands):

	Nine Months Ended July 31,		Three Months Ended July 31,	
	2008	**2007**	**2008**	**2007**
Completed contract	$ 66,096	$ 71,719	$ 22,852	$ 25,690
Percentage of completion	1,070	4,256	230	1,257
Land sales	128	283	88	174
	$ 67,294	$ 76,258	$ 23,170	$ 27,121

The Company recognized inventory impairment charges and the expensing of costs that it believed not to be recoverable in the nine months and three months ended July 31, 2008 and 2007, as follows (amounts in thousands):

	Nine Months Ended July 31,		Three Months Ended July 31,	
	2008	**2007**	**2008**	**2007**

Operating communities and owned land	$ 437,355	$ 338,739	$ 96,330	$ 139,628
Land options and predevelopment costs	89,374	25,165	9,660	7,664
Total	$ 526,729	$ 363,904	$ 105,990	$ 147,292

At the end of each fiscal quarter, the Company reviews the profitability of each of its operating communities. For those communities operating below certain profitability thresholds, it estimates the expected future cash flow for each of those communities. For those communities whose estimated cash flow is not sufficient to recover its carrying value, the Company estimates the fair value of these communities and recognizes an impairment charge for the difference between the estimated fair value of each community and its carrying value. The table below provides, as of the date indicated, the number of operating communities in which the Company recognized impairment

TOLL BROTHERS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

charges, the fair value of those communities, net of impairment charges, and the amount of impairment charges recognized ($ amounts in thousands):

	2008			2007		
	Number of Communities	Fair Value of Communities, Net of Impairment Charges	Impairment Charges	Number of Communities	Fair Value of Communities, Net of Impairment Charges	Impairment Charges
Three Months Ended:						
January 31,	38	$ 339,303	$ 145,175	18	$ 211,800	$ 82,961
April 30,	46	$ 406,031	195,850	24	$ 228,900	116,150
July 31,	23	$ 228,909	96,330	28	$ 344,100	139,628
			$ 437,355			$ 338,739

At July 31, 2008, the Company evaluated its land purchase contracts to determine if any of the selling entities were variable interest entities (VIEs) and, if they were, whether the Company was the primary beneficiary of any of them. Under these purchase contracts, the Company does not possess legal title to the land and its risk is generally limited to deposits paid to the sellers; the creditors of the sellers generally have no recourse against the Company. At July 31, 2008, the Company determined that it was the primary beneficiary of two VIEs related to land purchase contracts and had recorded $20.9 million of inventory and $17.3 million of accrued liabilities.

3. Investments in and Advances to Unconsolidated Entities

The Company has investments in and advances to a number of joint ventures with unrelated parties to develop land (land joint ventures). Some of these land joint ventures develop land for the sole use of the venture participants, including the Company, and others develop land for sale to the joint venture participants and to unrelated builders. The Company recognizes its share of earnings from the sale of home sites to other builders. With regard to home sites the Company purchases from the land joint ventures, it reduces its cost basis in those home sites by its share of the earnings on the home sites. At July 31, 2008, the Company had approximately $66.1 million, net of impairment charges, invested in or advanced to these land joint ventures. At July 31, 2008, the land joint ventures had aggregate loan commitments of $1.09 billion, and had approximately $1.06 billion borrowed against these commitments. In connection with certain of these land joint ventures, the Company executed completion guarantees and conditional repayment guarantees. The obligations under the guarantees are several, and not joint, and are limited to the Company s pro-rata share of the loan obligations of the respective land joint venture. At July 31, 2008, the maximum amount of these guarantees (net of amounts that the Company has accrued) is approximately $50.3 million, if any liability is determined to be due thereunder. With respect to another land joint venture, the partners are in the process of determining whether or not to move forward with the project based upon, among other things, market conditions. If

the project proceeds as originally planned, the Company s estimated contribution would be approximately $145.3 million, less any outside financing the land joint venture is able to obtain. The Company has recognized cumulative impairment charges against certain land joint venture investments because it did not believe that such investments were fully recoverable. From August 1, 2007 through July 31, 2008, the Company recognized $200.4 million of impairment charges related to its land joint ventures ($28.4 million in the three-month period ended July 31, 2008, $85.0 million in the three-month period ended April 30, 2008, $27.8 million in the three-month period ended January 31, 2008 and $59.2 million in the three-month period ended October 31, 2007). At July 31, 2008, two of these joint ventures were in default under their respective loan agreements; the Company does not believe that these joint venture defaults will have a material impact on the Company s financial condition.

