

KIMBERLY CLARK CORP  
Form 10-Q  
August 08, 2008

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 June 30, 2008

OR

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

For the transition period from.....to.....

Commission file number 1-225

KIMBERLY-CLARK CORPORATION  
(Exact name of registrant as specified in its charter)

Delaware	39-0394230
(State or other	(I.R.S. Employer
jurisdiction of	Identification No.)
incorporation or	
organization)	

P. O. Box 619100  
Dallas, Texas  
75261-9100  
(Address of principal executive offices)  
(Zip Code)

(972) 281-1200  
(Registrant's telephone number, including area code)

No change  
(Former name, former address and former fiscal year, if changed since last report)

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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 is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)  
company

Smaller reporting  
company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of July 31, 2008, there were 415,216,107 shares of the Corporation's common stock outstanding.

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## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements.

KIMBERLY-CLARK CORPORATION AND SUBSIDIARIES  
CONSOLIDATED INCOME STATEMENT  
(Unaudited)

(Millions of dollars, except per share amounts)	Three Months Ended June 30		Six Months Ended June 30	
	2008	2007	2008	2007
Net Sales	\$ 5,006.2	\$ 4,502.0	\$ 9,818.9	\$ 8,887.3
Cost of products sold	3,521.7	3,056.0	6,878.7	6,089.0
Gross Profit	1,484.5	1,446.0	2,940.2	2,798.3
Marketing, research and general expenses	827.3	797.6	1,625.7	1,530.2
Other (income) and expense, net	7.1	(.3)	.3	3.3
Operating Profit	650.1	648.7	1,314.2	1,264.8
Nonoperating expense	-	(47.5)	-	(75.1)
Interest income	7.4	7.4	15.7	14.0
Interest expense	(72.8)	(51.9)	(147.5)	(102.8)
Income Before Income Taxes, Equity Interests and Extraordinary Loss	584.7	556.7	1,182.4	1,100.9
Provision for income taxes	(174.6)	(111.5)	(339.2)	(223.6)
Income Before Equity Interests and Extraordinary Loss	410.1	445.2	843.2	877.3
Share of net income of equity companies	48.4	42.8	91.8	87.8
Minority owners' share of subsidiaries' net income	(34.1)	(26.2)	(69.7)	(51.3)
Extraordinary loss, net of income taxes	(7.7)	-	(7.7)	-
Net Income	\$ 416.7	\$ 461.8	\$ 857.6	\$ 913.8

## Per Share Basis:

Net Income				
Basic				
Before extraordinary loss	\$ 1.02	\$ 1.01	\$ 2.07	\$ 2.01
Extraordinary loss	(.02)	-	(.02)	-
Net Income	\$ 1.00	\$ 1.01	\$ 2.05	\$ 2.01
Diluted				
Before extraordinary loss	\$ 1.01	\$ 1.00	\$ 2.06	\$ 1.99
Extraordinary loss	(.02)	-	(.02)	-
Net Income	\$ .99	\$ 1.00	\$ 2.04	\$ 1.99

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Cash Dividends Declared	\$	.58	\$	.53	\$	1.16	\$	1.06
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See Notes to Consolidated Financial Statements.

2

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KIMBERLY-CLARK CORPORATION AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEET  
(Unaudited)

(Millions of dollars)	June 30, 2008	December 31, 2007
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 545.8	\$ 472.7
Accounts receivable, net	2,599.0	2,560.6
Inventories	2,629.8	2,443.8
Other current assets	536.4	619.5
<b>Total Current Assets</b>	<b>6,311.0</b>	<b>6,096.6</b>
Property	16,718.8	16,243.0
Less accumulated depreciation	8,490.7	8,149.0
<b>Net Property</b>	<b>8,228.1</b>	<b>8,094.0</b>
Investments in Equity Companies	422.8	390.0
<b>Goodwill</b>	<b>3,097.1</b>	<b>2,942.4</b>
Long-Term Notes Receivable	599.7	-
<b>Other Assets</b>	<b>966.8</b>	<b>916.7</b>
	\$ 19,625.5	\$ 18,439.7
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current Liabilities</b>		
Debt payable within one year	\$ 1,348.4	\$ 1,097.9
Accounts payable	1,751.6	1,768.3
Accrued expenses	1,763.9	1,782.8
Other current liabilities	350.6	279.6
<b>Total Current Liabilities</b>	<b>5,214.5</b>	<b>4,928.6</b>
Long-Term Debt	4,995.5	4,393.9
Noncurrent Employee Benefits	1,534.7	1,558.5
Long-Term Income Taxes Payable	170.7	288.3
Deferred Income Taxes	463.6	369.7
Other Liabilities	205.1	188.3
Minority Owners' Interests in Subsidiaries	427.0	484.1
Redeemable Preferred Securities of Subsidiary	1,011.0	1,004.6
<b>Stockholders' Equity</b>	<b>5,603.4</b>	<b>5,223.7</b>
	\$ 19,625.5	\$ 18,439.7

See Notes to Consolidated Financial Statements.

KIMBERLY-CLARK CORPORATION AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED CASH FLOW STATEMENT  
 (Unaudited)

(Millions of dollars)	Six Months Ended June 30	
	2008	2007
<b>Operating Activities</b>		
Net income	\$ 857.6	\$ 913.8
Extraordinary loss, net of income taxes	7.7	-
Depreciation and amortization	400.2	412.9
Stock-based compensation	24.7	37.6
Increase in operating working capital	(192.5)	(100.5)
Deferred income tax provision	50.2	(90.2)
Net losses on asset dispositions	16.6	14.7
Equity companies' earnings in excess of dividends paid	(52.7)	(55.5)
Minority owners' share of subsidiaries' net income	69.7	51.3
Postretirement benefits	(3.6)	.5
Other	19.0	(8.6)
<b>Cash Provided by Operations</b>	<b>1,196.9</b>	<b>1,176.0</b>
<b>Investing Activities</b>		
Capital spending	(433.6)	(544.0)
Acquisition of businesses, net of cash acquired	(76.4)	(15.7)
Proceeds from sales of investments	38.8	12.4
Proceeds from dispositions of property	1.0	60.0
Net decrease in time deposits	43.8	17.9
Investments in marketable securities	(8.6)	(4.1)
Other	(1.1)	(24.9)
<b>Cash Used for Investing</b>	<b>(436.1)</b>	<b>(498.4)</b>
<b>Financing Activities</b>		
Cash dividends paid	(467.5)	(465.8)
Net increase in short-term debt	213.1	8.2
Proceeds from issuance of long-term debt	34.3	27.4
Repayments of long-term debt	(34.7)	(35.7)
Cash paid on redeemable preferred securities of subsidiary	(20.1)	-
Proceeds from exercise of stock options	67.0	213.5
Acquisitions of common stock for the treasury	(437.0)	(315.5)
Other	(34.4)	(16.7)
<b>Cash Used for Financing</b>	<b>(679.3)</b>	<b>(584.6)</b>
<b>Effect of Exchange Rate Changes on Cash and Cash Equivalents</b>	<b>(8.4)</b>	<b>3.2</b>
Increase in Cash and Cash Equivalents	73.1	96.2
Cash and Cash Equivalents, beginning of year	472.7	360.8

Cash and Cash Equivalents, end of period	\$	545.8	\$	457.0
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See Notes to Consolidated Financial Statements.

