

TORO CO  
Form 10-Q  
September 11, 2007

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**  
**FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
**For the Quarterly Period Ended August 3, 2007**

**THE TORO COMPANY**  
(Exact name of registrant as specified in its charter)

**Delaware**  
(State of Incorporation)

**1-8649**  
(Commission File Number)

**41-0580470**  
(I.R.S. Employer Identification  
Number)

**8111 Lyndale Avenue South**  
**Bloomington, Minnesota 55420**  
**Telephone number: (952) 888-8801**

(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

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Large accelerated filer  S

Accelerated filer  £

Non-accelerated filer  £

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

Yes  £ No  S

The number of shares of Common Stock outstanding as of August 31, 2007 was 39,705,479.

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**PART I. FINANCIAL INFORMATION**  
**Item 1. FINANCIAL STATEMENTS**  
**THE TORO COMPANY AND SUBSIDIARIES**  
**Condensed Consolidated Statements of Earnings (Unaudited)**  
**(Dollars and shares in thousands, except per share data)**

|   | Three Months Ended |                   | Nine Months Ended |                   |
|---|--------------------|-------------------|-------------------|-------------------|
|   | August 3,<br>2007  | August 4,<br>2006 | August 3,<br>2007 | August 4,<br>2006 |
| Net sales   | \$ 478,707         | \$ 477,861        | \$ 1,544,448      | \$ 1,506,505      |
| Cost of sales   | 301,264            | 307,525           | 982,224           | 974,039           |
| Gross profit  | 177,443            | 170,336           | 562,224           | 532,466           |
| Selling, general, and administrative expense                            | 110,598            | 108,615           | 348,722           | 340,129           |
| Earnings from operations  | 66,845             | 61,721            | 213,502           | 192,337           |
| Interest expense  | (4,959)            | (4,677)           | (15,235)          | (14,097)          |
| Other income, net   | 1,954              | 2,756             | 5,821             | 6,088             |
| Earnings before income taxes  | 63,840             | 59,800            | 204,088           | 184,328           |
| Provision for income taxes  | 21,354             | 19,478            | 68,186            | 59,645            |
| Net earnings  | \$ 42,486          | \$ 40,322         | \$ 135,902        | \$ 124,683        |
| Basic net earnings per share of common stock                            | \$ 1.05            | \$ 0.94           | \$ 3.32           | \$ 2.88           |
| Diluted net earnings per share of common stock                          | \$ 1.02            | \$ 0.91           | \$ 3.23           | \$ 2.78           |
| Weighted-average number of shares of common stock outstanding – Basic   | 40,569             | 42,852            | 40,938            | 43,283            |
| Weighted-average number of shares of common stock outstanding – Diluted | 41,803             | 44,360            | 42,113            | 44,806            |

See accompanying notes to condensed consolidated financial statements.

**THE TORO COMPANY AND SUBSIDIARIES**  
**Condensed Consolidated Balance Sheets (Unaudited)**  
**(Dollars in thousands, except per share data)**

|  | August 3,<br>2007 | August 4,<br>2006 | October 31,<br>2006 |
|--|-------------------|-------------------|---------------------|
| <b><u>ASSETS</u></b>   |                   |                   |                     |
| Cash and cash equivalents  | \$ 94,192         | \$ 24,815         | \$ 55,523           |
| Receivables, net   | 379,788           | 394,038           | 294,833             |
| Inventories, net   | 243,437           | 255,031           | 238,544             |
| Prepaid expenses and other current assets  | 13,018            | 14,624            | 9,437               |
| Deferred income taxes  | 58,499            | 56,326            | 55,846              |
| Total current assets   | 788,934           | 744,834           | 654,183             |
| Property, plant, and equipment   | 569,981           | 528,846           | 540,339             |
| Less accumulated depreciation  | 399,233           | 365,143           | 374,016             |
|  | 170,748           | 163,703           | 166,323             |
| Deferred income taxes  | 1,861             | -                 | 1,862               |
| Other assets   | 11,269            | 8,197             | 10,011              |
| Goodwill   | 81,768            | 81,402            | 81,469              |
| Other intangible assets, net   | 5,526             | 5,332             | 5,225               |
| Total assets   | \$ 1,060,106      | \$ 1,003,468      | \$ 919,073          |
| <b><u>LIABILITIES AND STOCKHOLDERS' EQUITY</u></b>   |                   |                   |                     |
| Current portion of long-term debt  | \$ -              | \$ 12             | \$ -                |
| Short-term debt  | 1,449             | 24,535            | 320                 |
| Accounts payable   | 83,366            | 86,998            | 89,673              |
| Accrued liabilities  | 266,383           | 269,145           | 252,636             |
| Total current liabilities  | 351,198           | 380,690           | 342,629             |
| Long-term debt, less current portion   | 223,157           | 175,000           | 175,000             |
| Deferred revenue and other long-term liabilities   | 10,354            | 10,477            | 9,415               |
| <b>Stockholders' equity:</b>   |                   |                   |                     |
| Preferred stock, par value \$1.00, authorized 1,000,000 voting and 850,000 non-voting shares, none issued and outstanding  | -                 | -                 | -                   |
| Common stock, par value \$1.00, authorized 100,000,000 shares, issued and outstanding 39,774,219 shares as of August 3, 2007 (net of 14,258,001 treasury shares), 41,374,724 shares as of August 4, 2006 (net of 12,657,496 treasury shares), and 40,355,714 shares as of October 31, 2006 (net of 13,676,506 treasury shares) | 39,774            | 41,375            | 40,356              |
| Retained earnings  | 439,780           | 405,947           | 358,522             |
| Accumulated other comprehensive loss   | (4,157)           | (10,021)          | (6,849)             |
| Total stockholders' equity   | 475,397           | 437,301           | 392,029             |
| Total liabilities and stockholders' equity   | \$ 1,060,106      | \$ 1,003,468      | \$ 919,073          |

See accompanying notes to condensed consolidated financial statements.

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**THE TORO COMPANY AND SUBSIDIARIES**  
**Condensed Consolidated Statements of Cash Flows (Unaudited)**  
**(Dollars in thousands)**

|   | Nine Months Ended |                   |
|---|-------------------|-------------------|
|   | August 3,<br>2007 | August 4,<br>2006 |
| <b>Cash flows from operating activities:</b>  |                   |                   |
| Net earnings  | \$ 135,902        | \$ 124,683        |
| Adjustments to reconcile net earnings to net cash provided by operating activities: |                   |                   |
| Equity losses from investments  | 136               | 1,004             |
| Provision for depreciation and amortization   | 30,263            | 31,490            |
| Gain on disposal of property, plant, and equipment                                  | (133)             | (84)              |
| Stock-based compensation expense  | 5,474             | 6,018             |
| (Increase) decrease in deferred income taxes  | (2,323)           | 419               |
| Changes in operating assets and liabilities:  |                   |                   |
| Receivables, net  | (86,942)          | (99,062)          |
| Inventories, net  | 101               | (17,481)          |
| Prepaid expenses and other assets   | (3,693)           | 3,042             |
| Accounts payable, accrued expenses, and deferred revenue                            | 4,948             | 13,836            |
| Net cash provided by operating activities   | 83,733            | 63,865            |
| <b>Cash flows from investing activities:</b>  |                   |                   |
| Purchases of property, plant, and equipment   | (32,863)          | (26,693)          |
| Proceeds from asset disposals   | 152               | 908               |
| Increase in investment in affiliates  | -                 | (371)             |
| Decrease in other assets  | 734               | 5,716             |
| Acquisition, net of cash acquired   | (1,088)           | -                 |
| Net cash used in investing activities   | (33,065)          | (20,440)          |
| <b>Cash flows from financing activities:</b>  |                   |                   |
| Increase in short-term debt   | 998               | 24,191            |
| Issuance of long-term debt, net of costs  | 121,465           | -                 |
| Repayments of long-term debt  | (75,000)          | (34)              |
| Excess tax benefits from stock-based awards   | 12,956            | 16,270            |
| Proceeds from exercise of stock options   | 11,456            | 8,196             |
| Purchases of Toro common stock  | (70,382)          | (97,388)          |
| Dividends paid on Toro common stock   | (14,729)          | (11,700)          |
| Net cash used in financing activities   | (13,236)          | (60,465)          |
| Effect of exchange rates on cash  | 1,237             | 453               |
| Net increase (decrease) in cash and cash equivalents                                | 38,669            | (16,587)          |
| Cash and cash equivalents as of the beginning of the fiscal period                  | 55,523            | 41,402            |
| Cash and cash equivalents as of the end of the fiscal period                        | \$ 94,192         | \$ 24,815         |

See accompanying notes to condensed consolidated financial statements.





**THE TORO COMPANY AND SUBSIDIARIES**  
**Notes to Condensed Consolidated Financial Statements (Unaudited)**  
**August 3, 2007**

**Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and do not include all the information and notes required by accounting principles generally accepted in the United States of America for complete financial statements. Unless the context indicates otherwise, the terms “company” and “Toro” refer to The Toro Company and its subsidiaries. In the opinion of management, the unaudited condensed consolidated financial statements include all adjustments, consisting primarily of recurring accruals, considered necessary for a fair presentation of the financial position and results of operations. Since the company’s business is seasonal, operating results for the nine months ended August 3, 2007 cannot be annualized to determine the expected results for the fiscal year ending October 31, 2007. Certain amounts from prior period’s financial statements have been reclassified to conform to this period’s presentation.

The company’s fiscal year ends on October 31, and quarterly results are reported based on three month periods that generally end on the Friday closest to the quarter end. For comparative purposes, however, the company’s second and third quarters always include exactly 13 weeks of results so that the quarter end date for these two quarters is not necessarily the Friday closest to the quarter end.

For further information, refer to the consolidated financial statements and notes included in the company’s Annual Report on Form 10-K for the fiscal year ended October 31, 2006. The policies described in that report are used for preparing quarterly reports.

**Accounting Policies**

In preparing the consolidated financial statements in conformity with U.S. generally accepted accounting principles, management must make decisions that impact the reported amounts and the related disclosures. Such decisions include the selection of the appropriate accounting principles to be applied and the assumptions on which to base accounting estimates. In reaching such decisions, management applies judgments based on its understanding and analysis of the relevant circumstances, historical experience, and actuarial valuations. Actual amounts could differ from those estimated at the time the consolidated financial statements are prepared. Note 1 to the consolidated financial statements in the company’s most recent Annual Report on Form 10-K provides a summary of the significant accounting policies followed in the preparation of the financial statements. Other footnotes to the consolidated financial statements in the company’s Annual Report on Form 10-K describe various elements of the financial statements and the assumptions made in determining specific amounts.

