TOLL BROTHERS INC
Form 10-Q
June 06, 2014

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

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

For the quarterly period ended April 30, 2014
or

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

For the transition period from to
Commission file number 001-09186
TOLL BROTHERS, INC.
(Exact name of registrant as specified in its charter)

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

(215) 938-8000
(Registrant’s telephone number, including area code)
Not applicable
(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No o

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

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

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

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

At June 2, 2014, there were approximately 177,773,000 shares of Common Stock, $0.01 par value, outstanding.

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STATEMENT ON FORWARD-LOOKING INFORMATION

Certain information included in this report or in other materials we have filed or will file with the SEC (as well as information included in oral statements or other written statements made or to be made by us) contains or may contain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. You can identify these statements by the fact that they do not relate to matters of strictly historical or factual nature and generally discuss or relate to estimates or other expectations regarding future events. They contain words such as “anticipate,” “estimate,” “expect,” “project,” “intend,” “plan, “believe,” “may,” “can,” “could,” “might,” “should” and other words or phrases of similar meaning in connection with any discussion of future operating or financial performance. Such statements may include, but are not limited to, information related to: anticipated operating results; home deliveries; financial resources and condition; changes in revenues; changes in profitability; changes in margins; changes in accounting treatment; cost of revenues; selling, general and administrative expenses; interest expense; inventory write-downs; unrecognized tax benefits; anticipated tax refunds; sales paces and prices; effects of home buyer cancellations; growth and expansion; joint ventures in which we are involved; anticipated results from our investments in unconsolidated entities; the ability to acquire land and pursue real estate opportunities; the ability to gain approvals and open new communities; the ability to sell homes and properties; the ability to deliver homes from backlog; the ability to secure materials and subcontractors; the ability to produce the liquidity and capital necessary to expand and take advantage of opportunities; legal proceedings and claims; the anticipated benefits to be realized from the consummation of the Shapell acquisition; and post-closing asset sales.

From time to time, forward-looking statements also are included in other periodic reports on Forms 10-Q and 8-K, in press releases, in presentations, on our website and in other materials released to the public. Any or all of the forward-looking statements included in this report and in any other reports or public statements made by us are not guarantees of future performance and may turn out to be inaccurate. This can occur as a result of incorrect assumptions or as a consequence of known or unknown risks and uncertainties. Many factors mentioned in this report or in other reports or public statements made by us, such as government regulation and the competitive environment, will be important in determining our future performance. Consequently, actual results may differ materially from those that might be anticipated from our forward-looking statements.

Forward-looking statements speak only as of the date they are made. We undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise.

For a more detailed discussion of these factors, see the information under the captions “Risk Factors” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in our most recent Annual Report on Form 10-K filed with the Securities and Exchange Commission and in this report.

When this report uses the words “we,” “us,” “our,” and the “Company,” they refer to Toll Brothers, Inc. and its subsidiaries, unless the context otherwise requires. References herein to “fiscal 2013,” “fiscal 2012,” “fiscal 2011,” and “fiscal 2010” refer to our fiscal years ending October 31, 2013, October 31, 2012, October 31, 2011, and October 31, 2010, respectively. References herein to “fiscal 2014” refer to our fiscal year ending October 31, 2014.

PART I — FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS
TOLL BROTHERS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Amounts in thousands)

	April 30, 2014 (unaudited)	October 31, 2013
ASSETS		
Cash and cash equivalents	$351,821	$772,972
Marketable securities	13,000	52,508
Restricted cash	22,542	32,036
Inventory	6,548,024	4,650,412
Property, construction and office equipment, net	131,222	131,320
Receivables, prepaid expenses and other assets	249,934	229,295
Mortgage loans held for sale	68,642	113,517
Customer deposits held in escrow	54,417	46,888
Investments in and advances to unconsolidated entities	441,842	403,133
Investments in distressed loans	18,799	36,374
Investments in foreclosed real estate	76,652	72,972
Deferred tax assets, net of valuation allowances	268,171	286,032
	$8,245,066	$6,827,459
LIABILITIES AND EQUITY		
Liabilities		
Loans payable	$747,088	$107,222
Senior notes	2,654,438	2,321,442
Mortgage company warehouse loan	56,842	75,000
Customer deposits	254,621	212,669
Accounts payable	204,728	167,787
Accrued expenses	539,673	522,987
Income taxes payable	84,619	81,188
Total liabilities	4,542,009	3,488,295
Equity		
Stockholders’ equity		
Preferred stock, none issued	—	—
Common stock, 177,761 and 169,353 shares issued at April 30, 2014 and October 31, 2013, respectively	1,778	1,694
Additional paid-in capital	694,335	441,677
Retained earnings	3,002,805	2,892,003
Treasury stock, at cost — 2 shares and 0 shares at April 30, 2014 and October 31, 2013, respectively	(79)	—
Accumulated other comprehensive loss	(2,030)	(2,387)
Total stockholders’ equity	3,696,809	3,332,987
Noncontrolling interest	6,248	6,177
Total equity	3,703,057	3,339,164
	$8,245,066	$6,827,459

See accompanying notes

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TOLL BROTHERS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Amounts in thousands, except per share data)
(Unaudited)

	Six months ended April 30,		Three months ended April 30,	
	2014	2013	2014	2013
Revenues	$1,504,055	$940,605	$860,374	$516,004
Cost of revenues	1,202,030	765,950	687,998	420,013
Selling, general and administrative	202,190	157,597	104,320	79,550
	1,404,220	923,547	792,318	499,563
Income from operations	99,835	17,058	68,056	16,441
Other:				
Income from unconsolidated entities	37,242	8,076	14,327	4,993
Other income - net	27,642	24,160	11,101	19,534
Income before income taxes	164,719	49,294	93,484	40,968
Income tax provision	53,917	20,188	28,262	16,294
Net income	$110,802	$29,106	$65,222	$24,674
Income per share:				
Basic	$0.63	$0.17	$0.37	$0.15
Diluted	$0.60	$0.17	$0.35	$0.14
Weighted-average number of shares:				
Basic	177,278	169,222	178,082	169,380
Diluted	185,665	177,949	186,442	178,136

See accompanying notes

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Amounts in thousands)
(Unaudited)