4

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KIMBERLY-CLARK CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 1. Accounting Policies

Basis of Presentation

The accompanying unaudited condensed Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S.”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the U.S. for complete financial statements. In the opinion of management, all adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation have been included.

For further information, refer to the Consolidated Financial Statements and footnotes thereto included in the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2007.

New Accounting Standards

In February 2007, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards (“SFAS”) No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (“SFAS 159”). SFAS 159 allows entities to choose, at specified election dates, to measure financial instruments (financial assets and liabilities) at fair value (the “Fair Value Option”). The election is made on an instrument-by-instrument basis and is irrevocable. If the Fair Value Option is elected for an instrument, SFAS 159 specifies that all subsequent changes in fair value for that instrument be reported in earnings. SFAS 159 was effective as of the beginning of the first fiscal year that began after November 15, 2007. The Corporation has not applied the Fair Value Option to any of its existing financial assets or liabilities.

In December 2007, the FASB issued SFAS No. 141(R), Business Combinations (“SFAS 141(R)"). SFAS 141(R) requires the acquirer in a business combination to:

- recognize 100 percent of the fair values of acquired assets, including goodwill, and assumed liabilities, with only limited exceptions, even if the acquirer has not acquired 100 percent of the target entity,
  - fair value contingent consideration arrangements at the acquisition date,
- expense transaction costs as incurred rather than being considered part of the fair value of an acquirer’s interest,
  - fair value certain preacquisition contingencies, such as environmental or legal issues,
- limit accrual of the costs for a restructuring plan to pre-acquisition date restructuring obligations, and
  - capitalize the value of acquired research and development as an indefinite-lived intangible asset, subject to impairment accounting, rather than being expensed at the acquisition date.

SFAS 141(R) is effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Adoption is prospective, and early adoption is not permitted. Adoption of SFAS 141(R) is not expected to have a material effect on the Corporation’s financial statements.

Note 1. (Continued)

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51 ("SFAS 160"). SFAS 160 clarifies the classification of noncontrolling interests (i.e., minority owners' interests in subsidiaries) in consolidated balance sheets and the accounting for and reporting of transactions between the reporting entity and holders of such noncontrolling interests.

Under SFAS 160:

- Noncontrolling interests are reported as an element of consolidated equity, thereby eliminating the current practice of classifying minority owners' interests within a mezzanine section of the balance sheet.
- The current practice of reporting minority owners' share of subsidiaries' net income will change. Reported net income will include the total income of all consolidated subsidiaries, with separate disclosure on the face of the income statement of the split of net income between the controlling and noncontrolling interests.
- Increases and decreases in the noncontrolling ownership interest amount will be accounted for as equity transactions. If the controlling interest loses control and deconsolidates a subsidiary, full gain or loss on the transition will be recognized.

SFAS 160 is effective for fiscal years, and interim periods within fiscal years, beginning on or after December 15, 2008. Early adoption is not permitted. Adoption is prospective, except for the following provisions, which are required to be adopted retrospectively:

- Noncontrolling interests are required to be reclassified from the mezzanine to equity, separate from the parent's shareholders' equity, in the consolidated balance sheet.
- Consolidated net income must be recast to include net income attributable to both controlling and noncontrolling interests.

Except for the reclassification of minority owners' interests into equity and the inclusion of all of the income of less than 100 percent owned subsidiaries in reported net income, adoption of SFAS 160 is not expected to have a material effect on the Corporation's financial statements.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133 ("SFAS 161"). SFAS 161 applies to all derivative instruments and related hedged items accounted for under SFAS 133, Accounting for Derivative Instruments and Hedging Activities ("SFAS 133"). SFAS 161 requires enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, results of operations, and cash flows.

SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Adoption of SFAS 161 is not expected to have a material effect on the Corporation's financial statements.

In June 2008, the FASB issued Staff Position (FSP) EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities. The FSP specifies that certain share-based payment awards are participating securities, which must be included in the computation of basic and diluted earnings per share under the two-class method prescribed in SFAS 128, Earnings per Share. Under the two-class method, earnings per share is computed by allocating net income of an entity to both common shareholders and participating securities.



Note 1. (Continued)

The FSP is effective for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is not permitted. The FSP requires that earnings per share presented for prior periods be retrospectively restated. Adoption of the FSP is not expected to have a material effect on the Corporation's financial statements.

Note 2. Variable Interest Entities

The Corporation has minority voting interests in two financing entities (the "Financing Entities") used to monetize long-term notes (the "Notes") received from the sale of certain nonstrategic timberlands and related assets to nonaffiliated buyers. The Notes have an aggregate face value of \$617 million and are backed by irrevocable standby letters of credit issued by money center banks. The Notes and certain other assets were transferred to the Financing Entities in 1999 and 2000. A nonaffiliated financial institution (the "Third Party") has made substantive capital investments in each of the Financing Entities and has majority voting control over them. The Third Party also made monetization loans aggregating \$617 million to the Corporation, which were assumed by the Financing Entities at the time they acquired the Notes. These monetization loans are secured by the Notes. The Corporation also contributed to the Financing Entities intercompany notes receivable aggregating \$662 million and intercompany preferred stock of \$50 million, which serve as secondary collateral for the monetization loans.

In 2003 upon adoption of FIN 46(R), Consolidation of Variable Interest Entities, ("FIN 46(R)"), the Corporation determined that the Third Party was the primary beneficiary of the Financing Entities as a result of the interest rate variability allocated to it in accordance with FIN 46(R).

On June 30, 2008, the maturity dates of the lending arrangements with the Third Party were extended. FASB Staff Position FIN 46(R)-6, Determining the Variability to be Considered in Applying FASB Interpretation No. 46(R), ("FSP 46(R)"), which was issued in 2006, requires that certain interest rate variability no longer be considered in determining the primary beneficiary of variable interest entities. As required by FIN 46(R) in connection with the extensions, the Corporation reconsidered the primary beneficiary determination and concluded, after excluding the interest rate variability as required by FSP 46(R), that it was now the primary beneficiary.

Because the Corporation became the primary beneficiary of the Financing Entities on June 30, 2008, it began consolidating them. In accordance with FIN 46(R), the assets and liabilities of the Financing Entities were recorded at fair value as of June 30, 2008. As a result of the consolidation, the Notes held by the Financing Entities with an aggregate fair value of \$599.7 million and the fair value of the monetization loans aggregating \$611.8 million have been included in long-term notes receivable and long-term debt, respectively, on the consolidated balance sheet.

Fair values have been classified within level 3 of the fair value hierarchy contained in SFAS No. 157, Fair Value Measurements ("SFAS 157"). These financial assets and liabilities are not traded in active markets. Accordingly, their fair values were calculated using a floating rate pricing model that compares the stated spread to the fair value spread to determine the price at which each of the financial instruments should trade. The model uses the following inputs to calculate fair values: current LIBOR rate, fair value spread, stated spread, maturity date and interest payment dates.

## Note 2. (Continued)

The following summarizes the terms of the Notes and the monetization loans.