**Comprehensive Income**

Comprehensive income and the components of other comprehensive income (loss) were as follows:

| (Dollars in thousands)   | Three Months Ended |                   | Nine Months Ended |                   |
|--|--------------------|-------------------|-------------------|-------------------|
|  | August 3,<br>2007  | August 4,<br>2006 | August 3,<br>2007 | August 4,<br>2006 |
| Net earnings   | \$ 42,486          | \$ 40,322         | \$ 135,902        | \$ 124,683        |
| Other comprehensive income (loss):                             |                    |                   |                   |                   |
| Cumulative translation adjustments                             | 1,239              | 450               | 4,563             | 2,245             |
| Unrealized (loss) gain on derivative instruments, net of taxes | (498)              | 828               | (1,871)           | (685)             |
| Comprehensive income   | \$ 43,227          | \$ 41,600         | \$ 138,594        | \$ 126,243        |



## Stock-Based Compensation

The company accounts for stock-based compensation awards in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (Revised 2004), "Share-Based Payment." During the first two quarters of fiscal 2007, option awards were granted with an exercise price equal to the market price of the company's common stock as of the date of grant. For certain non-officer employees, the options vest after two years from the date of grant and have a five-year contractual term. Other options granted during the first quarter of fiscal 2007 vest one-third each year over a three-year period and have a ten-year contractual term. Compensation expense equal to the grant date fair value is recognized for these awards over the vesting period. The company also issues performance shares to key employees. The company determines the fair value of these performance shares as of the date of grant and recognizes the expense over the vesting period. Total compensation expense for option awards and performance shares for both the third quarter of fiscal 2007 and 2006 was \$1.6 million. Year-to-date compensation expense for option awards and performance shares through the third quarter of fiscal 2007 and 2006 was \$5.5 million and \$5.6 million, respectively.

The fair value of each share-based option is estimated on the date of grant using a Black-Scholes valuation method that uses the assumptions noted in the table below. The expected life is a significant assumption as it determines the period for which the risk-free interest rate, volatility, and dividend yield must be applied. The expected life is the average length of time over which the employee groups are expected to exercise their options, which is based on historical experience with similar grants. Separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. Expected volatilities are based on the movement of the company's stock over the most recent historical period equivalent to the expected life of the option. The risk-free interest rate for periods within the contractual life of the option is based on the U.S. Treasury rate over the expected life at the time of grant. Dividend yield is estimated over the expected life based on the company's dividend policy, historical dividends paid, expected increase in future cash dividends, and expected increase in the company's stock price. The following table illustrates the assumptions for options granted in the following fiscal periods.

|                                  | Fiscal 2007     | Fiscal 2006     |
|----------------------------------|-----------------|-----------------|
| Expected life of option in years | 3 – 6.5         | 2.5 – 6.5       |
| Expected volatility              | 24.96% - 26.44% | 25.26% - 26.96% |
| Weighted-average volatility      | 25.65%          | 26.12%          |
| Risk-free interest rate          | 4.420% - 4.528% | 4.399% - 4.526% |
| Expected dividend yield          | 0.78%- 0.90%    | 0.65%- 0.70%    |
| Weighted-average dividend yield  | 0.84%           | 0.67%           |

The weighted-average fair value of options granted during the first two quarters of fiscal 2007 was \$12.32 per share and during the first quarter of fiscal 2006 was \$10.90 per share. The fair value of performance shares granted during the first quarter of fiscal 2007 and fiscal 2006 was \$44.90 per share and \$41.44 per share, respectively. No options were granted during the third quarter of fiscal 2007 or the second and third quarters of fiscal 2006, and no performance shares were granted during the second and third quarters of fiscal 2007 and fiscal 2006.

## Inventories

Inventories are valued at the lower of cost or net realizable value, with cost determined by the last-in, first-out (LIFO) method for most inventories and first-in, first-out (FIFO) method for all other inventories. The company establishes a reserve for excess, slow-moving, and obsolete inventory that is equal to the difference between the cost and estimated net realizable value for that inventory. These reserves are based on a review and comparison of current inventory levels to the planned production as well as planned and historical sales of the inventory.

Inventories were as follows:

| (Dollars in thousands) | August 3,<br>2007 | August 4,<br>2006 | October 31,<br>2006 |
|------------------------|-------------------|-------------------|---------------------|
|------------------------|-------------------|-------------------|---------------------|

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|                                   |            |            |            |
|-----------------------------------|------------|------------|------------|
| Raw materials and work in process | \$ 65,615  | \$ 65,005  | \$ 67,976  |
| Finished goods and service parts  | 237,744    | 247,387    | 229,137    |
|                                   | 303,359    | 312,392    | 297,113    |
| Less: LIFO                        | 40,860     | 40,011     | 40,860     |
| Other reserves                    | 19,062     | 17,350     | 17,709     |
| Total                             | \$ 243,437 | \$ 255,031 | \$ 238,544 |

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**Per Share Data**

Reconciliations of basic and diluted weighted-average shares of common stock outstanding are as follows:

| (Shares in thousands)   | Three Months Ended |                   | Nine Months Ended |                   |
|---|--------------------|-------------------|-------------------|-------------------|
|   | August 3,<br>2007  | August 4,<br>2006 | August 3,<br>2007 | August 4,<br>2006 |
| <i>Basic</i>  |                    |                   |                   |                   |
| Weighted-average number of shares of common stock   | 40,569             | 42,852            | 40,910            | 43,232            |
| Assumed issuance of contingent shares   | -                  | -                 | 28                | 51                |
| Weighted-average number of shares of common stock and assumed issuance of contingent shares                                 | 40,569             | 42,852            | 40,938            | 43,283            |
| <i>Diluted</i>  |                    |                   |                   |                   |
| Weighted-average number of shares of common stock and assumed issuance of contingent shares                                 | 40,569             | 42,852            | 40,938            | 43,283            |
| Effect of dilutive securities   | 1,234              | 1,508             | 1,175             | 1,523             |
| Weighted-average number of shares of common stock, assumed issuance of contingent shares, and effect of dilutive securities | 41,803             | 44,360            | 42,113            | 44,806            |

**Segment Data**

The presentation of segment information reflects the manner in which management organizes segments for making operating decisions and assessing performance. On this basis, the company has determined it has two reportable business segments: Professional and Residential. The Other segment consists of company-owned distributor operations in the United States and corporate activities, including corporate financing activities and elimination of intersegment revenues and expenses.

The following table shows the summarized financial information concerning the company's reportable segments:

| (Dollars in thousands)                   |              |             |           |              |
|--|--------------|-------------|-----------|--------------|
| <u>Three months ended August 3, 2007</u> | Professional | Residential | Other     | Total        |
| Net sales                                | \$ 332,014   | \$ 132,981  | \$ 13,712 | \$ 478,707   |
| Intersegment gross sales                 | 11,972       | 1,655       | (13,627)  | -            |
| Earnings (loss) before income taxes      | 70,887       | 8,246       | (15,293)  | 63,840       |
| <u>Three months ended August 4, 2006</u> | Professional | Residential | Other     | Total        |
| Net sales                                | \$ 319,733   | \$ 145,308  | \$ 12,820 | \$ 477,861   |
| Intersegment gross sales                 | 12,580       | 1,945       | (14,525)  | -            |
| Earnings (loss) before income taxes      | 62,474       | 8,752       | (11,426)  | 59,800       |
| <u>Nine months ended August 3, 2007</u>  | Professional | Residential | Other     | Total        |
| Net sales                                | \$ 1,052,013 | \$ 463,043  | \$ 29,392 | \$ 1,544,448 |
| Intersegment gross sales                 | 35,011       | 4,900       | (39,911)  | -            |
| Earnings (loss) before income taxes      | 227,737      | 40,055      | (63,704)  | 204,088      |
| Total assets                             | 522,963      | 210,660     | 326,483   | 1,060,106    |
| <u>Nine months ended August 4, 2006</u>  | Professional | Residential | Other     | Total        |
| Net sales                                | \$ 1,012,436 | \$ 463,786  | \$ 30,283 | \$ 1,506,505 |
| Intersegment gross sales                 | 39,117       | 6,132       | (45,249)  | -            |
| Earnings (loss) before income taxes      | 208,311      | 32,037      | (56,020)  | 184,328      |
| Total assets                             | 511,953      | 217,037     | 274,478   | 1,003,468    |



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The following table presents the details of the Other segment operating loss before income taxes:

| (Dollars in thousands)                     | Three Months Ended |                | Nine Months Ended |                |
|--|--------------------|----------------|-------------------|----------------|
|  | August 3, 2007     | August 4, 2006 | August 3, 2007    | August 4, 2006 |
| Corporate expenses                         | \$ (18,408)        | \$ (15,145)    | \$ (66,701)       | \$ (63,071)    |
| Finance charge revenue                     | 590                | 806            | 1,451             | 2,046          |
| Elimination of corporate financing expense | 4,072              | 5,136          | 11,178            | 14,052         |
| Interest expense, net                      | (4,959)            | (4,677)        | (15,235)          | (14,097)       |
| Other                                      | 3,412              | 2,454          | 5,603             | 5,050          |
| Total                                      | \$ (15,293)        | \$ (11,426)    | \$ (63,704)       | \$ (56,020)    |

### Goodwill

The changes in the net carrying amount of goodwill for the first nine months of fiscal 2007 were as follows:

| (Dollars in thousands)       | Professional Segment           | Residential Segment | Total     |
|------------------------------|--------------------------------|---------------------|-----------|
|                              | Balance as of October 31, 2006 | \$ 70,948           | \$ 10,521 |
| Translation adjustment       | 148                            | 151                 | 299       |
| Balance as of August 3, 2007 | \$ 71,096                      | \$ 10,672           | \$ 81,768 |

### Other Intangible Assets

The components of other amortizable intangible assets were as follows:

| (Dollars in thousands)             | August 3, 2007        |                          | October 31, 2006      |                          |
|------------------------------------|-----------------------|--------------------------|-----------------------|--------------------------|
|                                    | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Patents                            | \$ 6,553              | \$ (6,119)               | \$ 6,553              | \$ (5,964)               |
| Non-compete agreements             | 1,000                 | (904)                    | 1,000                 | (885)                    |
| Customer related                   | 1,422                 | (355)                    | 1,336                 | (234)                    |
| Other                              | 3,201                 | (2,116)                  | 2,363                 | (1,615)                  |
| Total                              | \$ 12,176             | \$ (9,494)               | \$ 11,252             | \$ (8,698)               |
| Total other intangible assets, net | \$ 2,682              |                          | \$ 2,554              |                          |

Amortization expense for intangible assets during the first nine months of fiscal 2007 was \$773,000. Estimated amortization expense for the remainder of fiscal 2007 and succeeding fiscal years is as follows: fiscal 2007 (remainder), \$266,000; fiscal 2008, \$864,000; fiscal 2009, \$515,000; fiscal 2010, \$241,000; fiscal 2011, \$175,000; fiscal 2012, \$175,000 and after fiscal 2012, \$446,000.

The company also has \$2.8 million of non-amortizable intangible assets related to the Hayter brand name.