In addition, at July 31, 2008, the Company had $47.6 million of investments in three joint ventures with unrelated parties to develop luxury condominium projects, including for-sale residential units and commercial

TOLL BROTHERS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

space. At July 31, 2008, these joint ventures had an aggregate of $302.9 million of loan commitments, and had approximately $202.4 million borrowed against the commitments. At July 31, 2008, the Company had guaranteed $18.6 million of the loans and other liabilities of these joint ventures. One of these joint ventures is developing a condominium project in two phases. Construction of the first phase has been substantially completed and deliveries commenced in May 2008 of units that had been previously sold. At July 31, 2008, the Company was committed to make an additional contribution of up to $11.0 million, if required by this joint venture. Further, the Company has the right to withdraw from phase two of the project upon the payment of a termination fee to its partner of $30.0 million. A second joint venture has a project that is currently in the planning stages; any contribution by the Company to this second joint venture will be based upon the partners mutual agreement to proceed with the project. If the project were to go forward, and if the joint venture was unable to obtain outside financing and the Company was to fund its entire commitment to this second joint venture, the Company s estimated contribution would be approximately $112.5 million. In the three-month period ended July 31, 2008, the Company recognized its pro-rata share of an impairment charge recognized by one of the joint ventures in which it has an investment: the Company s pro-rata share of the impairment charge was $5.0 million and is included in (Loss) Earnings from Unconsolidated Entities.

The Company also has a 50% interest in a joint venture with an unrelated party to convert a 525-unit apartment complex located in Hoboken, New Jersey, into luxury condominium units. At July 31, 2008, the Company had investments in and advances to this joint venture of $16.7 million.

In fiscal 2005, the Company, together with the Pennsylvania State Employees Retirement System (PASERS), formed Toll Brothers Realty Trust II (Trust II) to be in a position to take advantage of commercial real estate opportunities. Trust II is owned 50% by the Company and 50% by PASERS. At July 31, 2008, the Company had an investment of $11.4 million in Trust II. In addition, the Company and PASERS each entered into subscription agreements that expire in September 2009, whereby each agreed to invest additional capital in an amount not to exceed $11.1 million if required by Trust II.

Prior to the formation of Trust II, the Company used Toll Brothers Realty Trust (the Trust) to invest in commercial real estate opportunities. The Company formed the Trust in 1998 to take advantage of commercial real estate opportunities. The Trust is effectively owned one-third by the Company; one-third by Robert I. Toll, Bruce E. Toll (and trusts established for the benefit of members of his family), Zvi Barzilay (and trusts established for the benefit of members of his family), Joel H. Rassman, and other members of the Company s current and former senior management; and one-third by PASERS. During fiscal 2007, the Company received distributions from the Trust that resulted in reducing the carrying value of its investment in the Trust to zero. The Company provided development, finance and management services to the Trust and recognized fees under the terms of various agreements in the amounts of $1.6 million and $0.5 million in the nine-month and three-month periods ended July 31, 2008, respectively, and $1.5 million and $0.6 million in the nine-month and three-month periods ended July 31, 2007, respectively. The Company believes that the transactions between itself and the Trust were on terms no less favorable than it would have agreed to with an unrelated party.

The Company s investments in these entities are accounted for using the equity method.

4. Goodwill Impairment

In the three-month period ended January 31, 2007, due to the continued decline of the Detroit housing market, the Company re-evaluated the carrying value of goodwill that resulted from a 1999 acquisition in accordance with SFAS No. 142, Goodwill and Other Intangible Assets . The Company estimated the fair value of its assets in this market, including goodwill. Fair value was determined based on the discounted future cash flow expected to be generated in this market. Based upon this evaluation and the Company s expectation that this market would not recover for a number of years, the Company determined that the related goodwill was impaired. The Company recognized a $9.0 million impairment charge in the first quarter of fiscal 2007. After recognizing this charge, the Company did not have any goodwill remaining from this acquisition.