	Six months ended April 30,		Three months ended April 30,	
	2014	2013	2014	2013
Net income	$110,802	$29,106	$65,222	$24,674
Other comprehensive income (loss), net of tax:				
Change in pension liability	156	(18)	103	155
Change in fair value of available-for-sale securities	(22)	(37)	9	(133)
Change in unrealized income (loss) on derivative held by equity investee	223	13	(18)	(80)
Other comprehensive income (loss)	357	(42)	94	(58)
Total comprehensive income	$111,159	$29,064	$65,316	$24,616

See accompanying notes

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TOLL BROTHERS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Amounts in thousands)
(Unaudited)

	Six months ended April 30,	
	2014	2013
Cash flow used in operating activities:		
Net income	$110,802	$29,106
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	11,095	12,768
Stock-based compensation	12,294	10,027
Excess tax benefits from stock-based compensation	(1,841)	—
Income from unconsolidated entities	(37,242)	(8,076)
Distributions of earnings from unconsolidated entities	39,471	8,855
Income from distressed loans and foreclosed real estate	(7,934)	(4,893)
Deferred tax provision	18,864	18,348
Deferred tax valuation allowances	(1,226)	(1,277)
Inventory impairments and write-offs	3,906	1,738
Change in fair value of mortgage loans receivable and derivative instruments	429	292
Gain on marketable securities	(6)	(137)
Changes in operating assets and liabilities		
Increase in inventory	(319,826)	(617,360)
Origination of mortgage loans	(308,466)	(301,952)
Sale of mortgage loans	352,349	322,160
Decrease in restricted cash	9,494	13,475
Increase in receivables, prepaid expenses and other assets	(4,587)	(15,172)
Increase in customer deposits	28,994	47,119
Increase in accounts payable and accrued expenses	21,973	36,405
Increase in income taxes payable	5,272	3,166
Net cash used in operating activities	(66,185)	(445,408)
Cash flow (used in) provided by investing activities:		
Purchase of property and equipment — net	(5,767)	(20,264)
Purchase of marketable securities		(36,162)
Sale and redemption of marketable securities	39,243	239,484
Investments in and advances to unconsolidated entities	(80,654)	(31,994)
Return of investments in unconsolidated entities	39,014	34,686
Investments in distressed loans and foreclosed real estate	(757)	(26,155)
Return of investments in distressed loans and foreclosed real estate	22,424	6,114
Acquisition of a business, net of cash acquired	(1,489,116)	
Net cash (used in) provided by investing activities	(1,475,613)	165,709
Cash flow provided by financing activities:		
Proceeds from issuance of senior notes	600,000	298,050
Debt issuance costs for senior notes	(4,700)	
Proceeds from loans payable	1,597,562	501,884
Debt issuance costs for loans payable	(3,005)	
Principal payments of loans payable	(1,046,677)	(545,175)
Redemption of senior notes	(267,960)	(59,068)
Net proceeds from issuance of common stock	220,357	
Proceeds from stock-based benefit plans	23,333	8,430

Excess tax benefits from stock-based compensation	1,841	—
Receipts related to noncontrolling interest	81	33
Purchase of treasury stock	(185)	(178)
Net cash provided by financing activities	1,120,647	203,976
Net decrease in cash and cash equivalents	(421,151)	(75,723)
Cash and cash equivalents, beginning of period	772,972	778,824
Cash and cash equivalents, end of period	$351,821	$703,101

See accompanying notes

TOLL BROTHERS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Significant Accounting Policies

Basis of Presentation

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

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC") for interim financial information. The October 31, 2013 balance sheet amounts and disclosures included herein have been derived from the Company's October 31, 2013 audited financial statements. Since the accompanying condensed consolidated financial statements do not include all the information and footnotes required by U.S. generally accepted accounting principles ("GAAP") for complete financial statements, the Company suggests that they be read in conjunction with the consolidated financial statements and notes thereto included in its Annual Report on Form 10-K for the fiscal year ended October 31, 2013. In the opinion of management, the accompanying unaudited condensed consolidated financial statements include all adjustments, which are of a normal recurring nature, necessary to present fairly the Company's financial position as of April 30, 2014, the results of its operations for the six-month and three-month periods ended April 30, 2014 and 2013, and its cash flows for the six-month periods ended April 30, 2014 and 2013. The results of operations for such interim periods are not necessarily indicative of the results to be expected for the full year.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, "Revenue from Contracts with Customers" ("ASU 2014-09"), which provides guidance for revenue recognition. ASU 2014-09 affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets and supersedes the revenue recognition requirements in Topic 605, "Revenue Recognition," and most industry-specific guidance. This ASU also supersedes some cost guidance included in Subtopic 605-35, "Revenue Recognition-Construction-Type and Production-Type Contracts." The standard's core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which a company expects to be entitled in exchange for those goods or services. In doing so, companies will need to use more judgment and make more estimates than under today's guidance. These may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. ASU 2014-09 is effective for the Company beginning November 1, 2017 and, at that time the Company may adopt the new standard under the full retrospective approach or the modified retrospective approach. Early adoption is not permitted. The Company is currently evaluating the method and impact the adoption of ASU 2014-09 will have on the Company's condensed consolidated financial statements and disclosures.

In April 2014, the FASB issued ASU No. 2014-08, "Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity" ("ASU 2014-08"), which changes the criteria for reporting discontinued operations while enhancing disclosures in this area. Pursuant to ASU 2014-08, only disposals representing a strategic shift, such as a major line of business, a major geographical area or a major equity investment, should be presented as a discontinued operation. If the disposal does qualify as a discontinued operation under ASU 2014-08, the entity will be required to provide expanded disclosures. ASU 2014-08 is effective for the Company beginning November 1, 2015. The adoption of ASU 2014-08 is not expected to have a material effect on the Company's condensed consolidated financial statements or disclosures.

In January 2014, the FASB issued ASU No. 2014-04, "Receivables - Troubled Debt Restructurings by Creditors" ("ASU 2014-04"), which clarifies when an in substance repossession or foreclosure of residential real estate property collateralizing a consumer mortgage loan has occurred. By doing so, this guidance helps determine when the creditor

should derecognize the loan receivable and recognize the real estate property. ASU 2014-04 is effective prospectively for the Company beginning November 1, 2015. The adoption of ASU 2014-04 is not expected to have a material effect on the Company's condensed consolidated financial statements or disclosures.