Description	Face Value	Fair Value	Maturity	Interest Rate (a) (b)
Note 1	\$397 million	\$388.4 million	September 30, 2009	LIBOR minus 15 bps
Note 2	220 million	211.3 million	July 7, 2011	LIBOR minus 12.5 bps
Loan 1	397 million	392.0 million	September 30, 2009	LIBOR plus 75 bps
Loan 2	220 million	219.8 million	July 1, 2009	LIBOR plus 75 bps

(a) Payable quarterly

(b) 3 month LIBOR

Because the fair value of the monetization loans exceeded the fair value of the Notes, the Corporation recorded an after-tax extraordinary charge of \$7.7 million on its Consolidated Income Statement for the period ended June 30, 2008, as required by FIN 46(R). In accordance with FIN 46(R), prior period financial statements have not been adjusted to reflect the consolidation of the Financing Entities.

Interest income on the Notes and interest expense on the monetization loans will be reported on the Consolidated Income Statement. In addition, the Notes and monetization loans will be adjusted from their June 30, 2008 fair values to their face values through their respective maturity dates with the adjustment recorded as interest income and interest expense, respectively.

## Note 3. Fair Value Measurements

Effective January 1, 2008, the Corporation adopted SFAS 157, for its financial assets and liabilities, as required. In February 2008, the FASB issued FASB Staff Position No. 157-2 which deferred the effective date of SFAS 157 for nonfinancial assets and liabilities except for those recognized or disclosed on a recurring basis. SFAS 157 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The three levels in the hierarchy used to measure fair value are:

Level 1 – Unadjusted quoted prices in active markets accessible at the reporting date for identical assets and liabilities.

Level 2 – Quoted prices for similar assets or liabilities in active markets. Quoted prices for identical or similar assets and liabilities in markets that are not considered active or financial instruments for which all significant inputs are observable, either directly or indirectly.

Level 3 – Prices or valuations that require inputs that are significant to the valuation and are unobservable.

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

## Note 3. (Continued)

Set forth below, are the financial assets and liabilities measured at fair value as of June 30, 2008, together with the inputs used to develop those fair value measurements. The Corporation has no financial assets or liabilities for which fair value was measured on a recurring basis using Level 3 inputs.

(Millions of dollars)	June 30, 2008	Fair Value Measurements	
		Level 1	Level 2
<b>Assets</b>			
Company-owned life insurance ("COLI")	\$ 47.7	\$ -	\$ 47.7
Available-for-sale securities	15.3	15.3	-
Derivatives	39.8	-	39.8
<b>Total</b>	<b>\$102.8</b>	<b>\$15.3</b>	<b>\$ 87.5</b>
<b>Liabilities</b>			
Derivatives	\$ 31.6	\$ -	\$ 31.6

The COLI policies are a source of funding primarily for the Corporation's nonqualified employee benefit plans and are included in other assets. Available-for-sale securities are included in other assets. The derivative assets and liabilities are included in other current assets, other assets, accrued expenses and other liabilities, as appropriate.

Level 1 Fair Values - The fair values of available-for-sale securities are based on quoted market prices in active markets for identical assets.

Level 2 Fair Values - The fair value of the COLI policies is derived from investments in a mix of money market, fixed income and equity funds managed by unrelated fund managers. The fair values of derivatives used to manage interest rate risk and commodity price risk are based on LIBOR rates and the interest rate swap curves and NYMEX price quotations, respectively. The fair value of hedging instruments used to manage foreign currency risk is based on published quotations of spot currency rates and forward points, which are converted into implied forward currency rates.

## Note 4. Strategic Cost Reduction Plan

In July 2005, the Corporation authorized a multi-year plan to further improve its competitive position by accelerating investments in targeted growth opportunities and strategic cost reductions aimed at streamlining manufacturing and administrative operations, primarily in North America and Europe.

The strategic cost reductions commenced in the third quarter of 2005 and are expected to be substantially completed by December 31, 2008. Based on current estimates, the strategic cost reductions are expected to result in cumulative charges of approximately \$880 to \$900 million before tax (\$610 - \$620 million after tax) over that three and one-half year period.

By the end of 2008, it is anticipated there will be a net workforce reduction of about 10 percent, or approximately 6,000 employees. Since the inception of the strategic cost reductions, a net workforce reduction of approximately 5,200 has occurred. As of June 30, 2008, charges have been recorded related to strategic cost reduction initiatives for all affected facilities. To date, 14 facilities have been



Note 4. (Continued)

disposed of and three additional facilities have been closed and are being marketed for sale. Two other facilities will be closed prior to December 31, 2008. In addition, streamlining at four facilities has been completed.

The following pretax charges were incurred in connection with the strategic cost reductions:

(Millions of dollars)	Three Months Ended June 30		Six Months Ended June 30	
	2008	2007	2008	2007
Noncash charges	\$ 5.4	\$ 20.726,552		

\$  
25,336

9

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### NOTE 3. Investment in Unconsolidated Joint Ventures

#### Investment in Unconsolidated Joint Ventures

In order to minimize our investment and risk of land exposure in a single location, we have periodically partnered with other land developers or homebuilders to share in the land investment and development of a property through joint ownership and development agreements, joint ventures, and other similar arrangements. During the nine month period ended September 30, 2016, we decreased our total investment in such joint venture arrangements by \$10.5 million from \$37.0 million at December 31, 2015 to \$26.5 million at September 30, 2016, which was driven primarily by our increased lot distributions from unconsolidated joint ventures of \$20.9 million, offset, in part, by our cash contributions to our unconsolidated joint ventures during the first nine months of 2016 of \$10.1 million.

We use the equity method of accounting for investments in unconsolidated joint ventures over which we exercise significant influence but do not have a controlling interest. Under the equity method, our share of the unconsolidated joint ventures' earnings or loss, if any, is included in our consolidated statement of income. The Company assesses its investments in unconsolidated joint ventures for recoverability on a quarterly basis. Refer to Note 4 for additional details relating to our procedures for evaluating our investments for impairment.

For joint venture arrangements where a special purpose entity is established to own the property, we generally enter into limited liability company or similar arrangements ("LLCs") with the other partners. The Company's ownership in these LLCs as of both September 30, 2016 and December 31, 2015 ranged from 25% to 74%. These entities typically engage in land development activities for the purpose of distributing or selling developed lots to the Company and its partners in the LLC.

We believe that the Company's maximum exposure related to its investment in these joint venture arrangements as of September 30, 2016 is the amount invested of \$26.5 million, which is reported as Investment in Unconsolidated Joint Ventures on our Unaudited Condensed Consolidated Balance Sheets, although we expect to invest further amounts in these joint venture arrangements as development of the properties progresses. Included in the Company's investment in unconsolidated joint ventures at September 30, 2016 and December 31, 2015 were \$0.3 million and \$0.4 million, respectively, of capitalized interest and other costs.

#### Variable Interest Entities

With respect to our investments in these LLCs, we are required, under ASC 810-10, Consolidation ("ASC 810"), to evaluate whether or not such entities should be consolidated into our financial statements. We initially perform these evaluations when each new entity is created and upon any events that require reconsideration of the entity. See Note 1, "Summary of Significant Accounting Policies - Variable Interest Entities" in the Company's 2015 Form 10-K for additional information regarding the Company's methodology for evaluating entities for consolidation.