TOLL BROTHERS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Accrued Expenses

Accrued expenses at July 31, 2008 and October 31, 2007 consisted of the following (amounts in thousands):

	July 31, 2008	October 31, 2007
Land, land development and construction	$ 198,631	$ 247,322
Compensation and employee benefits	96,772	100,893
Insurance and litigation	155,921	144,349
Commitments to unconsolidated entities	120,123	27,792
Warranty	62,141	59,249
Interest	44,823	47,136
Other	74,294	97,488
	$ 752,705	$ 724,229

The Company accrues for expected warranty costs at the time each home is closed and title and possession are transferred to the home buyer. Costs are accrued based upon historical experience. Changes in the warranty accrual for the nine-month and three-month periods ended July 31, 2008 and 2007 were as follows (amounts in thousands):

	Nine Months Ended July 31,		Three Months Ended July 31,	
	2008	2007	2008	2007
Balance, beginning of period	$ 59,249	$ 57,414	$ 60,816	$ 58,716
Additions	20,223	22,392	7,193	7,509
Charges incurred	(17,331)	(20,321)	(5,868)	(6,740)
Balance, end of period	$ 62,141	$ 59,485	$ 62,141	$ 59,485

6. Income Taxes

On November 1, 2007, the Company adopted the provisions of FIN 48. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in accordance with SFAS No. 109, Accounting for Income Taxes , and prescribes a recognition threshold and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 requires a company to recognize the financial statement effect of a tax position when it is more-likely-than-not (defined as a substantiated

likelihood of more than 50 percent), based on the technical merits of the position, that the position will be sustained upon examination. A tax position that meets the more-likely-than-not recognition threshold is measured to determine the amount of benefit to be recognized in the financial statements based upon the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. The inability of the Company to determine that a tax position meets the more-likely-than-not recognition threshold does not mean that the Internal Revenue Service (IRS) or any other taxing authority will disagree with the position that the Company has taken.

If a tax position does not meet the more-likely-than-not recognition threshold despite the Company s belief that its filing position is supportable, the benefit of that tax position is not recognized in the financial statements and the Company is required to accrue potential interest and penalties until the uncertainty is resolved. Potential interest and penalties are recognized as a component of the provision for income taxes which is consistent with the Company s historical accounting policy. Differences between amounts taken in a tax return and amounts recognized in the financial statements are considered unrecognized tax benefits. The Company believes that it has a reasonable basis for each of its filing positions and intends to defend those positions if challenged by the IRS or another taxing jurisdiction. If the IRS or other taxing authorities do not disagree with the Company s position and after the statute

TOLL BROTHERS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

of limitations expires, the Company will recognize the unrecognized tax benefit in the period that the uncertainty of the tax position is eliminated.

As of November 1, 2007, the Company recorded a $47.5 million charge to retained earnings to recognize the net cumulative effect of the adoption of FIN 48. As of November 1, 2007, after adoption of FIN 48, the Company s cumulative net unrecognized tax benefits were $218.6 million.

During the nine-month period ended July 31, 2008, the Company entered into a settlement with the IRS for fiscal years 2003 through 2005, and settled certain state tax audits for fiscal years 2002 and 2003. In connection with these settlements and certain amended filings that came out of these audits, the Company agreed to pay $33.0 million. The Company estimates that it will pay an additional $12.0 million as a result of these audits in subsequent quarters. The state impact of any amended federal returns remains subject to examination by various states for a period of up to one year after formal notification of such amendments to the states. The Company and its subsidiaries have various state and other income tax returns in the process of examination or administrative appeal. The Company does not anticipate any material adjustments to its financial statements resulting from tax examinations currently in progress. During the nine-month period ended July 31, 2008, the Company reduced its net unrecognized tax benefits by $9.1 million largely related to expiring tax statutes offset by new reserves.

During the next twelve months, it is possible that the amount of unrecognized tax benefits will decrease primarily from the completion of tax audits where certain of the filing positions will ultimately be accepted by the IRS and/or other tax jurisdictions and/or expiration of tax statutes. The Company does not believe these reversals will have a material impact on the Company s financial statements. The Company s net unrecognized tax benefits at July 31, 2008, amounted $187.6 million and are included in Income taxes payable on the accompanying condensed consolidated balance sheet at July 31, 2008. If these tax benefits reverse in the future, they would have an impact on the Company s effective tax rate.