In July 2013, the FASB issued ASU No. 2013-11, "Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists" ("ASU 2013-11"). ASU 2013-11 is intended to end inconsistent practices regarding the presentation of unrecognized tax benefits when a net operating loss, a similar tax loss, or a tax credit carryforward is available to reduce the taxable income or tax payable that would result from the disallowance of a tax position. ASU 2013-11 is effective for the Company beginning November 1, 2014. The adoption of ASU 2013-11 is not expected to have a material effect on the Company's condensed consolidated financial statements or disclosures.

2. Acquisition

On February 4, 2014, the Company completed its acquisition of Shapell Industries, Inc. ("Shapell") pursuant to the Purchase and Sale Agreement (the "Purchase Agreement") dated November 6, 2013, with Shapell Investment Properties, Inc. ("SIPI"). Pursuant to the Purchase Agreement, the Company acquired, for cash, all of the equity interests in Shapell from SIPI for an aggregate purchase price of $1.60 billion (the "Acquisition"). The Company acquired the single-family residential real property development business of Shapell, including a portfolio of approximately 4,950 home sites in California, some of which the Company will sell to other builders. This acquisition provides the Company with a premier California land portfolio including 11 active selling communities, as of the acquisition date, in affluent, high-growth markets: the San Francisco Bay area, metro Los Angeles, Orange County and the Carlsbad market. As part of the acquisition, the Company assumed contracts to deliver 126 homes with an aggregate value of approximately $105.3 million.

The Company did not acquire apartment and commercial rental properties owned and operated by Shapell (the "Shapell Commercial Properties") or Shapell's mortgage lending activities relating to its home building operations. Accordingly, the Purchase Agreement provides that SIPI will indemnify the Company for any loss arising out of or resulting from, among other things, (i) any liability (other than environmental losses, subject to certain exceptions) related to the Shapell Commercial Properties, and (ii) any liability (other than environmental losses, subject to certain exceptions) to the extent related to Shapell Mortgage, Inc.

The Company financed the Acquisition with a combination of $370.0 million of borrowings under its $1.035 billion unsecured revolving credit facility, $485.0 million from a term loan facility, as well as with $815.7 million in net proceeds from debt and equity financings completed in November 2013. See Note 6, "Loans Payable, Senior Notes and Mortgage Company Loan Facility" and Note 12, "Stock Issuance and Stock Repurchase Program" for further details. As a result of the Acquisition, Shapell became a wholly-owned subsidiary of the Company. Accordingly, the Shapell results are included in the Company's condensed consolidated financial statements from the date of the Acquisition. For the period from February 5, 2014 to April 30, 2014, revenues and operating income from the Shapell operations, excluding $5.1 million of acquisition-related costs, were $102.0 million and $6.1 million, respectively.

The Acquisition was accounted for in accordance with ASC 805, "Business Combinations" ("ASC 805"), and, therefore, the acquired assets and assumed liabilities were recorded by the Company at their preliminary estimated fair values. The following table summarizes the preliminary amounts for acquired assets and liabilities recorded at their fair values as of the acquisition date (amounts in thousands):

Assets acquired and liabilities assumed	
Cash and cash equivalents	$106,233
Inventory	1,509,501
Property, construction and office equipment, net	404
Receivables, prepaid expenses and other assets	10,759
Total assets acquired	1,626,897
Customer deposits	(5,429)
Accounts payable and accrued liabilities	(26,119)
Total liabilities assumed	(31,548)
Total net assets acquired	$1,595,349

Cash and cash equivalents, customer deposits and accounts payable were generally stated at historical carrying values given the short-term nature of these assets and liabilities. Receivables, prepaid expenses and other assets and accrued

expenses were adjusted to reflect fair values.

The Company determined the fair value of inventory on a community-by-community basis primarily using a combination of discounted cash flow models and market comparable land transactions, where available. These estimated cash flows are significantly impacted by estimates related to: (i) expected selling prices, (ii) expected settlement paces, (iii) expected land development and construction timelines, and anticipated land development costs and construction costs, and (iv) overhead costs

expected to be incurred in the future. Such estimates must be made for each individual community and may vary significantly between communities. See Note 1 in the Company's Annual Report on Form 10-K and Note 14 in this Form 10-Q for additional discussion of the factors impacting the fair value of inventory.
The Company completed the majority of its business combination accounting as of April 30, 2014 and expects to substantially complete the remainder by October 31, 2014. The Company is in the process of finalizing its fair value estimates for all of the Shapell assets acquired and liabilities assumed and, therefore, the estimates used at April 30, 2014 are subject to change.
The Company recorded $5.9 million and $5.1 million in acquisition-related costs for the six and three month periods ended April 30, 2014, which are included in the Condensed Consolidated Statements of Operations within "Selling, general and administrative." Such costs were expensed as incurred in accordance with ASC 805. There were no acquisition-related costs incurred in the six and three month periods ended April 30, 2013.
Supplemental pro forma information
The following presents unaudited pro forma amounts as if the acquisition had been completed as of November 1, 2012 (amounts in thousands, except per share data):

	Six months ended April 30,		Three months ended April 30,	
	2014	2013	2014	2013
Revenues	$1,637,554	$1,145,337	$860,374	$606,564
Net income	137,943	39,485	74,674	29,488
Income per share – basic	0.78	0.22	0.42	0.17
Income per share – diluted	0.75	0.22	0.40	0.16

The unaudited pro forma operating results have been determined after adjusting the operating results of Shapell to reflect the purchase accounting and other acquisition adjustments including interest expense associated with the debt used to fund a portion of the acquisition. The unaudited pro forma results do not reflect any cost savings, operating synergies or revenue enhancements that the Company may achieve as a result of the Acquisition, the costs to integrate Shapell's operations, or the costs necessary to achieve these cost savings, operating synergies and revenue enhancements. Accordingly, the unaudited pro forma amounts are for comparative purposes only and may not necessarily reflect the results of operations which would have resulted had the acquisition been completed at the beginning of the applicable period or indicative of the results that will be attained in the future.
Certain other adjustments, including those related to conforming accounting policies and interest capitalization, have not been reflected in the supplemental pro forma operating results due to the impracticability of estimating such impacts.
3. Inventory
Inventory at April 30, 2014 and October 31, 2013 consisted of the following (amounts in thousands):