As of September 30, 2016 and December 31, 2015, we have determined that one of the LLCs in which we have an interest meets the requirements of a variable interest entity ("VIE") due to a lack of equity at risk in the entity. However, we have determined that we do not have substantive control over that VIE because we do not have the ability to control the activities that most significantly impact its economic performance. As a result, we are not required to consolidate the VIE into our financial statements, and we instead record the VIE in Investment in Unconsolidated Joint Ventures on our Unaudited Condensed Consolidated Balance Sheets.

#### Land Option Agreements

In the ordinary course of business, the Company enters into land option or purchase agreements for which we generally pay non-refundable deposits. Pursuant to these land option agreements, the Company provides a deposit to the seller as consideration for the right to purchase land at different times in the future, usually at predetermined prices. In accordance with ASC 810, we analyze our land option or purchase agreements to determine whether the corresponding land sellers are VIEs and, if so, whether we are the primary beneficiary, as further described in Note 1, "Summary of Significant Accounting Policies - Land Option Agreements" in the Company's 2015 Form 10-K. If we are deemed to be the primary beneficiary of the VIE, we will consolidate the VIE in our consolidated financial statements and reflect such assets and liabilities in our Consolidated Inventory not Owned in our Unaudited Condensed Consolidated Balance Sheets. At both September 30, 2016 and December 31, 2015, we concluded that we were not the primary beneficiary of any VIEs from which we are purchasing land under option or purchase agreements.

### NOTE 4. Fair Value Measurements

There are three measurement input levels for determining fair value: Level 1, Level 2, and Level 3. Fair values determined by Level 1 inputs utilize quoted prices in active markets for identical assets or liabilities that the Company has the ability to access.

10

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Fair values determined by Level 2 inputs utilize inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals. Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability.

#### Assets Measured on a Recurring Basis

The Company measures both mortgage loans held for sale and interest rate lock commitments (“IRLCs”) at fair value. Fair value measurement results in a better presentation of the changes in fair values of the loans and the derivative instruments used to economically hedge them.

In the normal course of business, our financial services segment enters into contractual commitments to extend credit to buyers of single-family homes with fixed expiration dates. The commitments become effective when the borrowers “lock-in” a specified interest rate within established time frames. Market risk arises if interest rates move adversely between the time of the “lock-in” of rates by the borrower and the sale date of the loan to an investor. To mitigate the effect of the interest rate risk inherent in providing rate lock commitments to borrowers, the Company enters into optional or mandatory delivery forward sale contracts to sell whole loans and mortgage-backed securities to broker/dealers. The forward sale contracts lock in an interest rate and price for the sale of loans similar to the specific rate lock commitments. The Company does not engage in speculative trading or derivative activities. Both the rate lock commitments to borrowers and the forward sale contracts to broker/dealers or investors are undesignated derivatives, and accordingly, are marked to fair value through earnings. Changes in fair value measurements are included in earnings in the accompanying statements of income.

The fair value of mortgage loans held for sale is estimated based primarily on published prices for mortgage-backed securities with similar characteristics. To calculate the effects of interest rate movements, the Company utilizes applicable published mortgage-backed security prices, and multiplies the price movement between the rate lock date and the balance sheet date by the notional loan commitment amount. The Company sells loans on a servicing released or servicing retained basis, and receives servicing compensation. Thus, the value of the servicing rights included in the fair value measurement is based upon contractual terms with investors and depends on the loan type. The Company applies a fallout rate to IRLCs when measuring the fair value of rate lock commitments. Fallout is defined as locked loan commitments for which the Company does not close a mortgage loan and is based on management’s judgment and company experience.

The fair value of the Company’s forward sales contracts to broker/dealers solely considers the market price movement of the same type of security between the trade date and the balance sheet date. The market price changes are multiplied by the notional amount of the forward sales contracts to measure the fair value.

**Interest Rate Lock Commitments.** IRLCs are extended to certain home-buying customers who have applied for a mortgage loan and meet certain defined credit and underwriting criteria. Typically, the IRLCs will have a term of less than six months; however, in certain markets, the term could extend to twelve months.

Some IRLCs are committed to a specific third party investor through the use of best-efforts whole loan delivery commitments matching the exact terms of the IRLC loan. Uncommitted IRLCs are considered derivative instruments and are fair value adjusted, with the resulting gain or loss recorded in current earnings.

**Forward Sales of Mortgage-Backed Securities.** Forward sales of mortgage-backed securities (“FMBSs”) are used to protect uncommitted IRLC loans against the risk of changes in interest rates between the lock date and the funding date. FMBSs related to uncommitted IRLCs are classified and accounted for as non-designated derivative instruments and are recorded at fair value, with gains and losses recorded in current earnings.

**Mortgage Loans Held for Sale.** Mortgage loans held for sale consists primarily of single-family residential loans collateralized by the underlying property. Generally, all of the mortgage loans and related servicing rights are sold to third-party investors shortly after origination. During the period between when a loan is closed and when it is sold to an investor, the interest rate risk is covered through the use of a best-efforts contract or by FMBSs. The FMBSs are classified and accounted for as non-designated derivative instruments, with gains and losses recorded in current earnings.



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The table below shows the notional amounts of our financial instruments at September 30, 2016 and December 31, 2015:

Description of Financial Instrument (in thousands)	September 30, December 31,	
	2016	2015
Best efforts contracts and related committed IRLCs	\$ 3,799	\$ 2,625
Uncommitted IRLCs	90,244	46,339
FMBSs related to uncommitted IRLCs	92,000	46,000
Best efforts contracts and related mortgage loans held for sale	6,927	100,152
FMBSs related to mortgage loans held for sale	87,000	27,000
Mortgage loans held for sale covered by FMBSs	87,700	26,690

The table below shows the level and measurement of assets and liabilities measured on a recurring basis at September 30, 2016 and December 31, 2015:

Description of Financial Instrument (in thousands)	Fair Value Measurements September 30, 2016	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Forward sales of mortgage-backed securities	(338 )	—	(338 )	—
Interest rate lock commitments	709	—	709	—
Best-efforts contracts	(175 )	—	(175 )	—
Total	\$ 95,741	\$ —	\$ 95,741	\$ —

Description of Financial Instrument (in thousands)	Fair Value Measurements December 31, 2015	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Forward sales of mortgage-backed securities	(93 )	—	(93 )	—
Interest rate lock commitments	321	—	321	—
Best-efforts contracts	(206 )	—	(206 )	—
Total	\$ 127,023	\$ —	\$ 127,023	\$ —

The following table sets forth the amount of gain (loss) recognized, within our revenue in the Unaudited Condensed Consolidated Statements of Income, on assets and liabilities measured on a recurring basis for the three and nine months ended September 30, 2016 and 2015:

Description (in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Mortgage loans held for sale	\$(1,127)	\$1,585	\$1,059	\$761
Forward sales of mortgage-backed securities	1,443	(2,520 )	(245 )	(1,088)
Interest rate lock commitments	(531 )	924	388	696