During the nine months ended July 31, 2008 and 2007, the Company recognized in its tax provision, before reduction for applicable taxes, potential interest and penalties of approximately $10.5 million and $18.5 million, respectively. During the three months ended July 31, 2008 and 2007, the Company recognized in its tax provision, before reduction for applicable taxes, potential interest and penalties of approximately $3.5 million and $15.8 million, respectively. At July 31, 2008 and October 31, 2007, the Company had accrued potential interest and penalties, before reduction of applicable taxes, of $150.5 million and $54.8 million, respectively; these amounts were included in Income taxes payable on the accompanying condensed consolidated balance sheets. The increase in the nine-month period ended July 31, 2008 relates primarily to the adoption of FIN 48.

7. Comprehensive Loss

The components of other comprehensive loss in the nine-month and three-month periods ended July 31, 2008 were as follows (amounts in thousands):

	Nine Months Ended July 31, 2008	Three Months Ended July 31, 2008

Net loss per statement of operations		$ (218,989)		$ (29,295)
Changes in pension liability, net of tax				
Change in benefits	(3,056)			
Change in actuarial assumptions	1,701			
Amortization of prior service cost and unrecognized gains	329		109	
		(1,026)		109
Other comprehensive loss		$ (220,015)		$ (29,186)

TOLL BROTHERS, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. Employee Retirement Plans

In December 2007, the Company amended its Supplemental Executive Retirement Plan to provide for increased benefits to certain participants if such participants continue to work beyond retirement age. Based on this amendment and a concomitant change in the assumption related to the participants retirement dates, the Company s unrecognized prior service cost increased by $5.1 million and its unrecognized actuarial gains increased by $2.8 million. The additional unrecognized prior service cost and unrecognized actuarial gains will be amortized over the extended period that the Company has estimated that the participants will continue to work.

For the nine-month and three-month periods ended July 31, 2008 and 2007, the Company recognized costs and made payments related to its supplemental retirement plans as follows (amounts in thousands):

	Nine Months Ended July 31,		Three Months Ended July 31,	
	2008	**2007**	**2008**	**2007**
Service cost	$ 157	$ 247	$ 52	$ 83
Interest cost	918	760	306	253
Amortization of initial benefit obligation	1,027	1,088	343	203
Amortization of unrecognized gains	(480)		(160)	
	$ 1,622	$ 2,095	$ 541	$ 539
Benefits paid	$ 92	$ 154	$ 29	$ 29

9. Stock-Based Benefit Plans

The fair value of each option award is estimated on the date of grant using a lattice-based option valuation model that uses assumptions noted in the following table. The lattice-based option valuation model incorporates ranges of assumptions for inputs; those ranges are disclosed in the table below. Expected volatilities were based on implied volatilities from traded options on the Company s stock, historical volatility of the Company s stock and other factors. The expected lives of options granted were derived from the historical exercise patterns and anticipated future patterns and represents the period of time that options granted are expected to be outstanding; the range given below results from certain groups of employees exhibiting different behavior. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

The weighted-average assumptions and the fair value used for the Company s annual stock option grants for fiscal 2008 and 2007 were as follows:

	2008	**2007**

Expected volatility	46.67% - 48.63%	36.32% - 38.22%
Weighted-average volatility	47.61%	37.16%
Risk-free interest rate	3.32% - 3.85%	4.57% - 4.61%
Expected life (years)	4.29 - 8.32	3.69 - 8.12
Dividends	none	none
Weighted-average grant date fair value per share of options	$9.50	$11.17

In the quarter ended July 31, 2008, pursuant to stockholder-approved amendments to the Company s Stock Incentive Plan (1998) and the Company s Stock Incentive Plan for Employees (2007), the Company offered certain eligible employees the ability to exchange certain out-of-the-money stock options (old options) in exchange for replacement options with the same terms and conditions as the old options, except for the number of shares subject to the replacement options and the per-share exercise pr