	April 30, 2014	October 31, 2013
Land controlled for future communities	$139,961	$99,802
Land owned for future communities	2,385,234	1,287,630
Operating communities	4,022,829	3,262,980
	$6,548,024	$4,650,412

Operating communities include communities offering homes for sale; communities that have sold all available home sites but have not completed delivery of the homes; communities that were previously offering homes for sale but are temporarily closed due to business conditions or non-availability of improved home sites and that are expected to reopen within twelve months of the end of the fiscal period being reported on; and communities preparing to open for sale. The carrying value attributable to operating communities includes the cost of homes under construction, land and land development costs, the carrying cost of home sites in current and future phases of these communities, and the carrying cost of model homes.
Communities that were previously offering homes for sale but are temporarily closed due to business conditions that do not have any remaining backlog and are not expected to reopen within twelve months of the end of the fiscal period being reported on have been classified as land owned for future communities. Backlog consists of homes under

contract but not yet delivered to the Company’s home buyers (“backlog”).

Information regarding the classification, number and carrying value of these temporarily closed communities, as of the date indicated, is provided in the table below.

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	April 30, 2014	October 31, 2013
Land owned for future communities:		
Number of communities	20	25
Carrying value (in thousands)	$136,870	$153,498
Operating communities:		
Number of communities	14	15
Carrying value (in thousands)	$83,172	$88,534

The amounts the Company provided for inventory impairment charges and the expensing of costs that it believed not to be recoverable, for the periods indicated, are shown in the table below (amounts in thousands).

	Six months ended April 30,		Three months ended April 30,	
	2014	2013	2014	2013
Land controlled for future communities	$1,006	$698	$324	$689
Operating communities	2,900	1,040	1,600	340
	$3,906	$1,738	$1,924	$1,029

See Note 14, “Fair Value Disclosures,” for information regarding the number of operating communities that the Company tested for potential impairment, the number of operating communities in which it recognized impairment charges, the amount of impairment charges recognized, and the fair values of those communities, net of impairment charges.

See Note 16, “Commitments and Contingencies,” for information regarding land purchase commitments.

At April 30, 2014, the Company evaluated its land purchase contracts to determine if any of the selling entities were variable interest entities (“VIEs”) and, if they were, whether the Company was the primary beneficiary of any of them. Under these land purchase contracts, the Company does not possess legal title to the land and its risk is generally limited to deposits paid to the sellers, and the creditors of the sellers generally have no recourse against the Company. At April 30, 2014, the Company determined that 79 land purchase contracts, with an aggregate purchase price of $802.7 million, on which it had made aggregate deposits totaling $47.9 million, were VIEs, and that it was not the primary beneficiary of any VIE related to its land purchase contracts. At October 31, 2013, the Company determined that 87 land purchase contracts, with an aggregate purchase price of $1.12 billion, on which it had made aggregate deposits totaling $51.9 million, were VIEs, and that it was not the primary beneficiary of any VIE related to its land purchase contracts.

Interest incurred, capitalized and expensed, for the periods indicated, was as follows (amounts in thousands):

	Six months ended April 30,		Three months ended April 30,	
	2014	2013	2014	2013
Interest capitalized, beginning of period	$343,077	$330,581	$356,618	$340,904
Interest incurred	82,628	64,051	42,684	32,303
Interest expensed to cost of revenues	(54,585)	(42,990)	(29,145)	(23,016)
Write-off against other income	(1,039)	(1,221)	(722)	(1,133)
Interest capitalized on investments in unconsolidated entities	(4,757)	(2,872)	(2,300)	(1,509)
Previously capitalized interest on investments in unconsolidated entities transferred to inventory	1,811	—	—	—
Interest capitalized, end of period	$367,135	$347,549	$367,135	$347,549

Inventory impairment charges are recognized against all inventory costs of a community, such as land, land improvements, cost of home construction and capitalized interest. The amounts included in the table directly above reflect the gross amount of capitalized interest without allocation of any impairment charges recognized. The Company estimates that, had inventory impairment charges been allocated on a pro-rata basis to the individual components of inventory, capitalized interest at April 30, 2014 and 2013 would have been reduced by approximately

$35.4 million and $43.4 million, respectively.

4. Investments in and Advances to Unconsolidated Entities
The Company has investments in and advances to various unconsolidated entities. These entities include land development joint ventures, home building joint ventures, rental property joint ventures, Toll Brothers Realty Trust and Trust II, and a structured asset joint venture. At April 30, 2014, the Company had investments in and advances to these unconsolidated entities of $441.8 million and was committed to invest or advance up to an additional $101.7 million to these entities if they require additional funding. The Company’s investments in these entities are accounted for using the equity method of accounting.
More specific information regarding the Company’s investments in, advances to, and future commitments to these entities is provided below.
Land Development Joint Ventures

The Company has investments in and advances to a number of joint ventures with unrelated parties to develop land (“Land Development Joint Ventures”). Some of these Land Development Joint Ventures develop land for the sole use of the venture participants, including the Company, and others develop land for sale to the joint venture participants and to unrelated builders. The Company recognizes its share of earnings from the sale of home sites and other land by the Land Development Joint Ventures to other builders. With regard to home sites the Company purchases from the Land Development Joint Ventures, the Company adjusts its cost basis in those home sites by its share of the earnings/losses of the joint venture on the home sites the Company purchases. At April 30, 2014, the Company had approximately $160.5 million invested in or advanced to the Land Development Joint Ventures and a funding commitment of $45.4 million to four of the Land Development Joint Ventures which would be funded if additional investment in the ventures is required. At April 30, 2014, two of these joint ventures had aggregate loan commitments of $105.0 million and outstanding borrowings against these commitments of $29.2 million.