### Senior Notes

On April 26, 2007, the company issued \$125.0 million in aggregate principal amount of 6.625% senior notes due May 1, 2037. The senior notes were priced at 98.513% of par value, and the resulting discount of \$1.9 million associated with the issuance of these senior notes is being amortized over the term of the senior notes using the effective interest

rate method. The underwriting fee and direct debt issue costs totaling \$1.5 million will be amortized over the life of the senior notes. Although the coupon rate of the notes is 6.625%, the effective interest rate is 6.741% after taking into account the issuance discount. Interest on the senior notes is payable semi-annually, on May 1 and November 1 of each year. The notes are unsecured senior obligations of the company and rank equally with the company's other unsecured and unsubordinated indebtedness from time to time outstanding. The company may redeem some or all of the senior notes at any time at the greater of the full principal amount of the senior notes being redeemed, or the present value of the remaining scheduled payments of principal and interest discounted to the redemption date on a semi-annual basis at the treasury rate plus 30 basis points, plus, in both cases, accrued and unpaid



interest. The company used the proceeds from the issuance of the senior notes to pay \$75.0 million principal amount of 7.125% notes that were due June 15, 2007 as well as for general corporate uses.

### Warranty Guarantees

The company's products are warranted to ensure customer confidence in design, workmanship, and overall quality. Warranty coverage ranges from a period of six months to seven years, and generally covers parts, labor, and other expenses for non-maintenance repairs. Warranty coverage generally does not cover operator abuse or improper use. An authorized Toro distributor or dealer must perform warranty work. Distributors, dealers, and contractors submit claims for warranty reimbursement and are credited for the cost of repairs, labor, and other expenses as long as the repairs meet prescribed standards. Warranty expense is accrued at the time of sale based on the estimated number of products under warranty, historical average costs incurred to service warranty claims, the trend in the historical ratio of claims to sales, the historical length of time between the sale and resulting warranty claim, and other minor factors. Special warranty reserves are also accrued for major rework campaigns. The company also sells extended warranty coverage on select products for a prescribed period after the factory warranty period expires.

Warranty provisions, claims, and changes in estimates for the first nine-month periods in fiscal 2007 and fiscal 2006 were as follows:

| (Dollars in thousands)<br>Nine Months Ended | Beginning<br>Balance | Warranty<br>Provisions | Warranty<br>Claims | Changes in<br>Estimates | Ending<br>Balance |
|---|----------------------|------------------------|--------------------|-------------------------|-------------------|
| August 3, 2007                              | \$ 65,235            | \$ 37,409              | \$ (30,539)        | \$ (2,271)              | \$ 69,834         |
| August 4, 2006                              | \$ 61,385            | \$ 34,668              | \$ (27,110)        | \$ 2,509                | \$ 71,452         |

### Postretirement Benefit Plans

The following table presents the components of net periodic benefit costs:

| (Dollars in thousands) | Three Months Ended |                   | Nine Months Ended |                   |
|------------------------|--------------------|-------------------|-------------------|-------------------|
|                        | August 3,<br>2007  | August 4,<br>2006 | August 3,<br>2007 | August 4,<br>2006 |
| Service cost           | \$ 95              | \$ 95             | \$ 284            | \$ 285            |
| Interest cost          | 124                | 128               | 371               | 384               |
| Prior service cost     | (49)               | (48)              | (145)             | (144)             |
| Amortization of losses | 55                 | 68                | 163               | 204               |
| Net expense            | \$ 225             | \$ 243            | \$ 673            | \$ 729            |

As of August 3, 2007, approximately \$375,000 of contributions had been made. The company presently expects to contribute a total of \$500,000 to its postretirement health-care benefit plan in fiscal 2007, including contributions made through August 3, 2007.

The company maintains The Toro Company Investment, Savings and Employee Stock Ownership Plan for eligible employees. The company's expenses under this plan were \$3.8 million and \$13.7 million for the third quarter and year-to-date periods in fiscal 2007, respectively, and \$3.8 million and \$12.1 million for the third quarter and year-to-date periods in fiscal 2006, respectively.

During the first quarter of fiscal 2007, the company began to offer participants in the company's deferred compensation plans the option to invest their deferred compensation in multiple investment options. At the same time, the company elected to fund the majority of the deferred compensation plans, which amounted to \$18 million. The fair value of the investment in the deferred compensation plans as of August 3, 2007 was \$18.6 million, which reduced the company's deferred compensation liability reflected in accrued liabilities on the condensed consolidated balance sheet.



## **Derivative Instruments and Hedging Activities**

The company uses derivative instruments to assist in the management of exposure to currency exchange and interest rates. The company uses derivative instruments only to limit underlying exposure to currency and interest rate fluctuations, and not for trading purposes. The company documents relationships between hedging instruments and the hedged items, as well as its risk-management objective and strategy for undertaking various hedge transactions. The company assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are effective in offsetting changes in cash flows of the hedged item.

The company enters into foreign currency exchange contracts to hedge the risk from forecasted settlements in local currencies of trade sales and purchases. These contracts are designated as cash flow hedges and are reported at fair value as a hedge asset or liability in prepaid expenses or accrued liabilities, as applicable. Changes in the fair value of these contracts are reported in accumulated other comprehensive loss until the hedged transaction occurs. Once the forecasted transaction has been recognized as a sale or inventory purchase and a related asset or liability recorded in the balance sheet, the related fair value of the derivative hedge contract is reclassified from accumulated other comprehensive loss into earnings. During the three and nine months ended August 3, 2007, the amount of losses reclassified to earnings for such cash flow hedges was \$0.3 million and \$0.6 million, respectively. For the nine months ended August 3, 2007, the losses treated as a reduction to net sales for contracts to hedge trade sales were \$1.3 million and the gains treated as a reduction of cost of sales for contracts to hedge inventory purchases were \$0.7 million. As of August 3, 2007, the notional amount of such contracts outstanding was \$80.7 million. The unrecognized after-tax loss portion of the fair value of the contracts recorded in accumulated other comprehensive loss as of August 3, 2007 was \$1.3 million.

The company also enters into other foreign currency exchange contracts. These contracts are intended to hedge intracompany financing transactions and other activities and are not designated as hedging instruments under the accounting criteria of SFAS No. 133; therefore, changes in fair value of these instruments are recorded in other income, net.

During the second quarter of fiscal 2007, the company entered into three treasury lock agreements based on a 30-year US Treasury security with a principal balance of \$30 million for two of the agreements and \$40 million for the third agreement. These treasury lock agreements were entered into as hedges against changes in market interest rates in anticipation of our April 2007 senior note offering and provided for a single payment at their maturity, which was April 23, 2007, based on the change in value of the reference treasury security. These agreements were designated as cash flow hedges and resulted in a net settlement of \$0.2 million. This loss is recorded in accumulated other comprehensive loss, which will be amortized to interest expense over the 30 year term of the debt.

## **Contingencies**

On June 3, 2004, eight individuals who claim to have purchased lawnmowers in Illinois and Minnesota filed a lawsuit in Illinois state court against the company and eight other defendants alleging that the horsepower labels on the products the plaintiffs purchased were inaccurate. On May 17, 2006, the plaintiffs filed an amended complaint to add 84 additional plaintiffs and an engine manufacturer as an additional defendant. The amended complaint asserts violations of the federal Racketeer Influenced and Corrupt Organizations (RICO) Act and statutory and common law claims arising from the laws of 48 states. The plaintiffs seek certification of a class of all persons in the United States who, beginning January 1, 1994 through the present, purchased a lawnmower containing a two-stroke or four-stroke gas combustible engine up to 30 horsepower that was manufactured or sold by the defendants. The amended complaint seeks an injunction, unspecified compensatory and punitive damages, treble damages under the RICO Act and attorneys' fees. In late May 2006, the case was removed to Federal court in the Southern District of Illinois. On August 1, 2006, all of the defendants, except MTD Products Inc., filed motions to dismiss claims in the amended complaint. On August 4, 2006, the plaintiffs filed a motion for preliminary approval of a settlement agreement with MTD Products Inc. and certification of a settlement class. All remaining non-settling defendants have filed counterclaims against MTD Products Inc. for potential contribution amounts, and MTD Products Inc. has filed cross claims against the non-settling defendants. On December 21, 2006, another defendant, American Honda Motor

Company, notified us that it had reached an agreement of settlement with the plaintiffs. On March 30, 2007, the court entered an order dismissing plaintiffs' complaint, subject to the ability to re-plead certain claims pursuant to a detailed written order to follow. As of the date hereof, the court has not yet entered the detailed written order. We continue to evaluate this lawsuit and are unable to reasonably estimate the likelihood of loss or the amount or range of potential loss that could result from this litigation. Therefore, no accrual has been established for potential loss in connection with this lawsuit. We are also unable to assess at this time whether the lawsuit will have a material adverse effect on our annual consolidated operating results or financial condition, although an unfavorable resolution could be material to our consolidated operating results for a particular period.

In July 2005, Textron Innovations Inc., the patent holding company of Textron, Inc., filed a lawsuit in Delaware Federal District Court against the company for patent infringement. Textron alleges that we willfully infringe certain claims of three Textron patents by selling our Groundsmaster® commercial mowers. Textron seeks damages for our past sales and an injunction against future infringement. In August and November 2005, we answered the complaint, asserting defenses and counterclaims of

non-infringement, invalidity and equitable estoppel. Following the Court's order in October 2006 construing the claims of Textron's patents, discovery in the case was closed in February 2007. In March 2007, following unsuccessful attempts to mediate the case, we filed with the United States Patent and Trademark Office (USPTO) to have Textron's patents reexamined. Our reexamination applications are pending in the USPTO. In April 2007, the Court granted our motion to stay the litigation and, in June 2007, denied Textron's motion for reconsideration of the Court's order staying the proceedings. We continue to evaluate this lawsuit and are unable to reasonably estimate the likelihood of loss or the amount or range of potential loss that could result from the litigation. Therefore, no accrual has been established for potential loss in connection with this lawsuit. While we do not believe that the lawsuit will have a material adverse effect on our consolidated financial condition, an unfavorable resolution could be material to our consolidated operating results for a particular period.

We are a party to litigation in the ordinary course of business. Litigation occasionally involves claims for punitive as well as compensatory damages arising out of use of our products. We are also subject to administrative proceedings with respect to claims involving the discharge of hazardous substances into the environment. Some of these claims assert damages and liability for remedial investigations and clean up costs. We are also typically involved in commercial disputes, employment disputes, and patent litigation cases in the ordinary course of business, both as a plaintiff and as a defendant. While the ultimate results of the current cases are unknown at this time, management believes that, except for the lawsuits discussed above, the outcomes of these cases are unlikely to have a material adverse effect on our consolidated operating results or financial position. Further, although we are self-insured to some extent, we maintain insurance against certain product liability losses.

## **Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

### **Nature of Operations**

The Toro Company is in the business of designing, manufacturing, and marketing professional turf maintenance equipment and services, turf and agricultural irrigation systems, landscaping equipment, and residential yard products worldwide. We sell our products through a network of distributors, dealers, hardware retailers, home centers, mass retailers, and over the Internet, mainly through Internet retailers. Our businesses are organized into two segments: professional and residential. A third segment called "other" consists of domestic distribution companies and corporate activities. Our emphasis is to provide well-built, dependable, and innovative products supported by an extensive service network. A significant portion of our revenues has historically been attributable to new and enhanced products. As part of our "GrowLean" initiative, we are focusing our efforts on revenue growth, profit improvement, and asset management, while maximizing our use of Lean methods to reduce costs and improve quality and efficiency in our manufacturing facilities and corporate offices. The goals of this initiative are to grow revenues at an average annual rate of 8 percent or more and achieve a consistent after-tax annual return on net sales of 7 percent or more over the three-year period ending October 31, 2009. We have added a long-term asset management goal to reduce average net working capital as a percent of net sales below 20 percent, or in the "teens." We define average net working capital as accounts receivable plus inventory less trade payables.