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Best-efforts contracts	15	(125 )	31	(253 )
Total (loss) gain recognized	\$(200 )	\$(136 )	\$1,233	\$116

12

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The following tables set forth the fair value of the Company's derivative instruments and their location within the Unaudited Condensed Consolidated Balance Sheets for the periods indicated (except for mortgage loans held for sale which is disclosed as a separate line item):

Description of Derivatives	Asset Derivatives September 30, 2016		Liability Derivatives September 30, 2016	
	Balance Sheet Location	Fair Value (in thousands)	Balance Sheet Location	Fair Value (in thousands)
Forward sales of mortgage-backed securities	Other assets	\$ —	Other liabilities	\$ 338
Interest rate lock commitments	Other assets	709	Other liabilities	—
Best-efforts contracts	Other assets	—	Other liabilities	175
Total fair value measurements		\$ 709		\$ 513
Description of Derivatives	Asset Derivatives December 31, 2015		Liability Derivatives December 31, 2015	
	Balance Sheet Location	Fair Value (in thousands)	Balance Sheet Location	Fair Value (in thousands)
Forward sales of mortgage-backed securities	Other assets	\$ —	Other liabilities	\$ 93
Interest rate lock commitments	Other assets	321	Other liabilities	—
Best-efforts contracts	Other assets	—	Other liabilities	206
Total fair value measurements		\$ 321		\$ 299

#### Assets Measured on a Non-Recurring Basis

**Inventory.** The Company assesses inventory for recoverability on a quarterly basis based on the difference in the carrying value of the inventory and its fair value at the time of the evaluation. Determining the fair value of a community's inventory involves a number of variables, estimates and projections, which are Level 3 measurement inputs. See Note 1, "Summary of Significant Accounting Policies - Inventory" in the Company's 2015 Form 10-K for additional information regarding the Company's methodology for determining fair value.

The Company uses significant assumptions to evaluate the recoverability of its inventory, such as estimated average selling price, construction and development costs, absorption pace (reflecting any product mix change strategies implemented or to be implemented), selling strategies, alternative land uses (including disposition of all or a portion of the land owned), or discount rates. Changes in these assumptions could materially impact future cash flow and fair value estimates and may lead the Company to incur additional impairment charges in the future. Our analysis is conducted only if indicators of a decline in value of our inventory exist, which include, among other things, declines in gross margin on sales contracts in backlog or homes that have been delivered, slower than anticipated absorption pace, declines in average sales price or high incentive offers by management to improve absorptions, declines in margins regarding future land sales, or declines in the value of the land itself as a result of third party appraisals. If communities are not recoverable based on the estimated future undiscounted cash flows, the impairment to be recognized is measured as the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. During the three and nine months ended September 30, 2016 and 2015, the Company did not record any impairment charges on its inventory.

**Investment In Unconsolidated Joint Ventures.** We evaluate our investments in unconsolidated joint ventures for impairment on a quarterly basis based on the difference in the investment's carrying value and its fair value at the time of the evaluation. If the Company has determined that the decline in value is other than temporary, the Company

would write down the value of the investment to its estimated fair value. Determining the fair value of investments in unconsolidated joint ventures involves a number of variables, estimates and assumptions, which are Level 3 measurement inputs. See Note 1, "Summary of Significant Accounting Policies - Investment in Unconsolidated Joint Ventures," in the Company's 2015 Form 10-K for additional information regarding the Company's methodology for determining fair value. Because of the high degree of judgment involved in developing these assumptions, it is possible that changes in these assumptions could materially impact future cash flow and fair value estimates of the investments which may lead the Company to incur additional impairment charges in the future. During the three and nine months ended September 30, 2016 and 2015, the Company did not record any impairment charges on its investments in unconsolidated joint ventures.

#### Financial Instruments

**Counterparty Credit Risk.** To reduce the risk associated with losses that would be recognized if counterparties failed to perform as contracted, the Company limits the entities with whom management can enter into commitments. This risk of accounting loss



is the difference between the market rate at the time of non-performance by the counterparty and the rate to which the Company committed.

The following table presents the carrying amounts and fair values of the Company's financial instruments at September 30, 2016 and December 31, 2015. The objective of the fair value measurement is to estimate the price at which an orderly transaction to sell the asset or transfer the liability would take place between market participants at the measurement date under current market conditions.

(In thousands)	September 30, 2016		December 31, 2015	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Assets:</b>				
Cash, cash equivalents and restricted cash	\$23,308	\$23,308	\$13,101	\$13,101
Mortgage loans held for sale	95,545	95,545	127,001	127,001
Split dollar life insurance policies	214	214	199	199
Notes receivable	1,188	1,006	3,153	3,076
Commitments to extend real estate loans	709	709	321	321
<b>Liabilities:</b>				
Notes payable - homebuilding operations	85,000	85,000	43,800	43,800
Notes payable - financial services operations	91,483	91,483	123,648	123,648
Notes payable - other	8,566	7,922	8,441	8,039
Convertible senior subordinated notes due 2017 <sup>(a)</sup>	57,500	63,609	57,500	61,884
Convertible senior subordinated notes due 2018 <sup>(a)</sup>	86,250	88,083	86,250	84,741
Senior notes due 2021 <sup>(a)</sup>	300,000	314,250	300,000	295,500
Best-efforts contracts for committed IRLCs and mortgage loans held for sale	175	175	206	206
Forward sales of mortgage-backed securities	338	338	93	93
<b>Off-Balance Sheet Financial Instruments:</b>				
Letters of credit	—	839	—	735

Our senior notes and convertible senior subordinated notes are stated at the principal amount outstanding which (a) does not include the impact of premiums, discounts, and debt issuance costs that are amortized to interest cost over the respective terms of the notes.

The following methods and assumptions were used by the Company in estimating its fair value disclosures of financial instruments at September 30, 2016 and December 31, 2015:

**Cash, Cash Equivalents and Restricted Cash.** The carrying amounts of these items approximate fair value because they are short-term by nature.

**Mortgage Loans Held for Sale, Forward Sales of Mortgage-Backed Securities, Commitments to Extend Real Estate Loans, Best-Efforts Contracts for Committed IRLCs and Mortgage Loans Held for Sale, Convertible Senior Subordinated Notes due 2017, Convertible Senior Subordinated Notes due 2018 and Senior Notes due 2021.** The fair value of these financial instruments was determined based upon market quotes at September 30, 2016 and December 31, 2015. The market quotes used were quoted prices for similar assets or liabilities along with inputs taken from observable market data by correlation. The inputs were adjusted to account for the condition of the asset or liability. **Split Dollar Life Insurance Policy and Notes Receivable.** The estimated fair value was determined by calculating the present value of the amounts based on the estimated timing of receipts using discount rates that incorporate management's estimate of risk associated with the corresponding note receivable.

**Notes Payable - Homebuilding Operations.** The interest rate available to the Company during the quarter ended September 30, 2016 fluctuated with the Alternate Base Rate or the Eurodollar Rate for the Company's \$400 million unsecured revolving credit facility, dated July 18, 2013, as amended (the "Credit Facility"), and thus the carrying value is a reasonable estimate of fair value. Refer to [Note 7](#) for additional information regarding the Credit Facility.