At April 30, 2014, the Company had a purchase commitment to acquire 115 home sites from one of these Land Development Joint Ventures for an aggregate purchase price of $12.6 million. In addition, the Company expects to purchase approximately 3,800 additional lots from several Land Development Joint Ventures in which it has interests. The purchase price of the lots will be determined at a future date. The Company will also receive approximately 935 home sites from one of its Land Development Joint Ventures in consideration of its previous investment in the joint venture. Set forth below is additional information regarding activity in certain Land Development Joint Ventures; such activity is included in the summary information provided above.
In the first quarter of fiscal 2014, the Company entered into a joint venture with an unrelated party to develop a parcel of land in Texas. The joint venture expects to develop a master planned community consisting of up to 6,500 home sites and retail and commercial property. The Company has a 50% interest in this joint venture. Prior to the formation of the joint venture, the Company had entered into a land purchase agreement to acquire the land for approximately $79.3 million. The Company contributed its rights under the purchase agreement to the joint venture and was reimbursed by the Company’s joint venture partner for 50% of the costs the Company incurred prior to the formation of the joint venture. At April 30, 2014, the Company had an investment of $40.6 million in this joint venture. In May 2014, the joint venture obtained outside financing of $40.0 million to help fund the future development of the property.
In the fourth quarter of fiscal 2013, the Company entered into a joint venture with an unrelated party to develop a parcel of land in Maryland. The property consists of 945 acres which the joint venture expects to develop into approximately 1,300 home sites. The Company has a 50% interest in this joint venture. The current plan is to develop the property and sell approximately 50% of the home sites to each of the members of the joint venture. The Company made an initial investment of $11.8 million of cash to the joint venture. At April 30, 2014, the Company had an investment of $11.9 million in this joint venture.
In the second quarter of fiscal 2013, the Company entered into a joint venture with an unrelated party to develop a parcel of land in Texas as a master planned community consisting of approximately 2,900 lots. The Company has a 50% interest in this joint venture. The joint venture expects to develop the property in multiple phases and sell groups

of lots to the members of the joint venture and to other home builders. The Company made an initial investment of $15.5 million of cash to the joint venture. The joint venture entered into a $25.0 million line of credit with a bank, secured by a deed of trust on the property which can be expanded up to $40.0 million under certain conditions. At April 30, 2014, the joint venture had $24.2 million of borrowings under this line of credit. At April 30, 2014, the Company had an investment of $24.2 million in this joint venture and was committed to make additional contributions to this joint venture of up to $9.0 million.

The Company has a 50% interest in a joint venture that owns and is developing a master planned community in Orange County, California, consisting of over 2,000 home sites. At April 30, 2014, the joint venture owned approximately 1,200 home sites. At April 30, 2014, the Company had an investment of $77.3 million in this joint venture and was committed to make additional contributions to this joint venture of up to $10.0 million, if needed. The joint venture has an $80.0 million credit facility from a bank to fund the development of the property. At April 30, 2014, the venture had $5.0 million borrowed under the facility.

Home Building Joint Ventures

At April 30, 2014, the Company had an aggregate of $183.0 million of investments in and advances to various joint ventures with unrelated parties to develop approximately 600 luxury for-sale homes. At April 30, 2014, the Company had $33.0 million of funding commitments to two of these joint ventures.

Rental Property Joint Ventures

At April 30, 2014, the Company had an aggregate of $75.3 million of investments in and advances to several joint ventures with unrelated parties to develop luxury for-rent residential apartments, commercial space, and a hotel (“Rental Property Joint Ventures”). At April 30, 2014, the Company had $23.3 million of funding commitments to these joint ventures. At April 30, 2014, four of these joint ventures had aggregate loan commitments of $319.8 million and outstanding borrowings against these commitments of $32.2 million. Set forth below is additional information regarding activity in certain Rental Property Joint Ventures; such activity is included in the summary information provided above.

In the first quarter of 2014, two of the Company’s Rental Property Joint Ventures entered into $126.0 million of construction loan agreements to finance construction of multi-family residential apartments in suburban Philadelphia and northern New Jersey. At April 30, 2014, these ventures had $1.3 million borrowings under the new facilities.

In the fourth quarter of fiscal 2013, the Company entered into a joint venture with an unrelated party to develop a 287-unit luxury for-rent residential apartment building in the Capitol Riverfront of Washington, D.C. on land that the Company owned and conveyed to the joint venture. The Company has a 50% interest in this joint venture. As part of the Company’s initial capital contribution, it contributed land and improvements with a fair value of $27.1 million to the joint venture and subsequently received a cash distribution of $12.5 million to align the capital accounts of each of the members of the joint venture. The joint venture entered into a $54.0 million construction loan agreement with a bank to finance the development of this project. At April 30, 2014, the joint venture had $14.2 million borrowed under the construction loan agreement. At April 30, 2014, the Company had an investment of $14.5 million in this joint venture.

In the second quarter of fiscal 2013, the Company entered into a joint venture with an unrelated party to develop a luxury, 38-story for-rent residential apartment building and retail space in Jersey City, New Jersey on land that the Company owned and conveyed to the joint venture. The Company has a 50% interest in this joint venture. As part of the Company’s initial capital contribution, it contributed land and improvements with a fair value of $28.8 million to the joint venture and subsequently received distributions of $10.2 million and a $1.2 million payment by the joint venture on our behalf to align the capital accounts of each of the members of the joint venture. The joint venture entered into a $120.0 million construction loan agreement with a bank to finance the development of this project. At April 30, 2014, the joint venture had no borrowings under the construction loan agreement. At April 30, 2014, the Company had an investment of $29.4 million in this joint venture and was committed to make additional contributions to this joint venture of up to $0.2 million.

Toll Brothers Realty Trust and Trust II

In fiscal 2005, the Company, together with the Pennsylvania State Employees Retirement System (“PASERS”), formed Toll Brothers Realty Trust II (“Trust II”) to invest in commercial real estate opportunities. Trust II is owned 50% by the Company and 50% by an affiliate of PASERS. In December 2013, Trust II sold substantially all of its assets to an unrelated party. As a result of this sale, the Company realized income of approximately $23.5 million in the first quarter of fiscal 2014 representing its share of the gain on the sale. In the three-month period ended April 30, 2014, we recognized an additional gain of $0.6 million from the sale of a property by Trust II. The gain on sale of assets is included in “Income from unconsolidated entities” on the Company’s Condensed Consolidated Statement of Operations.

In December 2013, the Company received a $20.0 million cash distribution from Trust II. At April 30, 2014, the Company had an investment of $1.2 million in Trust II. In addition, in the first quarter of fiscal 2014, the Company recognized $2.9 million in previously deferred gains on the Company's initial sales of the properties to Trust II. This gain is included in "Other income - net" on the Company's Condensed Consolidated Statements of Operations in this Form 10-Q.