### **RESULTS OF OPERATIONS**

#### **Overview**

Our results for the third quarter of fiscal 2007 were positive with net earnings growth of 5.4 percent on a slight increase in net sales of 0.2 percent compared to the third quarter of fiscal 2006. Fiscal 2007 year-to-date net earnings rose 9.0 percent compared to the same period last fiscal year on a year-to-date sales growth rate of 2.5 percent. Continued strong international performance and acceptance of new products in both the professional and residential segments more than offset a decline in sales of snow thrower products and landscape contractor equipment for the fiscal 2007 year-to-date period compared to the same period last fiscal year. International sales continued its growth momentum with an increase of 5.9 percent and 9.9 percent for the third quarter and year-to-date period of fiscal 2007,

respectively, compared to the same periods last fiscal year. Net earnings as a percentage of net sales rose to 8.9 percent and 8.8 percent in the third quarter and year-to-date period of fiscal 2007, respectively, from 8.4 percent and 8.3 percent in the third quarter and year-to-date period of fiscal 2006, respectively. Higher gross margins contributed to the earnings improvement while a higher effective tax rate and increase in selling, general, and administrative expenses somewhat hampered the earnings growth rate. We also increased our third quarter cash dividend by 33 percent compared to the quarterly cash dividend paid in the third quarter of fiscal 2006.

Our fiscal 2007 third quarter financial results were not as strong as the financial results for the first half of fiscal 2007. However, we are optimistic that our results for the full fiscal year of 2007 will be positive. We continue to keep a cautionary eye on world economies, retail demand, field inventory levels, commodity prices, weather, competitive actions, and other factors identified below under the heading "Forward-Looking Information," which could cause our actual results to differ from our anticipated outlook.

## Net Earnings

Net earnings for the third quarter of fiscal 2007 were \$42.5 million or \$1.02 per diluted share compared to \$40.3 million or \$0.91 per diluted share for the third quarter of fiscal 2006, a net earnings per diluted share increase of 12.1 percent. Year-to-date net earnings in fiscal 2007 were \$135.9 million or \$3.23 per diluted share compared to \$124.7 million or \$2.78 per diluted share last fiscal year, a net earnings per diluted share increase of 16.2 percent. The primary factors contributing to these increases were higher sales volumes and an increase in gross margins, somewhat offset by higher selling, general, and administrative costs, a higher effective tax rate, and an increase in interest expense. In addition, third quarter and year-to-date fiscal 2007 net earnings per diluted share were benefited by approximately \$0.06 per share and \$0.20 per share, respectively, compared to the same periods in fiscal 2006 as a result of reduced shares outstanding from the repurchase of our common stock.

The following table summarizes the major operating costs and other income as a percentage of net sales:

|  | Three Months Ended |                   | Nine Months Ended |                   |
|--|--------------------|-------------------|-------------------|-------------------|
|  | August 3,<br>2007  | August 4,<br>2006 | August 3,<br>2007 | August 4,<br>2006 |
| Net sales                                    | 100.0%             | 100.0%            | 100.0%            | 100.0%            |
| Cost of sales                                | 62.9               | 64.4              | 63.6              | 64.7              |
| Gross profit                                 | 37.1               | 35.6              | 36.4              | 35.3              |
| Selling, general, and administrative expense | (23.1)             | (22.7)            | (22.6)            | (22.6)            |
| Interest expense                             | (1.0)              | (1.0)             | (1.0)             | (0.9)             |
| Other income, net                            | 0.4                | 0.6               | 0.4               | 0.4               |
| Provision for income taxes                   | (4.5)              | (4.1)             | (4.4)             | (3.9)             |
| Net earnings                                 | 8.9%               | 8.4%              | 8.8%              | 8.3%              |

## Net Sales

Worldwide consolidated net sales for the third quarter and year-to-date period of fiscal 2007 were up slightly by 0.2 percent and 2.5 percent, respectively, from the same periods in the prior fiscal year. Favorable currency exchange rates accounted for approximately \$4 million and \$18 million of the sales growth for the third quarter and year-to-date period of fiscal 2007, respectively. Disregarding currency exchange effects, international sales for the third quarter and year-to-date period of fiscal 2007 increased 2.0 percent and 5.4 percent, respectively, compared to the same periods in fiscal 2006. Professional segment products worldwide were strong as a result of continued demand in international markets, particularly in the golf market, and the successful introduction of new products. Landscape contractor equipment sales also increased for the third quarter comparison due to strong retail demand; however, sales of landscape contractor equipment were down for the year-to-date period comparison due to efforts to reduce field inventory levels, which were down as of the end of the third quarter of fiscal 2007 compared to same period last year. Residential segment net sales were down for the third quarter and year-to-date periods of fiscal 2007 compared to the same periods in fiscal 2006 as a result of lower worldwide shipments of snow thrower products due to the lack of snowfall during the winter season of 2006-2007 in key markets, somewhat offset by the introduction of our new innovative riding and walk power mower products. Other segment net sales were up for the third quarter of fiscal 2007 compared to the third quarter of fiscal 2006 but were down for the year-to-date period of fiscal 2007 compared to the year-to-date period of fiscal 2006 due to lower sales at a company-owned distributorship.

## Gross Profit

Gross profit for the third quarter and year-to-date period of fiscal 2007 increased 4.2 percent and 5.6 percent, respectively, compared to the same periods in the prior fiscal year due to increased sales. As a percentage of net sales, gross profit for the third quarter and year-to-date period of fiscal 2007 increased to 37.1 percent and 36.4 percent,

respectively, compared to 35.6 percent and 35.3 percent for the third quarter and year-to-date period of fiscal 2006, respectively. The increase in gross profit as a percentage of net sales was the result of the following factors: (i) increased sales of higher-margin products; (ii) cost reduction efforts, including benefits from past and continuing profit improvement initiatives; (iii) a weaker US dollar compared to the other worldwide currencies in which we transact business; and (iv) price increases on some products. Somewhat offsetting those positive factors were: (i) higher manufacturing costs from lower plant utilization as we curtailed production levels in an effort to lower inventory levels and (ii) higher commodity costs.



### **Selling, General, and Administrative Expense**

Selling, general, and administrative expense (SG&A) increased for the third quarter and year-to-date period of fiscal 2007 by 1.8 percent and 2.5 percent, respectively, from the same periods in the prior fiscal year. SG&A as a percentage of net sales for the third quarter of fiscal 2007 increased to 23.1 percent compared to 22.7 percent for the third quarter of fiscal 2006, and was even as a percentage of net sales for the year-to-date period of both fiscal 2007 and fiscal 2006 at 22.6 percent. The increase in SG&A expense as a percentage of net sales for the third quarter comparison was due primarily to lower self-insurance costs last year as a result of favorable claims experience, somewhat offset by a decline in warranty expense due to the reversal of a special warranty provision.

### **Interest Expense**

Interest expense for the third quarter and year-to-date period of fiscal 2007 increased by 6.0 percent and 8.1 percent, respectively, from the same periods in the prior fiscal year. These increases were due primarily to higher average debt levels and slightly higher average interest rates.

### **Other Income, Net**

Other income, net for the third quarter of fiscal 2007 decreased \$0.8 million compared to the third quarter of fiscal 2006. This decline was due mainly to lower financing revenue. Other income, net for the year-to-date period of fiscal 2007 was down \$0.3 million compared to the same period last fiscal year. This decrease was due mainly to a litigation settlement recovery we received last fiscal year and lower financing revenue, somewhat offset by higher interest income and lower losses on investments in fiscal 2007 compared to fiscal 2006.

### **Provision for Income Taxes**

The effective tax rate for the third quarter of fiscal 2007 was 33.4 percent compared to 32.6 percent in the third quarter of fiscal 2006. The effective tax rate for the year-to-date period of fiscal 2007 was 33.4 percent compared to 32.4 percent for the same period in the prior fiscal year. The increase in the effective tax rate was due to a favorable resolution of tax matters from prior years' tax returns last fiscal year as well as the accelerated phase-out of benefits for foreign export incentives as compared to the phase-in benefit for the domestic manufacturing credit.

### **BUSINESS SEGMENTS**

As described previously, we operate in two reportable business segments: professional and residential. A third reportable segment called "other" consists of company-owned distributorships in the United States, corporate activities, and financing functions. Operating earnings for each of our two business segments is defined as earnings from operations plus other income, net. Operating loss for our third "other" segment includes earnings (loss) from operations, corporate activities, including corporate financing activities, other income, net, and interest expense.

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The following table summarizes net sales by segment:

| (Dollars in thousands)             | Three Months Ended |                   |           |          |
|------------------------------------|--------------------|-------------------|-----------|----------|
|                                    | August 3,<br>2007  | August 4,<br>2006 | \$ Change | % Change |
| Professional                       | \$ 332,014         | \$ 319,733        | \$ 12,281 | 3.8%     |
| Residential                        | 132,981            | 145,308           | (12,327)  | (8.5)    |
| Other                              | 13,712             | 12,820            | 892       | 7.0      |
| Total *                            | \$ 478,707         | \$ 477,861        | \$ 846    | 0.2%     |
| * Includes international sales of: | \$ 120,319         | \$ 113,651        | \$ 6,668  | 5.9%     |

| (Dollars in thousands)             | Nine Months Ended |                   |           |          |
|------------------------------------|-------------------|-------------------|-----------|----------|
|                                    | August 3,<br>2007 | August 4,<br>2006 | \$ Change | % Change |
| Professional                       | \$ 1,052,013      | \$ 1,012,436      | \$ 39,577 | 3.9%     |
| Residential                        | 463,043           | 463,786           | (743)     | (0.2)    |
| Other                              | 29,392            | 30,283            | (891)     | (2.9)    |
| Total *                            | \$ 1,544,448      | \$ 1,506,505      | \$ 37,943 | 2.5%     |
| * Includes international sales of: | \$ 441,793        | \$ 402,000        | \$ 39,793 | 9.9%     |