**Notes Payable - Financial Services Operations.** M/I Financial, LLC ("M/I Financial") is a party to two credit agreements: (1) a \$125 million secured mortgage warehousing agreement, dated June 24, 2016 (the "MIF Mortgage

Warehousing Agreement”); and (2) a \$15 million mortgage repurchase agreement, as amended and restated on November 3, 2015, as further amended (the “MIF Mortgage Repurchase Facility”). For each of these credit facilities, the interest rate is based on a variable rate index, and thus their carrying value is a reasonable estimate of fair value. The interest rate available to M/I Financial during the third quarter of 2016 fluctuated with LIBOR. Refer to Note 7 for additional information regarding the MIF Mortgage Warehousing Agreement and the MIF Mortgage Repurchase Facility.

14

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Notes Payable - Other. The estimated fair value was determined by calculating the present value of the future cash flows using the Company's current incremental borrowing rate.

Letters of Credit. Letters of credit of \$36.4 million and \$42.5 million represent potential commitments at September 30, 2016 and December 31, 2015, respectively. The letters of credit generally expire within one or two years. The estimated fair value of letters of credit was determined using fees currently charged for similar agreements.

#### NOTE 5. Guarantees and Indemnifications

In the ordinary course of business, M/I Financial, a 100%-owned subsidiary of M/I Homes, Inc., enters into agreements that guarantee certain purchasers of its mortgage loans that M/I Financial will repurchase a loan if certain conditions occur, primarily if the mortgagor does not meet the terms of the loan within the first six months after the sale of the loan. Loans totaling approximately \$20.1 million and \$12.2 million were covered under these guarantees as of September 30, 2016 and December 31, 2015, respectively. The increase in loans covered by these guarantees from December 31, 2015 is a result of a change in the mix of investors and their related purchase terms. A portion of the revenue paid to M/I Financial for providing the guarantees on these loans was deferred at September 30, 2016, and will be recognized in income as M/I Financial is released from its obligation under the guarantees. The risk associated with the guarantees above is offset by the value of the underlying assets.

M/I Financial has received inquiries concerning underwriting matters from purchasers of its loans regarding certain loans totaling approximately \$0.3 million and \$1.3 million at September 30, 2016 and December 31, 2015, respectively. The risk associated with the guarantees above is offset by the value of the underlying assets.

M/I Financial has also guaranteed the collectability of certain loans to third party insurers (U.S. Department of Housing and Urban Development and U.S. Veterans Administration) of those loans for periods ranging from five to thirty years. As of September 30, 2016 and December 31, 2015, the total of all loans indemnified to third party insurers relating to the above agreements was \$1.6 million and \$2.2 million, respectively. The maximum potential amount of future payments is equal to the outstanding loan value less the value of the underlying asset plus administrative costs incurred related to foreclosure on the loans, should this event occur.

The Company recorded a liability relating to the guarantees described above totaling \$0.7 million and \$1.2 million at September 30, 2016 and December 31, 2015, respectively, which is management's best estimate of the Company's liability.

#### NOTE 6. Commitments and Contingencies

##### Warranty

We use subcontractors for nearly all aspects of home construction. Although our subcontractors are generally required to repair and replace any product or labor defects, we are, during applicable warranty periods, ultimately responsible to the homeowner for making such repairs. As such, we record warranty reserves to cover our exposure to the costs for materials and labor not expected to be covered by our subcontractors to the extent they relate to warranty-type claims. Warranty reserves are established by charging cost of sales and crediting a warranty reserve for each home closed. Warranty reserves are recorded for warranties under our Home Builder's Limited Warranty ("HBLW"), and our 30-year (offered on all homes sold after April 25, 1998 and on or before December 1, 2015 in all of our markets except our Texas markets), 15-year (offered on all homes sold after December 1, 2015 in all of our markets except our Texas markets) or 10-year (offered on all homes sold in our Texas markets) transferable structural warranty in Other Liabilities on the Company's Unaudited Condensed Consolidated Balance Sheets.

The warranty reserves for the HBLW are established as a percentage of average sales price and adjusted based on historical payment patterns determined, generally, by geographic area and recent trends. Factors that are given consideration in determining the HBLW reserves include: (1) the historical range of amounts paid per average sales price on a home; (2) type and mix of amenity packages added to the home; (3) any warranty expenditures not considered to be normal and recurring; (4) timing of payments; (5) improvements in quality of construction expected to impact future warranty expenditures; and (6) conditions that may affect certain projects and require a different percentage of average sales price for those specific projects. Changes in estimates for warranties occur due to changes in the historical payment experience and differences between the actual payment pattern experienced during the period and the historical payment pattern used in our evaluation of the warranty reserve balance at the end of each quarter. Actual future warranty costs could differ from our current estimated amount.

Our warranty reserves for our transferable structural warranty programs are established on a per-unit basis. While the structural warranty reserve is recorded as each house closes, the sufficiency of the structural warranty per unit charge and total reserve is re-evaluated on an annual basis, with the assistance of an actuary, using our own historical data and trends, industry-wide historical data and trends, and other project specific factors. The reserves are also evaluated quarterly and adjusted if we encounter activity

15

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that is inconsistent with the historical experience used in the annual analysis. These reserves are subject to variability due to uncertainties regarding structural defect claims for products we build, the markets in which we build, claim settlement history, insurance and legal interpretations, among other factors.

While we believe that our warranty reserves are sufficient to cover our projected costs, there can be no assurances that historical data and trends will accurately predict our actual warranty costs.

A summary of warranty activity for the three and nine months ended September 30, 2016 and 2015 is as follows:

	Three Months		Nine Months	
	Ended September 30,		Ended September 30,	
(In thousands)	2016	2015	2016	2015
Warranty reserves, beginning of period	\$15,815	\$10,638	\$14,281	\$12,671
Warranty expense on homes delivered during the period	2,755	2,263	7,276	5,847
Changes in estimates for pre-existing warranties	526	905	563	1,580
Charges related to stucco-related claims <sup>(a)</sup>	14,500	—	19,409	—
Settlements made during the period	(5,658 )	(3,328 )	(13,591 )	(9,620 )
Warranty reserves, end of period	\$27,938	\$10,478	\$27,938	\$10,478

(a) Estimated stucco-related claim costs, as described below, have been included in warranty accruals.

We have received claims related to stucco installation from homeowners in certain of our communities in our Tampa and Orlando, Florida markets and have been named as a defendant in legal proceedings initiated by certain of such homeowners. These claims primarily relate to homes built prior to 2014 which have second story elevations with frame construction.

Through 2015, we repaired certain of the identified homes and accrued for the estimated future cost of repairs for the other identified homes on which repairs had yet to be completed. The aggregate amounts of such repair costs and accruals were not material, and the reserve for identified homes in need of more than minor repair at December 31, 2015 was \$0.5 million. During the first half of 2016, we received an increased number of stucco-related claims in our Florida communities, and we recorded additional accruals totaling \$4.9 million as a change in estimate to our warranty reserves for homes that we identified during this period as requiring more than minor repairs. At June 30, 2016, the remaining reserve was \$2.9 million, covering the estimated repair costs for the approximately 178 identified homes on which repairs had yet to be completed. The \$2.9 million remaining reserve did not include any estimate of the future stucco repair costs for homes for which we had not received claims.