In 1998, prior to the formation of Trust II, the Company formed Toll Brothers Realty Trust ("Trust") to invest in commercial real estate opportunities. The Trust is effectively owned one-third by the Company; one-third by Robert I. Toll, Bruce E. Toll (and members of his family), Douglas C. Yearley, Jr. and former members of the Company's senior management; and one-third by an affiliate of PASERS. As of April 30, 2014, the Company had a negative investment in the Trust of $0.9 million resulting primarily from a loss recognized by the Trust in the fourth quarter of fiscal 2013. The Company provides development, finance and management services to the Trust and recognized fees under the terms of various agreements in the amounts of $1.1 million in each of the six-month periods ended April 30, 2014 and 2013 and $0.6 million and $0.5 million in the three-month periods ended April 30, 2014 and 2013, respectively. In the second quarter of fiscal 2014, the Trust refinanced the mortgage on one of its properties and distributed $36.0 million of the net proceeds from the refinancing to its partners. The Company received $12.0 million as its share of the proceeds and recognized this distribution as income in the quarter. This income is included in "Income from unconsolidated entities" in the Company's Condensed Consolidated Statements of Operations in this Form 10-Q.

Structured Asset Joint Venture

The Company, through Gibraltar Capital and Asset Management LLC ("Gibraltar"), is a 20% participant with two unrelated parties that purchased a 40% interest in an entity that owns and controls a portfolio of loans and real estate ("Structured Asset Joint Venture"). At April 30, 2014, the Company had an investment of $22.8 million in this Structured Asset Joint Venture.

Guarantees

The unconsolidated entities in which the Company has investments generally finance their activities with a combination of partner equity and debt financing. In some instances, the Company and its partners have guaranteed debt of certain unconsolidated entities which may include any or all of the following: (i) project completion including any cost overruns, in whole or in part, (ii) repayment guarantees, generally covering a percentage of the outstanding loan, (iii) indemnification of the lender as to environmental matters affecting the unconsolidated entity, (iv) a hazardous material indemnity that holds the lender harmless against any obligations for which the lender may incur liability resulting from the threat or presence of any hazardous or toxic substances at or near the property covered by a loan, and (v) indemnification of the lender from "bad boy acts" of the unconsolidated entity.

In some instances, the guarantees provided in connection with loans to an unconsolidated entity are joint and several. In these situations, the Company generally has a reimbursement agreement with its partner that provides that neither party is responsible for more than its proportionate share of the guarantee; however, if a joint venture partner does not have adequate financial resources to meet its obligations under the reimbursement agreement, the Company may be liable for more than its proportionate share.

The Company believes that, as of April 30, 2014, in the event it becomes legally obligated to perform under a guarantee of the obligation of an unconsolidated entity due to a triggering event, the collateral should be sufficient to repay a significant portion of the obligation. If it is not, the Company and its partners would need to contribute additional capital to the venture. At April 30, 2014, the unconsolidated entities that have guarantees related to debt had loan commitments aggregating $424.8 million and had borrowed an aggregate of $61.4 million. The term of these guarantees generally range from 19 months to 44 months. The Company estimates that the maximum potential exposure under these guarantees, if the full amount of the loan commitments were borrowed, would be $424.8 million before any reimbursement from the Company's partners. Based on the amounts borrowed at April 30, 2014, the Company's maximum potential exposure under these guarantees is estimated to be approximately $61.4 million before any reimbursement from the Company's partners.

In addition, the Company has guaranteed approximately $11.4 million of ground lease payments and insurance deductibles for three joint ventures.

As of April 30, 2014, the estimated aggregate fair value of the guarantees was approximately $2.0 million. The Company has not made payments under any of the guarantees, nor has it been called upon to do so.

Variable Interest Entities

At April 30, 2014, the Company determined that three of its joint ventures were VIEs under the guidance within FASB Accounting Standards Codification (“ASC”) 810, “Consolidation.” The Company has, however, concluded that it was not the primary beneficiary of the VIEs because the power to direct the activities of these VIEs that most significantly impact their performance was shared by the Company and the VIEs’ other members. Business plans, budgets and other major decisions are required to be unanimously approved by all members. Management and other fees earned by the Company are nominal and believed to be at market rates and there is no significant economic disproportionality between the Company and other members.

The information presented below regarding the investments, commitments and guarantees in unconsolidated entities deemed to be VIEs is also included in the information provided above. At April 30, 2014 and October 31, 2013, the Company’s investments in its unconsolidated joint ventures deemed to be VIEs, which are included in “Investments in and advances to unconsolidated entities” in the accompanying Condensed Consolidated Balance Sheets, totaled $31.4 million and $22.9 million, respectively. At April 30, 2014, the maximum exposure of loss to the Company’s investments in unconsolidated joint ventures that are VIEs is limited to its investment in the unconsolidated VIEs, except with regard to $47.8 million of additional commitments to the VIEs and $9.3 million of guarantees under ground lease agreements. At October 31, 2013, the maximum exposure to loss of the Company’s investments in unconsolidated joint ventures that are VIEs is limited to its investment in the unconsolidated VIEs, except with regard to a $41.7 million additional commitment to fund the joint ventures and a $9.6 million guaranty of ground lease payments.

Joint Venture Condensed Financial Information

The condensed balance sheets, as of the dates indicated, and the condensed statements of operations and comprehensive income for the periods indicated, for the unconsolidated entities in which the Company has an investment, aggregated by type of business, are included below (in thousands). The column titled “Rental Property Joint Ventures” includes the Rental Property Joint Ventures and Toll Brothers Realty Trust and Trust II described above.