The following table summarizes operating earnings (loss) before income taxes by segment:

| (Dollars in thousands) | Three Months Ended |                   |           |          |
|------------------------|--------------------|-------------------|-----------|----------|
|                        | August 3,<br>2007  | August 4,<br>2006 | \$ Change | % Change |
| Professional           | \$ 70,887          | \$ 62,474         | \$ 8,413  | 13.5%    |
| Residential            | 8,246              | 8,752             | (506)     | (5.8)    |
| Other                  | (15,293)           | (11,426)          | (3,867)   | (33.8)   |
| Total *                | \$ 63,840          | \$ 59,800         | \$ 4,040  | 6.8%     |
| (Dollars in thousands) | Nine Months Ended  |                   |           |          |
|                        | August 3,<br>2007  | August 4,<br>2006 | \$ Change | % Change |
| Professional           | \$ 227,737         | \$ 208,311        | \$ 19,426 | 9.3%     |
| Residential            | 40,055             | 32,037            | 8,018     | 25.0     |
| Other                  | (63,704)           | (56,020)          | (7,684)   | (13.7)   |
| Total *                | \$ 204,088         | \$ 184,328        | \$ 19,760 | 10.7%    |

### Professional

*Net Sales.* Worldwide net sales for the professional segment in the third quarter and year-to-date period of fiscal 2007 were up 3.8 percent and 3.9 percent, respectively, compared to the same periods last fiscal year. This increase was due primarily to strong international professional segment net sales, which were up 12.4 percent and 14.1 percent in the third quarter and year-to-date period of fiscal 2007, respectively, compared to the same periods last fiscal year due to continued demand and growth in international markets, particularly in the golf market, the success of new products introduced within the past two years, and a weaker US dollar compared to the other worldwide currencies in which we transact business. However, sales of domestic golf irrigation systems were down for the third quarter and year-to-date period comparisons due to a delay in golf course projects to later in the fiscal year and softness in golf community developments. Sales of domestic golf and sports field and grounds equipment were also down for the third quarter of

fiscal 2007 compared to the third quarter of fiscal 2006 as a result of customers' efforts to lower field inventory levels, which are lower as of the end of the third quarter of fiscal 2007 compared to

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the same period last fiscal year. On a positive note, sales of domestic golf and sports field and grounds equipment were up for the year-to-date period of fiscal 2007 compared to the year-to-date period of fiscal 2006, due to new product introductions and higher retail demand. Shipments of landscape contractor equipment increased in the third quarter of fiscal 2007 compared to the third quarter of fiscal 2006 due to strong retail demand. However, sales of landscape contractor equipment were down for the year-to-date period comparison due mainly to efforts to reduce field inventory levels, which are lower as of the end of the third quarter of fiscal 2007 compared to the same period last year.

Operating Earnings. Operating earnings for the professional segment in the third quarter and year-to-date period of fiscal 2007 increased 13.5 percent and 9.3 percent, respectively, compared to the same periods last fiscal year. Expressed as a percentage of net sales, professional segment operating margins increased to 21.4 percent compared to 19.5 percent in the third quarter of fiscal 2006, and the fiscal 2007 year-to-date professional segment operating margins increased to 21.6 percent compared to 20.6 percent last fiscal year. This profit improvement was the result of higher gross margins in the fiscal 2007 periods compared to the fiscal 2006 periods due to the same factors discussed previously in the Gross Profit section above. SG&A expense as a percentage of net sales was down for the third quarter comparison due mainly to a decline in warranty expense as a result of a one-time reversal of a special warranty provision in the third quarter of fiscal 2007 compared to a one-time charge for a warranty special provision in the third quarter of the prior fiscal year. However, SG&A expense as a percentage of net sales increased for the year-to-date comparison, which was due mainly to increased warranty expense and engineering spending.

## **Residential**

Net Sales. Worldwide net sales for the residential segment in the third quarter and year-to-date period of fiscal 2007 were down 8.5 percent and 0.2 percent, respectively, compared to the same periods last fiscal year. This decrease was due primarily to lower worldwide shipments of snow thrower products as the result of the lack of snowfall during the winter season of 2006-2007 in key markets, which has resulted in customers ordering product closer to retail demand. Therefore, we anticipate sales of snow thrower products to be higher in the fourth quarter of fiscal 2007 compared to the fourth quarter of fiscal 2006 as well as from the introduction of a new line of single-stage snow thrower products. Sales of electric trimmers were also down due to lost placement at a key retailer, and shipments of retail irrigation products declined due to unfavorable weather conditions in key markets. Somewhat offsetting the sales decline was strong worldwide demand for our new generation zero-turn radius riding mowers and the successful introduction of a new line of walk power mowers.

Operating Earnings. Operating earnings for the residential segment in the third quarter of fiscal 2007 decreased 5.8 percent compared to the third quarter of fiscal 2006; however, fiscal 2007 year-to-date operating earnings were up by 25.0 percent compared to the same period last fiscal year. Expressed as a percentage of net sales, residential segment operating margin increased to 6.2 percent in the third quarter of fiscal 2007 compared to 6.0 percent in the third quarter of fiscal 2006, and fiscal 2007 year-to-date residential segment operating margin increased to 8.7 percent compared to 6.9 percent in the same period last fiscal year. The operating earnings increase for the third quarter comparison was due to higher gross margins, somewhat offset by slightly higher SG&A expense as a percentage of net sales. Operating earnings for the year-to-date period of fiscal 2007 compared to the year-to-date period of fiscal 2006 also increased due to lower SG&A expense as a percentage of net sales due primarily to lower warranty costs as a result of the reversal of a special warranty provision, and lower spending for marketing.

## **Other**

Net Sales. Net sales for the other segment include sales from our wholly owned domestic distribution companies less sales from the professional and residential segments to those distribution companies. In addition, elimination of the professional and residential segments' floor plan interest costs from Toro Credit Company are also included in this

segment. Net sales for the other segment were up 7.0 percent for the third quarter of fiscal 2007 compared to the third quarter of fiscal 2006 due to increased sales at our company-owned distributorships. However, net sales for the year-to-date period of fiscal 2007 compared to the same period last fiscal year were down by 2.9 percent due mainly to lower sales at a company-owned distributorship.

Operating Losses. Operating losses for the other segment were up for the third quarter and year-to-date period of fiscal 2007 by \$3.9 million or 33.8 percent and \$7.7 million or 13.7 percent, respectively, compared to the same periods last fiscal year. The increased losses were due primarily to: (i) lower self-insurance costs last fiscal year as a result of favorable claims experience; (ii) higher legal expenses; (iii) lower financing revenue; and (iv) increased interest expense.

## FINANCIAL POSITION

### Working Capital

As part of our GrowLean initiative, we have placed additional emphasis on asset management, with a focus on: (i) ensuring strong profitability of our products and services all the way through the retail sale; (ii) minimizing the amount of working capital in the supply chain; and (iii) maintaining or improving order replenishment and service levels to end users. Our long-term goal is to reduce average net working capital (accounts receivable plus inventory minus trade payables) as a percentage of net sales to below 20 percent, or “in the teens.”

Average receivables for the first nine months of fiscal 2007 increased 2.8 percent compared to the first nine months of fiscal 2006 on a sales increase of 2.5 percent. Our average days sales outstanding for receivables were slightly up to 74.9 days based on sales for the last twelve months ended August 3, 2007, compared to 74.0 days for the twelve months ended August 4, 2006. This increase was due mainly to a higher proportion of international sales that have longer payment terms. Average inventory levels also increased by 4.9 percent for the first nine months of fiscal 2007 compared to the first nine months of fiscal 2006; however, inventory levels were down by 4.5 percent as of August 3, 2007 compared to August 4, 2006, as we curtailed production levels in an effort to lower inventory levels. As a result of these increases, the average net working capital for the twelve months ended August 3, 2007 was 29.7 percent compared to 29.1 percent for the twelve months ended August 4, 2006, an unfavorable change of 0.6 percentage points.

### Liquidity and Capital Resources

Our businesses are seasonally working capital intensive and require funding for purchases of raw materials used in production, replacement parts inventory, capital expenditures, expansion and upgrading of existing facilities, as well as for financing receivables from customers. We believe that cash generated from operations, together with our fixed rate long-term debt, bank credit lines, and cash on hand, will provide us with adequate liquidity to meet our operating requirements. We believe that the funds available through existing or anticipated financing arrangements and forecasted cash flows will be sufficient to provide the necessary capital resources for our anticipated working capital, capital expenditures, investments, acquisitions, debt repayments, dividend payments, and stock repurchases for at least the next twelve months.

On May 22, 2007, the company’s Board of Directors authorized the repurchase of an additional 3,000,000 shares of the company’s common stock in open-market or in privately negotiated transactions.

Our Board of Directors approved a cash dividend of \$0.12 per share for the third quarter of fiscal 2007 paid on July 12, 2007, which was an increase over our cash dividend of \$0.09 per share for the third quarter of fiscal 2006.

**Cash Flow.** Cash provided by operating activities for the first nine months of fiscal 2007 was 31.1 percent higher than the first nine months of fiscal 2006 due primarily to lower receivables and inventory levels and higher net earnings, somewhat offset by a decrease of accounts payable and accrued liabilities for the first nine months of fiscal 2007 compared to the first nine months of fiscal 2006. Cash used in investing activities increased by \$12.6 million compared to the first nine months of fiscal 2006, due mainly to an increase of purchases of property, plant, and equipment as well as cash received last fiscal year for payments of note receivables. Cash used in financing activities for the first nine months of fiscal 2007 was lower by \$47.2 million compared to the first nine months of fiscal 2006 due to proceeds received from the issuance of 30-year senior notes in April 2007 and lower levels of our common stock repurchased in the first nine months of fiscal 2007 compared to the first nine months of fiscal 2006, somewhat offset by repayments of short-term and long-term debt. Cash and cash equivalents increased \$69.4 million as of August 3, 2007 compared to August 4, 2006 as a result of additional net proceeds from the issuance of the senior notes in April 2007 less the payment of the \$75 million long-term notes paid in June 2007 plus an increase of cash provided by operations.

*Credit Lines and Other Capital Resources.* Our business is seasonal, with accounts receivable balances historically increasing between January and April as a result of higher sales volumes and extended payment terms made available to our customers, and decreasing between May and December when payments are received. The seasonality of production and shipments causes our working capital requirements to fluctuate during the year. Our peak borrowing usually occurs between February and May. Seasonal cash requirements are financed from operations and with short- and medium-term financing arrangements, including a \$175.0 million unsecured senior five-year revolving credit facility, which expires in January 2012. Interest expense on these credit lines is determined based on a LIBOR rate plus a basis point spread defined in the credit agreements. In addition, our non-U.S. operations and a domestic subsidiary also maintain unsecured short-term lines of credit of approximately \$15 million. These facilities bear interest at various rates depending on the rates in their respective countries of operation. We also have a letter of credit subfacility as part of our credit agreements. Average short-term debt was \$65.2 million in the first nine months of fiscal 2007 compared to \$56.7 million in the first nine months of fiscal 2006, an increase of 14.9 percent. This increase was primarily due to funding a majority of our deferred compensation plans during the first quarter of fiscal 2007 and additional working capital requirements as a result of higher average receivable and inventory levels in the first half of fiscal 2007 compared to the first half of fiscal 2006. As of August 3, 2007, we had \$188.3 million of unutilized availability under our credit agreements.