During the third quarter of 2016, we continued to receive stucco-related claims for homes in certain of our Florida communities, identified 199 additional homes that require more than minor stucco repairs and completed repairs on 112 homes. We also continued to review the stucco issues and to collect and analyze information to enable us to reasonably estimate the overall cost of stucco-related repairs to homes in our Florida communities. During the course of our review, we analyzed a number of factors, including: (1) the date of delivery of each home in our Florida communities and the expiration date of the 10-year statutory period of repose and contractual warranty period with respect to each such home; (2) the number of each type of home (i.e., one story, 1.5 stories or 2 stories); (3) our stucco-related claims experience with respect to each type of home and each individual community; and (4) other relevant factors and observations gained from the field.

Based on the progress of our review and analysis, we believe that we have accumulated an adequate understanding of, and sufficient experience with, the stucco-related issues to enable us to reasonably estimate the overall cost of stucco-related repairs to homes in our Florida communities. As a result, during the third quarter of 2016, we recorded an additional accrual of \$14.5 million as a change in estimate to our warranty reserves for the overall cost of stucco-related repairs. At September 30, 2016, the remaining reserve for the overall cost of stucco-related repairs was \$15.1 million. This remaining reserve represents (1) our estimate of the stucco repair costs for the 265 identified homes in our Florida communities on which repairs have not yet been completed as of September 30, 2016 and (2) our

estimate of the stucco repair costs for homes in our Florida communities that we have not yet identified as needing repairs but that may require repairs in the future.

Our review of the stucco-related issues in our Florida communities is ongoing. Our estimate, as of September 30, 2016, of our overall stucco repair costs is based on our judgment and various assumptions. Due to the degree of judgment and the potential for variability in our underlying assumptions, as we obtain additional information, we may revise our estimate, including to reflect additional estimated future stucco repairs costs, which revision could be material.

During the third quarter of 2016, we also continued our investigation of the extent to which we may be able to recover a portion of our stucco repair and claims handling costs from other sources, including our direct insurers, the subcontractors involved with the construction of the homes and their insurers. As of September 30, 2016, we are unable to estimate an amount, if any, that we

believe is probable that we will recover from these sources and, accordingly, we have not recorded a receivable for estimated recoveries nor included an estimated amount of recoveries in determining our warranty reserves.

#### Performance Bonds and Letters of Credit

At September 30, 2016, the Company had outstanding approximately \$145.8 million of completion bonds and standby letters of credit, some of which were issued to various local governmental entities that expire at various times through September 2024. Included in this total are: (1) \$102.1 million of performance and maintenance bonds and \$29.3 million of performance letters of credit that serve as completion bonds for land development work in progress; (2) \$7.1 million of financial letters of credit, of which \$5.3 million represent deposits on land and lot purchase agreements; and (3) \$7.3 million of financial bonds.

#### Land Option Contracts and Other Similar Contracts

At September 30, 2016, the Company also had options and contingent purchase agreements to acquire land and developed lots with an aggregate purchase price of approximately \$589.8 million. Purchase of properties under these agreements is contingent upon satisfaction of certain requirements by the Company and the sellers.

#### Legal Matters

In addition to the legal proceedings related to stucco, the Company and certain of its subsidiaries have been named as defendants in certain other legal proceedings which are incidental to our business. While management currently believes that the ultimate resolution of these other legal proceedings, individually and in the aggregate, will not have a material effect on the Company's financial position, results of operations and cash flows, such legal proceedings are subject to inherent uncertainties. The Company has recorded a liability to provide for the anticipated costs, including legal defense costs, associated with the resolution of these other legal proceedings. However, the possibility exists that the costs to resolve these legal proceedings could differ from the recorded estimates and, therefore, have a material effect on the Company's net income for the periods in which they are resolved. At September 30, 2016 and December 31, 2015, we had \$0.3 million and \$0.6 million reserved for legal expenses, respectively.

#### NOTE 7. Debt

##### Notes Payable - Homebuilding

The Credit Facility provides for an aggregate commitment amount of \$400 million, including a \$125 million sub-facility for letters of credit. The Credit Facility expires on October 20, 2018. For the quarter ended September 30, 2016, interest on amounts borrowed under the Credit Facility was payable at either the Alternate Base Rate plus a margin of 175 basis points, or at the Eurodollar Rate plus a margin of 275 basis points. These interest rates are subject to adjustment in subsequent periods based on the Company's leverage ratio. The Credit Facility also contains certain financial covenants. At September 30, 2016, the Company was in compliance with all financial covenants of the Credit Facility. At September 30, 2016, borrowing availability under the Credit Facility in accordance with the borrowing base calculation was \$536.2 million and, as a result, the full amount of the \$400 million facility was available. At September 30, 2016, there were \$85.0 million of borrowings outstanding and \$35.5 million of letters of credit outstanding, leaving net remaining borrowing availability of \$279.5 million.

The Company's obligations under the Credit Facility are guaranteed by all of the Company's subsidiaries, with the exception of subsidiaries that are primarily engaged in the business of mortgage financing, title insurance or similar financial businesses relating to the homebuilding and home sales business, certain subsidiaries that are not 100%-owned by the Company or another subsidiary, and other subsidiaries designated by the Company as Unrestricted Subsidiaries (as defined in Note 11), subject to limitations on the aggregate amount invested in such Unrestricted Subsidiaries in accordance with the terms of the Credit Facility and the indenture for the Company's \$300.0 million aggregate principal amount of 6.75% Senior Notes due 2021 (the "2021 Senior Notes"). The guarantors for the Credit Facility (the "Guarantor Subsidiaries") are the same subsidiaries that guarantee the 2021 Senior Notes, the

Company's \$57.5 million aggregate principal amount of 3.25% Convertible Senior Subordinated Notes due 2017 (the "2017 Convertible Senior Subordinated Notes") and the Company's \$86.3 million aggregate principal amount of 3.0% Convertible Senior Subordinated Notes due 2018 (the "2018 Convertible Senior Subordinated Notes").

The Company's obligations under the Credit Facility are general, unsecured senior obligations of the Company and the Guarantor Subsidiaries and rank equally in right of payment with all our and the Guarantor Subsidiaries' existing and future unsecured senior indebtedness. Our obligations under the Credit Facility are effectively subordinated to our and the Guarantor Subsidiaries' existing and future secured indebtedness with respect to any assets comprising security or collateral for such indebtedness.



As of June 30, 2016, the Company was a party to three secured credit agreements for the issuance of letters of credit outside of the Credit Facility (collectively, the “Letter of Credit Facilities”). During the third quarter of 2016, the Company terminated one Letter of Credit Facility and allowed another Letter of Credit Facility to expire. Therefore, at September 30, 2016, the Company was party to one remaining Letter of Credit Facility, with a maturity date of September 30, 2017, which allows for the issuance of letters of credit up to a total of \$2.0 million. At September 30, 2016 and December 31, 2015, there was \$0.9 million and \$2.7 million of outstanding letters of credit in aggregate under the Company’s Letter of Credit Facilities, respectively, which were collateralized with \$0.9 million and \$2.7 million of the Company’s cash, respectively.