Condensed Balance Sheets:

	April 30, 2014				
	Land Development Joint Ventures	Home Building Joint Ventures	Rental Property Joint Ventures	Structured Asset Joint Venture	Total
Cash and cash equivalents	$31,267	$26,209	$39,360	$11,816	$108,652
Inventory	256,691	409,188	392		666,271
Non-performing loan portfolio				69,909	69,909
Rental properties			125,298		125,298
Rental properties under development			177,390		177,390
Real estate owned (“REO”)				207,358	207,358
Other assets (1)	19,275	78,720	13,774	155,929	267,698
Total assets	$307,233	$514,117	$356,214	$445,012	$1,622,576
Debt (1)	$36,092	$10,174	$255,185	$155,900	$457,351
Other liabilities	26,279	38,783	19,210	218	84,490
Members’ equity	244,862	465,160	81,819	115,558	907,399
Noncontrolling interest				173,336	173,336
Total liabilities and equity	$307,233	$514,117	$356,214	$445,012	$1,622,576
Company’s net investment in unconsolidated entities (2)	$160,528	$182,956	$75,574	$22,784	$441,842

	October 31, 2013				
	Land Development Joint Ventures	Home Building Joint Ventures	Rental Property Joint Ventures	Structured Asset Joint Venture	Total
Cash and cash equivalents	$30,826	$31,164	$35,014	$40,097	$137,101
Inventory	350,150	338,814	4,998		693,962
Non-performing loan portfolio				107,411	107,411
Rental properties			164,325		164,325
Rental properties under development			133,081		133,081
Real estate owned (“REO”)				202,259	202,259
Other assets (1)	12,700	70,180	18,526	155,921	257,327
Total assets	$393,676	$440,158	$355,944	$505,688	$1,695,466
Debt (1)	$135,200	$11,977	$235,226	$155,900	$538,303
Other liabilities	21,015	19,636	9,461	379	50,491
Members’ equity	237,461	408,545	111,257	139,764	897,027
Noncontrolling interest				209,645	209,645
Total liabilities and equity	$393,676	$440,158	$355,944	$505,688	$1,695,466
Company’s net investment in unconsolidated entities (2)	$142,448	$166,271	$68,711	$25,703	$403,133

(1) Included in other assets of the Structured Asset Joint Venture at April 30, 2014 and October 31, 2013 is $155.9 million of restricted cash held in a defeasance account which will be used to repay debt of the Structured Asset Joint Venture.

(2)

Differences between the Company's net investment in unconsolidated entities and its underlying equity in the net assets of the entities is primarily a result of the acquisition price of an investment in a land development joint venture in fiscal 2012 which was in excess of the Company's pro-rata share of the underlying equity; impairments related to the Company's investments in unconsolidated entities; a loan made to one of the entities by the Company; interest capitalized on the Company's investment; and distributions from entities in excess of the carrying amount of the Company's net investment.

Condensed Statements of Operations and Comprehensive Income:

	For the six months ended April 30, 2014				
	Land Development Joint Ventures	Home Building Joint Ventures	Rental Property Joint Ventures	Structured Asset Joint Venture	Total
Revenues	$111,950	$23,228	$17,006	$3,789	$155,973
Cost of revenues	62,170	21,825	7,390	6,482	97,867
Other expenses	465	2,047	21,558	874	24,944
Total expenses	62,635	23,872	28,948	7,356	122,811
Gain on disposition of loans and REO				6,458	6,458
Income (loss) from operations	49,315	(644)	(11,942)	2,891	39,620
Other income	5	201	43,199	1,533	44,938
Net income (loss)	49,320	(443)	31,257	4,424	84,558
Less: income attributable to noncontrolling interest				(2,654)	(2,654)
Net income (loss) attributable to controlling interest	49,320	(443)	31,257	1,770	81,904
Other comprehensive income			729		729
Total comprehensive income (loss)	$49,320	$(443)	$31,986	$1,770	$82,633
Company's equity in earnings of unconsolidated entities (3)	$103	$327	$36,622	$190	$37,242

	For the three months ended April 30, 2014				
	Land Development Joint Ventures	Home Building Joint Ventures	Rental Property Joint Ventures	Structured Asset Joint Venture	Total
Revenues	$110,406	$11,647	$7,557	$3,505	$133,115
Cost of revenues	61,488	11,451	3,419	4,132	80,490
Other expenses	210	1,047	9,504	415	11,176
Total expenses	61,698	12,498	12,923	4,547	91,666
Gain on disposition of loans and REO				2,551	2,551
Income (loss) from operations	48,708	(851)	(5,366)	1,509	44,000
Other income	4	162	342	1,409	1,917
Net income (loss)	48,712	(689)	(5,024)	2,918	45,917
Less: income attributable to noncontrolling interest				(1,751)	(1,751)
Net income (loss) attributable to controlling interest	48,712	(689)	(5,024)	1,167	44,166
Other comprehensive loss			(56)		(56)
Total comprehensive income (loss)	$48,712	$(689)	$(5,080)	$1,167	$44,110
Company's equity in earnings of unconsolidated entities (3)	$135	$145	$12,872	$1,175	$14,327

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	For the six months ended April 30, 2013				
	Land Development Joint Ventures	Home Building Joint Ventures	Rental Property Joint Ventures	Structured Asset Joint Venture	Total
Revenues	$35,022	$22,757	$20,303	$21,714	$99,796
Cost of revenues	17,805	19,973	9,010	19,493	66,281
Other expenses	758	1,154	10,565	2,316	14,793
Total expenses	18,563	21,127	19,575	21,809	81,074
Gain on disposition of loans and REO				39,704	39,704
Income from operations	16,459	1,630	728	39,609	58,426
Other income	5	435	9	154	603
Net income	16,464	2,065	737	39,763	59,029
Less: income attributable to noncontrolling interest				(23,858)	(23,858)
Net income attributable to controlling interest	16,464	2,065	737	15,905	35,171
Other comprehensive income			282		282
Total comprehensive income	$16,464	$2,065	$1,019	$15,905	$35,453
Company's equity in earnings of unconsolidated entities (3)	$2,796	$1,079	$1,130	$3,071	$8,076

	For the three months ended April 30, 2013				
	Land Development Joint Ventures	Home Building Joint Ventures	Rental Property Joint Ventures	Structured Asset Joint Venture	Total
Revenues	$33,395	$13,787	$10,621	$12,009	$69,812
Cost of revenues	16,587	12,868	4,717	9,155	43,327
Other expenses	567	690	5,069	1,259	7,585
Total expenses	17,154	13,558	9,786	10,414	50,912
Gain on disposition of loans and REO				12,812	12,812
Income from operations	16,241	229	835	14,407	31,712
Other income	2	421	3	75	501
Net income	16,243	650	838	14,482	32,213
Less: income attributable to noncontrolling interest				(8,689)	(8,689)
Net income attributable to controlling interest	16,243	650	838	5,793	23,524
Other comprehensive loss			(20)		(20)
Total comprehensive income	$16,243	$650	$818	$5,793	$23,504
Company's equity in earnings of unconsolidated entities (3)	$2,894	$369	$572	$1,158	$4,993

(3) Differences between the Company's equity in earnings (losses) of unconsolidated entities and the underlying net income (loss) of the entities is primarily a result of prior impairments related to the Company's investment in unconsolidated entities, a basis difference of an acquired joint venture interest, distributions from entities in excess of the carrying amount of the Company's net investment, and the Company's share of the entities' profits related to

home sites purchased by the Company which reduces the Company's cost basis of the home sites.