On April 26, 2007, we issued \$125.0 million in aggregate principal amount of 6.625% senior notes due May 1, 2037. The senior notes were priced at 98.513% of par value, and the resulting discount of \$1.9 million associated with the issuance of these senior notes is being amortized over the term of the notes using the effective interest rate method. The underwriting fee and direct debt issue costs totaling \$1.5 million will be amortized over the life of the notes. Although the coupon rate of the senior notes is 6.625%, the effective interest rate is 6.741% after taking into account the issuance discount. Interest on the senior notes is payable semi-annually, on May 1 and November 1 of each year. The senior notes are unsecured senior obligations of the company and rank equally with our other unsecured and unsubordinated indebtedness from time to time outstanding. The indentures under which the senior notes were issued contain customary covenants and event of default provisions. We may redeem some or all of the senior notes at any time at the greater of the full principal amount of the senior notes being redeemed, or the present value of the remaining scheduled payments of principal and interest discounted to the redemption date on a semi-annual basis at the treasury rate plus 30 basis points, plus, in both cases, accrued and unpaid interest. In the event of the occurrence of both (i) a change of control of our company and (ii) a downgrade of the notes below an investment grade rating by both Moody's Investors Service, Inc. and Standard & Poor's Ratings Services within a specified period, we would be required to make an offer to purchase the senior notes at a price equal to 101% of the principal amount of the senior notes, plus accrued and unpaid interest to the date of repurchase. We used the proceeds from the issuance of the senior notes to pay \$75.0 million outstanding principal amount of 7.125% notes that were due on June 15, 2007 as well as for general corporate uses.

Significant financial covenants in our credit agreements are interest coverage and debt to capitalization ratios. We were in compliance with all covenants related to our credit agreements as of August 3, 2007, and expect to be in compliance with all covenants during the remainder of fiscal 2007. If we were out of compliance with any covenant required by our credit agreements following the applicable period, the banks could terminate their commitments unless we could negotiate a covenant waiver from the banks. In addition, our long-term public notes and debentures could become due and payable if we were unable to obtain a covenant waiver or refinance our medium-term debt under our credit agreements. If our credit rating falls below investment grade, the interest rate we currently pay on outstanding debt under the credit agreements could increase, but the credit commitments could not be cancelled by the banks based only on a ratings downgrade. Our debt rating for long-term unsecured senior, non-credit enhanced debt has been unchanged for the third quarter of fiscal 2007 by Standard and Poor's Ratings Group at BBB- and by Moody's Investors Service at Baa3.

### **Off-Balance Sheet Arrangements and Contractual Obligations**

Our off-balance sheet arrangements generally relate to customer financing activities, inventory purchase commitments, operating lease commitments, and currency contracts. See our most recently filed Annual Report on Form 10-K for further details regarding our off-balance sheet arrangements and contractual obligations. There has been no material change in this information, except for changes to long-term debt and interest payments resulting from our senior note issuance. Contractual obligations for long-term debt and interest payments as of August 3, 2007 are as follows: less than 1 year, \$16.1 million; 1-3 years, \$32.2 million; 3-5 years, \$32.2 million; more than 5 years, \$634.2 million.

### **Inflation**

We are subject to the effects of inflation and changing prices. In the first nine months of fiscal 2007, average prices paid for most commodities were slightly higher compared to the first nine months of fiscal 2006, which resulted in a slight negative impact on our gross profit and net earnings. We expect average commodity prices to continue to trend slightly higher for the remainder of fiscal 2007 compared to fiscal 2006. We will continue to attempt to mitigate the impact of commodity prices and other inflationary pressures through proactive vendor negotiations, by actively pursuing internal cost reduction efforts, and introducing moderate price increases on some products.

### **Critical Accounting Policies and Estimates**



In preparing our consolidated financial statements in conformity with U.S. generally accepted accounting principles, we must make decisions that impact the reported amounts of assets, liabilities, revenues and expenses, and related disclosures. Such decisions include the selection of the appropriate accounting principles to be applied and the assumptions on which to base accounting estimates. In reaching such decisions, we apply judgments based on our understanding and analysis of the relevant circumstances, historical experience, and actuarial valuations. Actual amounts could differ from those estimated at the time the consolidated financial statements are prepared.

Our significant accounting policies are described in Note 1 to the notes to our consolidated financial statements included in our Annual Report on Form 10-K for the fiscal year ended October 31, 2006. Some of those significant accounting policies require us to make difficult subjective or complex judgments or estimates. An accounting estimate is considered to be critical if it meets both of the following criteria: (i) the estimate requires assumptions about matters that are highly uncertain at the time the

accounting estimate is made, and (ii) different estimates reasonably could have been used, or changes in the estimate that are reasonably likely to occur from period to period, would have a material impact on the presentation of our financial condition, changes in financial condition or results of operations. Our critical accounting estimates include the following:

Warranty Reserve. Warranty coverage on our products ranges from a period of six months to seven years, and covers parts, labor, and other expenses for non-maintenance repairs. Warranty coverage generally does not cover operator abuse and improper use. At the time of sale, we accrue a warranty reserve by product line for estimated costs in connection with future warranty claims. We also establish reserves for major rework campaigns. The amount of our warranty reserves is based primarily on the estimated number of products under warranty, historical average costs incurred to service warranty claims, the trend in the historical ratio of claims to sales, and the historical length of time between the sale and resulting warranty claim. We periodically assess the adequacy of our warranty reserves based on changes in these factors and record any necessary adjustments if actual claim experience indicates that adjustments are necessary. Actual claims could be higher or lower than amounts estimated, as the amount and value of warranty claims are subject to variation due to such factors as performance of new products, significant manufacturing or design defects not discovered until after the product is delivered to customers, product failure rates, and higher or lower than expected service costs for a repair. We believe that analysis of historical trends and knowledge of potential manufacturing or design problems provide sufficient information to establish a reasonable estimate for warranty claims at the time of sale. However, since we cannot predict with certainty future warranty claims or costs associated with servicing those claims, our actual warranty costs may differ from our estimates. An unexpected increase in warranty claims or in the costs associated with servicing those claims would result in an increase in our warranty accrual and a decrease in our net earnings.

Sales Promotions and Incentives. At the time of sale to a customer, we record an estimate for sales promotion and incentive costs, which are classified as a reduction from gross sales or as a component of SG&A. Examples of sales promotion and incentive programs include rebate programs on certain professional products sold to distributors, volume discounts, retail financing support, floor planning, cooperative advertising, commissions, and other sales discounts and promotional programs. The estimates for sales promotion and incentive costs are based on the terms of the arrangements with customers, historical payment experience, field inventory levels, volume purchases, and expectations for changes in relevant trends in the future. Actual results may differ from these estimates if competitive factors dictate the need to enhance or reduce sales promotion and incentive accruals or if the customer usage and field inventory levels vary from historical trends. Adjustments to sales promotions and incentive accruals are made from time to time as actual usage becomes known in order to properly estimate the amounts necessary to generate consumer demand based on market conditions as of the balance sheet date.

Inventory Valuation. We value our inventories at the lower of the cost of inventory or net realizable value, with cost determined by either the last-in, first-out (LIFO) method for most U.S. inventories or the first-in, first-out (FIFO) method for all other inventories. We establish reserves for excess, slow moving, and obsolete inventory based on inventory levels, expected product lives, and forecasted sales demand. Valuation of inventory can also be affected by significant redesign of existing products or replacement of an existing product by an entirely new generation product. In assessing the ultimate realization of inventories, we are required to make judgments as to future demand requirements compared with inventory levels. Reserve requirements are developed according to our projected demand requirements based on historical demand, competitive factors, and technological and product life cycle changes. It is possible that an increase in our reserve may be required in the future if there is a significant decline in demand for our products and we do not adjust our manufacturing production accordingly.

We also record a reserve for inventory shrinkage. Our inventory shrinkage reserve represents anticipated physical inventory losses that are recorded based on historical loss trends, ongoing cycle-count and periodic testing adjustments, and inventory levels. Though management considers reserve balances adequate and proper, changes in economic conditions in specific markets in which we operate could have an effect on the reserve balances required.

Accounts and Notes Receivable Valuation. We value accounts and notes receivable, net of an allowance for doubtful accounts. Each quarter, we prepare an analysis of our ability to collect outstanding receivables that provides a basis for an allowance estimate for doubtful accounts. In doing so, we evaluate the age of our receivables, past collection history, current financial conditions of key customers, and economic conditions. Based on this evaluation, we establish a reserve for specific accounts and notes receivable that we believe are uncollectible, as well as an estimate of uncollectible receivables not specifically known. Portions of our accounts receivable are protected by a security interest in products held by customers, which minimizes our collection exposure. A deterioration in the financial condition of any key customer or a significant slow down in the economy could have a material negative impact on our ability to collect a portion or all of the accounts and notes receivable. We believe that an analysis of historical trends and our current knowledge of potential collection problems provide us with sufficient information to establish a reasonable estimate for an allowance for doubtful accounts. However, since we cannot predict with certainty future changes in the financial stability of our customers or in the general economy, our actual future losses from

uncollectible accounts may differ from our estimates. In the event we determined that a smaller or larger uncollectible accounts reserve is appropriate, we would record a credit or charge to SG&A in the period that we made such a determination.

### **Subsequent Event**

Subsequent to the last day of our fiscal 2007 third quarter on August 16, 2007, the company completed the acquisition of Rain Master Irrigation Systems, Inc., a manufacturer of irrigation central controllers and other products for the commercial landscape market with annual sales of approximately \$10 million.

### **New Accounting Pronouncements to be Adopted**

In October 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans." SFAS No. 158 requires employers to recognize on their balance sheets the funded status of pension and other postretirement benefit plans. In addition, employers will recognize, as a component of other comprehensive income, changes in the funded status of pension and other postretirement benefit plans, such as actuarial gains and losses and prior service costs that arise during the year but are not recognized as components of net periodic benefit cost. SFAS No. 158 will require the measurement date of plan assets and benefit obligations to be as of the end of the employer's fiscal year. We will adopt the provisions of SFAS No. 158, which requires the funded status of pension and other postretirement benefit plans to be recorded on the balance sheet as of October 31, 2007, as required, and we will adopt the provisions that require the measurement date of plan assets and benefit obligations to be the same as our fiscal year end as of October 31, 2009, as required. This new pronouncement is not expected to have a material impact on our financial condition, and will have no impact on our consolidated results of operations.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures concerning fair value. We will adopt the provisions of SFAS No. 157 during the first quarter of fiscal 2009, as required. We are currently evaluating the requirements of SFAS No. 157 and, we do not expect this new pronouncement will have a material impact on our consolidated financial condition or results of operations.

In August 2006, the FASB issued Staff Position No. AUG AIR-1, "Accounting for Planned Major Maintenance Activities." This Staff Position prohibits the use of the accrue-in-advance method of accounting for planned major maintenance activities in annual and interim financial reporting periods. We will adopt the provisions of this Staff Position as of November 1, 2007, as required. We are currently evaluating the requirements of Staff Position No. AUG AIR-1 and do not expect that the adoption of this Staff Position will have a material impact on our consolidated results of operations or financial condition.