#### Notes Payable — Financial Services

The MIF Mortgage Warehousing Agreement is used to finance eligible residential mortgage loans originated by M/I Financial. The Agreement provides a maximum borrowing availability of \$125 million, which increases to \$150 million during certain periods with higher expected mortgage origination volume, specifically from September 25, 2016 to October 15, 2016 and from December 15, 2016 to February 2, 2017. The MIF Mortgage Warehousing Agreement expires on June 23, 2017. Interest on amounts borrowed under the MIF Mortgage Warehousing Agreement is payable at a per annum rate equal to the greater of (1) the floating LIBOR rate plus 250 basis points and (2) 2.75%. The MIF Mortgage Warehousing Agreement also contains certain financial covenants. At September 30, 2016, M/I Financial was in compliance with all financial covenants of the MIF Mortgage Warehousing Agreement. The MIF Mortgage Repurchase Facility is used to finance eligible residential mortgage loans originated by M/I Financial and is structured as a mortgage repurchase facility with a maximum borrowing availability of \$15 million and an expiration date of November 1, 2016. M/I Financial expects to enter into an amendment to the MIF Mortgage Repurchase Facility prior to its expiration that would extend its term for an additional year, but M/I Financial can provide no assurances that it will be able to obtain such an extension. In December 2015, the MIF Mortgage Repurchase Facility was amended to include a “seasonal increase” provision which increased the maximum borrowing availability to \$20 million through January 31, 2016. M/I Financial pays interest on each advance under the MIF Mortgage Repurchase Facility at a per annum rate equal to the floating LIBOR rate plus 250 or 275 basis points depending on the loan type. The MIF Mortgage Repurchase Facility also contains certain financial covenants. At September 30, 2016, M/I Financial was in compliance with all financial covenants of the MIF Mortgage Repurchase Facility.

At September 30, 2016, M/I Financial’s total combined maximum borrowing availability under the two credit facilities was \$165.0 million, an increase from \$150.0 million at December 31, 2015 due to the seasonal increase from September 25, 2016 to October 15, 2016, as described in further detail above. At September 30, 2016 and December 31, 2015, M/I Financial had \$91.5 million and \$123.6 million outstanding on a combined basis under its credit facilities, respectively, and was in compliance with all financial covenants of those agreements for both periods.

#### Senior Notes

As of both September 30, 2016 and December 31, 2015, we had \$300.0 million of our 2021 Senior Notes outstanding. The 2021 Senior Notes bear interest at a rate of 6.75% per year, payable semiannually in arrears on January 15 and July 15 of each year, and mature on January 15, 2021. The 2021 Senior Notes are general, unsecured senior obligations of the Company and the Guarantor Subsidiaries and rank equally in right of payment with all our and the Guarantor Subsidiaries’ existing and future unsecured senior indebtedness. The 2021 Senior Notes are effectively subordinated to our and the Guarantor Subsidiaries’ existing and future secured indebtedness with respect to any assets comprising security or collateral for such indebtedness.

The 2021 Senior Notes contain certain covenants, as more fully described and defined in the indenture governing the 2021 Senior Notes, which limit the ability of the Company and the restricted subsidiaries to, among other things: incur additional indebtedness; make certain payments, including dividends, or repurchase any shares, in an aggregate amount exceeding our “restricted payments basket”; make certain investments; and create or incur certain liens, consolidate or merge with or into other companies, or liquidate or sell or transfer all or substantially all of our assets. These covenants are subject to a number of exceptions and qualifications as described in the indenture governing the 2021 Senior Notes. As of September 30, 2016, the Company was in compliance with all terms, conditions, and covenants under the indenture.

The 2021 Senior Notes are fully and unconditionally guaranteed jointly and severally on a senior unsecured basis by the Guarantor Subsidiaries.

The Company may redeem all or any portion of the 2021 Senior Notes on or after January 15, 2018 at a stated redemption price, together with accrued and unpaid interest thereon. The redemption price will initially be 103.375% of the principal amount outstanding, but will decline to 101.688% of the principal amount outstanding if redeemed during the 12-month period beginning on January 15, 2019, and will further decline to 100.000% of the principal amount outstanding if redeemed on or after January 15, 2020, but prior to maturity.

The indenture governing our 2021 Senior Notes limits our ability to pay dividends on, and repurchase, our common shares and our 9.75% Series A Preferred Shares (the “Series A Preferred Shares”) to the amount of the positive balance in our “restricted payments basket,” as defined in the indenture. The “restricted payments basket” is equal to \$125.0 million plus (1) 50% of our aggregate consolidated net income (or minus 100% of our aggregate consolidated net loss) from October 1, 2015, excluding income or loss from Unrestricted Subsidiaries, plus (2) 100% of the net cash proceeds from either contributions to the common equity of the Company after December 31, 2015 or the sale of qualified equity interests, plus other items and subject to other exceptions. The restricted payments basket was \$137.7 million and \$128.5 million at September 30, 2016 and December 31, 2015, respectively. The determination to pay future dividends on, or make future repurchases of, our common shares or Series A Preferred Shares will be at the discretion of our board of directors and will depend upon our results of operations, financial condition, capital requirements and compliance with debt covenants and the terms of our Series A Preferred Shares, and other factors deemed relevant by our board of directors.

#### Convertible Senior Subordinated Notes

As of both September 30, 2016 and December 31, 2015, we had \$86.3 million of our 2018 Convertible Senior Subordinated Notes outstanding. The 2018 Convertible Senior Subordinated Notes bear interest at a rate of 3.0% per year, payable semiannually in arrears on March 1 and September 1 of each year. The 2018 Convertible Senior Subordinated Notes mature on March 1, 2018. At any time prior to the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert their 2018 Convertible Senior Subordinated Notes into the Company’s common shares. The conversion rate initially equals 30.9478 shares per \$1,000 of principal amount. This corresponds to an initial conversion price of approximately \$32.31 per common share, which equates to approximately 2.7 million common shares. The conversion rate is subject to adjustment upon the occurrence of certain events. The 2018 Convertible Senior Subordinated Notes are fully and unconditionally guaranteed jointly and severally on a senior subordinated unsecured basis by the Guarantor Subsidiaries. The 2018 Convertible Senior Subordinated Notes are senior subordinated unsecured obligations of the Company and the Guarantor Subsidiaries, are subordinated in right of payment to our and the Guarantor Subsidiaries’ existing and future senior indebtedness and are also effectively subordinated to our and the Guarantor Subsidiaries’ existing and future secured indebtedness with respect to any assets comprising security or collateral for such indebtedness. The indenture governing the 2018 Convertible Senior Subordinated Notes requires the Company to repurchase the notes (subject to certain exceptions), at a holder’s option, upon the occurrence of a fundamental change (as defined in the indenture).

The Company may redeem for cash any or all of the 2018 Convertible Senior Subordinated Notes (except for any 2018 Convertible Senior Subordinated Notes that the Company is required to repurchase in connection with a fundamental change), but only if the last reported sale price of the Company’s common shares exceeds 130% of the applicable conversion price for the notes on each of at least 20 applicable trading days. The 20 tradin