In July 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" (FIN No. 48). This interpretation clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes." It prescribes a recognition threshold and measurement attributes for financial statement disclosure of tax positions taken or expected to be taken on a tax return. We will adopt the provisions of this interpretation as of November 1, 2007, as required. We are currently evaluating the requirements of FIN No. 48, and we do not expect this new pronouncement will have a material impact on our consolidated financial condition or results of operations.

### **Forward-Looking Information**

*This Quarterly Report on Form 10-Q contains not only historical information, but also forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and that are subject to the safe harbor created by those sections. In addition, we or others on our behalf may make forward-looking statements from time to time in oral presentations, including telephone conferences and/or web casts open to the public, in press releases or reports, on our Internet web sites, or*

*otherwise. Statements that are not historical are forward-looking and reflect expectations and assumptions. We try to identify forward-looking statements in this report and elsewhere by using words such as “expect”, “looking ahead”, “optimistic”, “plan”, “anticipate”, “estimate”, “believe”, “should”, “may”, “intend”, and similar expressions. Our forward-looking statements generally relate to our future performance, including our anticipated operating results and liquidity requirements, our business strategies and goals, and the effect of laws, rules, regulations, and new accounting pronouncements and outstanding litigation on our business, operating results, and financial condition.* Forward-looking statements involve risks and uncertainties. These risks and uncertainties include factors that affect all businesses operating in a global market as well as matters specific to Toro. The following are some of the factors known to us that could cause our actual results to differ materially from what we have anticipated in our forward-looking statements:

- Changes in economic conditions in the United States and around the world, including but not limited to worldwide economic growth rates; slow downs or reductions in home ownership, construction, and home sales; consumer spending levels; employment rates; interest rates; inflation; and consumer confidence in the United States and the foreign countries in which we conduct business.
  - Weather conditions may reduce demand for some of our products and adversely affect our net sales.
- Increases in the cost and availability of raw materials and components that we purchase and increases in our other costs of doing business, such as transportation costs, may adversely affect our profit margins and business.
- Our professional segment net sales are dependent upon the level of growth in the residential and commercial construction markets, growth of homeowners who outsource lawn care, the amount of investment in golf course renovations and improvements, new golf course development, and the amount of government spending.
- Our residential segment net sales are dependent upon the amount of product placement at retailers, changing buying patterns of customers, and The Home Depot, Inc. as a major customer.
- If we are unable to continue to enhance existing products and develop and market new products that respond to customer needs and achieve market acceptance, we may experience a decrease in demand for our products, and our business could suffer.
- We face intense competition in all of our product lines, including some competitors that have greater operations and financial resources than us. We may not be able to compete effectively against competitors' actions, which could harm our business and operating results.
- A significant percentage of our consolidated net sales is generated outside of the United States, and we intend to continue to expand our international business. Our international operations require significant management attention and financial resources, expose us to difficulties presented by international economic, political, legal, accounting, and business factors, and may not be successful or produce desired levels of net sales.
- Fluctuations in foreign currency exchange rates could result in declines in our reported net sales and net earnings.
- We manufacture and purchase our products at and distribute our products from several locations in the United States and internationally. Any disruption at any of these facilities could adversely affect our business and operating results.
- We intend to grow our business in part through additional acquisitions, alliances, and joint venture arrangements, which are risky and could harm our business, particularly if we are not able to successfully integrate such acquisitions, alliances, and joint ventures.
- We rely on our management information systems for inventory management, distribution, and other functions. If our information systems fail to adequately perform these functions or if we experience an interruption in their operation, our business and operating results could be adversely affected.
- A significant portion of our net sales are financed by third parties. Some Toro dealers and Exmark distributors and dealers finance their inventories with third party financing sources. The termination of our agreements with these third parties, any material change to the terms of our agreements with these third parties or in the availability or terms of credit offered to our customers by these third parties, or any delay in securing replacement credit sources, could adversely affect our sales and operating results.
- Our reliance upon patents, trademark laws, and contractual provisions to protect our proprietary rights may not be sufficient to protect our intellectual property from others who may sell similar products.
- Our business, properties, and products are subject to governmental regulation with which compliance may require us to incur expenses or modify our products or operations and may expose us to penalties for non-compliance. Governmental regulation may also adversely affect the demand for some of our products and our operating results.
- We are subject to product liability claims, product quality issues, and other litigation from time to time that could adversely affect our operating results or financial condition, including without limitation the pending litigation against the company and other defendants that challenges the horsepower ratings of lawnmowers, of which the company is currently unable to assess whether the litigation would have a material adverse effect on the company's consolidated operating results or financial condition, although an adverse result might be material to operating results in a particular period.
- If we are unable to retain our key employees, and attract and retain other qualified personnel, we may not be able to meet strategic objectives and our business could suffer.

- Our business is subject to a number of other factors that may adversely affect our operating results, financial condition, or business, such as natural disasters that may result in shortages of raw materials, higher fuel costs, and an increase in insurance premiums; financial viability of some distributors and dealers, changes in distributor ownership, our success in partnering with new dealers, and our customers' ability to pay amounts owed to us; and continued threat of terrorist acts and war that may result in heightened security and higher costs for import and export shipments of components or finished goods, reduced leisure travel, and contraction of the U.S. and world economies.

For more information regarding these and other uncertainties and factors that could cause our actual results to differ materially from what we have anticipated in our forward-looking statements or otherwise could materially adversely affect our business, financial condition, or operating results, see our most recent filed Annual Report on Form 10-K and our Quarterly Report on Form 10-Q for the quarter ended May 4, 2007.

*All forward-looking statements included in this report are expressly qualified in their entirety by the foregoing cautionary statements. We wish to caution readers not to place undue reliance on any forward-looking statement which speaks only as of the date made and to recognize that forward-looking statements are predictions of future results, which may not occur as anticipated. Actual results could differ materially from those anticipated in the forward-looking statements and from historical results, due to the risks and uncertainties described above, as well as others that we may consider immaterial or do not anticipate at this time. The foregoing risks and uncertainties are not exclusive and further information concerning the company and our businesses, including factors that potentially could materially affect our financial results or condition, may emerge from time to time. We assume no obligation to update forward-looking statements to reflect actual results or changes in factors or assumptions affecting such forward-looking statements. We advise you, however, to consult any further disclosures we make on related subjects in our future annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K we file with or furnish to the Securities and Exchange Commission.*

### **Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to market risk stemming from changes in foreign currency exchange rates, interest rates, and commodity prices. Changes in these factors could cause fluctuations in our net earnings and cash flows. See further discussions on these market risks below.

*Foreign Currency Exchange Rate Risk.* In the normal course of business, we actively manage the exposure of our foreign currency market risk by entering into various hedging instruments, authorized under company policies that place controls on these activities, with counterparties that are highly rated financial institutions. Our hedging activities involve the primary use of forward currency contracts. We use derivative instruments only in an attempt to limit underlying exposure from currency fluctuations and to minimize earnings and cash flow volatility associated with foreign currency exchange rate changes, and not for trading purposes. We are exposed to foreign currency exchange rate risk arising from transactions in the normal course of business, such as sales and loans to wholly owned subsidiaries as well as sales to third party customers, and purchases from suppliers. Because our products are manufactured or sourced primarily from the United States, a stronger U.S. dollar generally has a negative impact on results from operations outside the United States while a weaker dollar generally has a positive effect. Our primary currency exchange rate exposures are with the Euro, the Japanese yen, the Australian dollar, the Canadian dollar, the British pound, and the Mexican peso against the U.S. dollar.

We enter into various contracts, principally forward contracts that change in value as foreign currency exchange rates change, to protect the value of existing foreign currency assets, liabilities, anticipated sales, and probable commitments. Decisions on whether to use such contracts are made based on the amount of exposures to the currency involved, and an assessment of the near-term market value for each currency. Worldwide foreign currency exchange rate exposures are reviewed monthly. The gains and losses on these contracts offset changes in the value of the related exposures. Therefore, changes in market values of these hedge instruments are highly correlated with changes in market values of underlying hedged items both at inception of the hedge and over the life of the hedge contract. During the three and nine months ended August 3, 2007, the amount of losses reclassified to earnings for such cash flow hedges was \$0.3 million and \$0.6 million, respectively. For the nine months ended August 3, 2007, the losses treated as a reduction to net sales for contracts to hedge trade sales were \$1.3 million and the gains treated as a reduction of cost of sales for contracts to hedge inventory purchases were \$0.7 million.



The following foreign currency exchange contracts held by us have maturity dates in fiscal 2007 and fiscal 2008. All items are non-trading and stated in U.S. dollars. Some derivative instruments we enter into do not meet the hedging criteria of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities;" therefore, changes in their fair value are recorded in other income, net. The average contracted rate, notional amount, pre-tax value of derivative instruments in accumulated other comprehensive loss (AOCL), and fair value impact of derivative instruments in other income, net for the nine months ended August 3, 2007 were as follows:

| Dollars in thousands<br>(except average contracted rate) | Average<br>Contracted<br>Rate | Notional<br>Amount | Value in   |  |
|--|-------------------------------|--------------------|--|--|
|  |                               |                    | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Fair Value<br>Impact<br>Gain<br>(Loss) |
| Buy US dollar/Sell Australian dollar                     | 0.8251                        | \$ 39,980.3        | \$ (1,210.7)   | \$ (899.7)                             |
| Buy US dollar/Sell Canadian dollar                       | 0.9364                        | 5,103.4            | (64.6)   | 132.0                                  |
| Buy US dollar/Sell Euro                                  | 1.3548                        | 90,803.8           | (993.6)  | (910.3)                                |
| Buy US dollar/Sell British pound                         | 2.0300                        | 9,540.9            | -  | (3.0)                                  |
| Buy Australian dollar /Sell US dollar                    | 0.8366                        | 1,171.2            | -  | 22.7                                   |
| Buy Japanese yen /Sell US dollar                         | 119.0000                      | 42.0               | -  | 0.1                                    |
| Buy Mexican peso/Sell US dollar                          | 11.2957                       | 13,810.6           | 250.4  | 722.7                                  |

**Interest Rate Risk.** We are exposed to interest rate risk arising from transactions that are entered into during the normal course of business. Our short-term debt rates are dependent upon LIBOR plus a basis point spread defined in our credit agreements. See our most recently filed Annual Report on Form 10-K (Item 7A). There has been no material change in this information.

During the second quarter of fiscal 2007, the company entered into three treasury lock agreements based on a 30-year US Treasury security with a principal balance of \$30 million for two of the agreements and \$40 million for the third agreement. These treasury lock agreements provided for a single payment at maturity, which was April 23, 2007, based on the change in value of the reference treasury security. These agreements were designated as cash flow hedges and resulted in a net settlement of \$0.2 million. This loss is recorded in accumulated other comprehensive loss, which will be amortized to interest expense over the 30 year term of the senior notes.

**Commodity Price Risk.** Some raw materials used in our products are exposed to commodity price changes. The primary commodity price exposures are with steel, aluminum, fuel, petroleum-based resin, and linerboard. Further information regarding rising prices for commodities is presented in Item 2, section entitled "Inflation."

We enter into fixed-price contracts for future purchases of natural gas in the normal course of operations as a means to manage natural gas price risks. These contracts meet the definition of "normal purchases and normal sales" and, therefore, are not considered derivative instruments for accounting purposes.

#### Item 4. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) that are designed to reasonably ensure that information required to be disclosed by us in the reports we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, we recognize that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and we are required to apply our judgment in evaluating the cost-benefit relationship of possible internal controls. Our management evaluated, with the participation of our Chief Executive Officer and Chief Financial Officer, the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the

period covered in this Quarterly Report on Form 10-Q. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of such period to provide reasonable assurance that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and that material information relating to our company and our consolidated subsidiaries is made known to management, including our Chief Executive Officer and Chief Financial Officer, particularly during the period when our periodic reports are being prepared. There was no change in our internal control over financial reporting that occurred during our fiscal third quarter ended August 3, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II. OTHER INFORMATION**

### **Item 1. LEGAL PROCEEDINGS**

On June 3, 2004, eight individuals who claim to have purchased lawnmowers in Illinois and Minnesota filed a lawsuit in Illinois state court against the company and eight other defendants alleging that the horsepower labels on the products the plaintiffs purchased were inaccurate. On May 17, 2006, the plaintiffs filed an amended complaint to add 84 additional plaintiffs and an engine manufacturer as an additional defendant. The amended complaint asserts violations of the federal Racketeer Influenced and Corrupt Organizations (RICO) Act and statutory and common law claims arising from the laws of 48 states. The plaintiffs seek certification of a class of all persons in the United States who, beginning January 1, 1994 through the present, purchased a lawnmower containing a two-stroke or four-stroke gas combustible engine up to 30 horsepower that was manufactured or sold by the defendants. The amended complaint seeks an injunction, unspecified compensatory and punitive damages, treble damages under the RICO Act and attorneys' fees. In late May 2006, the case was removed to Federal court in the Southern District of Illinois. On August 1, 2006, all of the defendants, except MTD Products Inc., filed motions to dismiss claims in the amended complaint. On August 4, 2006, the plaintiffs filed a motion for preliminary approval of a settlement agreement with MTD Products Inc. and certification of a settlement class. All remaining non-settling defendants have filed counterclaims against MTD Products Inc. for potential contribution amounts, and MTD Products Inc. has filed cross claims against the non-settling defendants. On December 21, 2006, another defendant, American Honda Motor Company, notified us that it had reached an agreement of settlement with the plaintiffs. On March 30, 2007, the court entered an order dismissing plaintiffs' complaint, subject to the ability to re-plead certain claims pursuant to a detailed written order to follow. As of the date hereof, the court has not yet entered the detailed written order. We continue to evaluate this lawsuit and are unable to reasonably estimate the likelihood of loss or the amount or range of potential loss that could result from this litigation. Therefore, no accrual has been established for potential loss in connection with this lawsuit. We are also unable to assess at this time whether the lawsuit will have a material adverse effect on our annual consolidated operating results or financial condition, although an unfavorable resolution could be material to our consolidated operating results for a particular period.

In July 2005, Textron Innovations Inc., the patent holding company of Textron, Inc., filed a lawsuit in Delaware Federal District Court against the company for patent infringement. Textron alleges that we willfully infringe certain claims of three Textron patents by selling our Groundsmaster® commercial mowers. Textron seeks damages for our past sales and an injunction against future infringement. In August and November 2005, we answered the complaint, asserting defenses and counterclaims of non-infringement, invalidity and equitable estoppel. Following the Court's order in October 2006 construing the claims of Textron's patents, discovery in the case was closed in February 2007. In March 2007, following unsuccessful attempts to mediate the case, we filed with the United States Patent and Trademark Office (USPTO) to have Textron's patents reexamined. Our reexamination applications are pending in the USPTO. In April 2007, the Court granted our motion to stay the litigation and, in June 2007, denied Textron's motion for reconsideration of the Court's order staying the proceedings. We continue to evaluate this lawsuit and are unable to reasonably estimate the likelihood of loss or the amount or range of potential loss that could result from the litigation. Therefore, no accrual has been established for potential loss in connection with this lawsuit. While we do not believe that the lawsuit will have a material adverse effect on our consolidated financial condition, an unfavorable resolution could be material to our consolidated operating results for a particular period.

We are a party to litigation in the ordinary course of business. Litigation occasionally involves claims for punitive as well as compensatory damages arising out of use of our products. We are also subject to administrative proceedings with respect to claims involving the discharge of hazardous substances into the environment. Some of these claims assert damages and liability for remedial investigations and clean up costs. We are also typically involved in commercial disputes, employment disputes, and patent litigation cases in the ordinary course of business, both as a plaintiff and as a defendant. While the ultimate results of the current cases are unknown at this time, management believes that, except for the lawsuits discussed above, the outcomes of these cases are unlikely to have a material adverse effect on our consolidated operating results or financial position. Further, although we are self-insured to some extent, we maintain insurance against certain product liability losses.

**Item 1A. RISK FACTORS**

We are affected by risks specific to us as well as factors that affect all businesses operating in a global market. The significant factors known to us that could materially adversely affect our business, financial condition, or operating results are described in our most recently filed Annual Report on Form 10-K for the fiscal year ended October 31, 2006 (Part I, Item 1A) and our Quarterly Report on Form 10-Q for the quarter ended May 4, 2007 (Part II, Item 1A). There has been no material change in those risk factors.

**Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

The following table shows our third quarter of fiscal 2007 stock repurchase activity.

| Period                                  | Total<br>Number of<br>Shares<br>Purchased<br>(1) | Average<br>Price<br>Paid per<br>Share | Total<br>Number of<br>Shares<br>Purchased<br>As Part of<br>Publicly<br>Announced<br>Plans<br>or<br>Programs | Maximum<br>Number<br>of Shares<br>that May<br>Yet Be<br>Purchased<br>Under the<br>Plans or<br>Programs<br>(1) (2) |
|---|--|---------------------------------------|---|---|
| May 5, 2007 through<br>June 1, 2007     | 544,834  | \$ 52.26                              | 544,834   | 3,046,563   |
| June 2, 2007 through<br>June 29, 2007   | -  | -                                     | -   | 3,046,563   |
| June 30, 2007 through<br>August 3, 2007 | 1,551(3)   | 61.82                                 | -   | 3,046,563   |
| <b>Total</b>                            | <b>546,385</b>                                   | <b>\$ 52.28</b>                       | <b>544,834</b>  | <b>3,046,563</b>  |

- (1) On July 18, 2006, the company's Board of Directors authorized the repurchase of 3,000,000 shares of the company's common stock in open-market or in privately negotiated transactions. This program has no expiration date but may be terminated by the company's Board of Directors at any time. The company purchased an aggregate of 544,834 shares during the periods indicated above under this program. There are 46,563 shares remaining for repurchase under this program.
- (2) On May 22, 2007, the company's Board of Directors authorized the repurchase of an additional 3,000,000 shares of the company's common stock in open-market or in privately negotiated transactions. This program has no expiration date but may be terminated by the company's Board of Directors at any time. No shares were purchased during the periods indicated above under this program.
- (3) Includes 1,551 units (shares) of the company's common stock purchased in open-market transactions at an average price of \$61.82 per share on behalf of a rabbi trust formed to pay benefit obligations of the company to participants in deferred compensation plans. These 1,551 shares were not repurchased under the company's repurchase programs described in footnotes (1) and (2) above.

**Item 6. EXHIBITS**

## (a) Exhibits

3(i) and 4(a) The Toro Company Amended and Restated Certificate of Incorporation of Registrant (incorporated by reference to Exhibit 3(i) and 4(a) to Registrant's Current Report on Form 8-K dated March 15, 2005, Commission File No. 1-8649).

3(ii) and 4(b)

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Bylaws of Registrant (incorporated by reference to Exhibit 3 to Registrant's Current Report on Form 8-K dated November 30, 2005, Commission File No. 1-8649).

- 4(c) Specimen Form of Common Stock Certificate (incorporated by reference to Exhibit 4(c) to Registrant's Annual Report on Form 10-K for the fiscal year ended October 31, 2006).
- 4(d) Rights Agreement dated as of May 20, 1998, between Registrant and Wells Fargo Bank Minnesota, National Association relating to rights to purchase Series B Junior Participating Voting Preferred Stock, as amended (incorporated by reference to Registrant's Current Report on Form 8-K dated May 27, 1998, Commission File No. 1-8649).

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- 4(e) Certificate of Adjusted Purchase Price or Number of Shares dated April 14, 2003 filed by Registrant with Wells Fargo Bank Minnesota, N.A., as Rights Agent, in connection with Rights Agreement dated as of May 20, 1998 (incorporated by reference to Exhibit 2 to Registrant's Amendment No. 1 to Registration Statement on Form 8-A/A as filed with the Securities and Exchange Commission on April 14, 2003, Commission File No. 1-8649).
- 4(f) Certificate of Adjusted Purchase Price or Number of Shares dated April 12, 2005 filed by Registrant with Wells Fargo Bank Minnesota, N.A., as Rights Agent, in connection with Rights Agreement dated as of May 20, 1998 (incorporated by reference to Exhibit 2 to Registrant's Amendment No. 2 to Registration Statement on Form 8-A/A as filed with the Securities and Exchange Commission on March 21, 2005, Commission File No. 1-8649).
- 4(g) Indenture dated as of January 31, 1997, between Registrant and First National Trust Association, as Trustee, relating to the Registrant's 7.125% Notes due June 15, 2007 and its 7.80% Debentures due June 15, 2027 (incorporated by reference to Exhibit 4(a) to Registrant's Current Report on Form 8-K dated June 24, 1997, Commission File No. 1-8649).
- 4(h) Indenture dated as of April 20, 2007, between Registrant and The Bank of New York Trust Company, N.A., as Trustee, relating to the Registrant's 6.625% Notes due May 1, 2037 (incorporated by reference to Exhibit 4.3 to Registrant's Registration Statement on Form S-3 as filed with the Securities and Exchange Commission on April 23, 2007, Registration No. 333-142282).
- 4(i) First Supplemental Indenture dated as of April 26, 2007, between Registrant and The Bank of New York Trust Company, N.A., as Trustee, relating to the Registrant's 6.625% Notes due May 1, 2037 (incorporated by reference to Exhibit 4.1 to Registrant's Current Report on Form 8-K dated April 23, 2007, Commission File No. 1-8649).
- 4(j) Form of The Toro Company 6.625% Note due May 1, 2037 (incorporated by reference to Exhibit 4.2 to Registrant's Current Report on Form 8-K dated April 23, 2007, Commission File No. 1-8649).
- 31(a) Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) (Section 302 of the Sarbanes-Oxley Act of 2002) (filed herewith).
- 31(b) Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) (Section 302 of the Sarbanes-Oxley Act of 2002) (filed herewith).
- 32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

THE TORO COMPANY  
(Registrant)

Date: September 10, 2007

By /s/ Stephen P. Wolfe  
Stephen P. Wolfe  
Vice President Finance  
and Chief Financial Officer  
(duly authorized officer and principal financial officer)