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5. Investments in Distressed Loans and Foreclosed Real Estate

Investments in Distressed Loans

The Company's investments in distressed loans consisted of the following as of the dates indicated (amounts in thousands):

	April 30, 2014	October 31, 2013
Unpaid principal balance	$35,528	$63,381
Discount on acquired loans	(16,729)	(27,007)
Carrying value	$18,799	$36,374

The Company's investments in distressed loans includes performing loans and non-performing loans and also includes investments in loan participations classified as secured borrowings under ASC 860, "Transfers and Servicing."

For acquired distressed loans where it is probable that the Company will collect less than the contractual amounts due under the terms of the loan based, at least in part, on the assessment of the credit quality of the borrowers, the loans are accounted for under ASC 310-30, "Loans and Debt Securities Acquired with Deteriorated Credit Quality" ("ASC 310-30"). Under ASC 310-30, provided the Company does not presently have the intention to utilize real estate secured by the loans for use in its operations or to significantly improve the collateral for resale, the amount by which the future cash flows expected to be collected at the acquisition date exceeds the estimated fair value of the loan, or accretable yield, is recognized in other income - net over the estimated remaining life of the loan using a level yield methodology. The difference between the contractually required payments of the loan as of the acquisition date and the total cash flows expected to be collected, or nonaccretable difference, is not recognized.

The accretable yield activity for the Company's investments in distressed loans accounted for under ASC 310-30 for the six-month and three-month periods ended April 30, 2014 and 2013 was as follows (amounts in thousands):

	Six months ended April 30,		Three months ended April 30,	
	2014	2013	2014	2013
Balance, beginning of period	$6,606	$17,196	$3,090	$13,406
Loans acquired				
Additions	554	471	385	471
Deletions	(3,372)	(3,915)	(189)	(1,528)
Accretions	(956)	(2,523)	(454)	(1,120)
Balance, end of period	$2,832	$11,229	$2,832	$11,229

Additions primarily represent the reclassification to accretable yield from nonaccretable yield and the impact of impairments. Deletions primarily represent loan dispositions, which include foreclosure of the underlying collateral and resulting removal of the loans from the accretable yield portfolios, and reclassifications from accretable yield to nonaccretable yield. The reclassifications between accretable and nonaccretable yield and the accretion of interest income are based on various estimates regarding loan performance and the value of the underlying real estate securing the loans. As the Company continues to gather additional information regarding the loans and the underlying collateral, the accretable yield may change. Therefore, the amount of accretable income recorded in the six-month and three-month periods ended April 30, 2014 and 2013 is not necessarily indicative of future results.

The Company acquires distressed loans where it has determined that (1) it is possible to collect all contractual amounts due under the terms of the loan, (2) it expects to utilize the real estate secured by the loans in its operations, or (3) forecasted cash flows cannot be reasonably estimated. For non-performing loans acquired meeting any of these conditions, in accordance with ASC 310-10, "Receivable," ("ASC 310-10"), the loans are classified as nonaccrual and interest income is not recognized. When a loan is classified as nonaccrual, any subsequent cash receipt is accounted for using the cost recovery method. For performing loans, payments are applied to principal and interest in accordance with the terms of the loan when received. As of April 30, 2014 and October 31, 2013, the Company had investments in non-performing loans, accounted for in accordance with ASC 310-10, of $11.5 million and $21.4 million, respectively. At October 31, 2013, the Company had investments in performing loans of $0.8 million. The Company had no investments in performing loans as of April 30, 2014.

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Foreclosed Real Estate Owned (REO)

The table below provides, for the periods indicated, the activity in REO (amounts in thousands):

	Six months ended April 30,		Three months ended April 30,	
	2014	2013	2014	2013
Balance, beginning of period	$72,972	$58,353	$79,267	$68,764
Additions	8,036	14,317	871	3,277
Sales	(4,192)	(911)	(3,384)	(472)
Impairments	(2)	(15)	(2)	
Depreciation	(162)	(286)	(100)	(111)
Balance, end of period	$76,652	$71,458	$76,652	$71,458

As of April 30, 2014, approximately $7.2 million and $69.5 million of REO was classified as held-for-sale and held-and-used, respectively. As of April 30, 2013, approximately $9.4 million and $62.0 million of REO was classified as held-for-sale and held-and-used, respectively. For the six-month periods ended April 30, 2014 and 2013, the Company recorded gains of $1.5 million and $1.5 million, respectively, from acquisitions of REO through foreclosure. For the three-month periods ended April 30, 2014 and 2013, the Company recorded gains of $5,000 and $0.8 million, respectively, from the acquisition of REO through foreclosure.

General

The Company's earnings from Gibraltar's operations, excluding its investment in the Structured Asset Joint Venture, are included in "Other income - net" in its Condensed Consolidated Statements of Operations. In the six-month periods ended April 30, 2014 and 2013, the Company recognized $5.7 million and $1.1 million of earnings (excluding earnings from its investment in the Structured Asset Joint Venture), respectively, from Gibraltar's operations. In the three-month periods ended April 30, 2014 and 2013, the Company recognized $1.4 million and $1.0 million of earnings (excluding earnings from its investment in the Structured Asset Joint Venture), respectively, from Gibraltar's operations.

6. Loans Payable, Senior Notes and Mortgage Company Loan Facility

Loans Payable

At April 30, 2014 and October 31, 2013, loans payable consisted of the following (amounts in thousands):

	April 30, 2014	October 31, 2013
Credit facility borrowings	$95,000	
Unsecured bank term loan	485,000	
Loans payable - other	167,088	$107,222
	$747,088	$107,222

Credit Facility

On August 1, 2013, the Company entered into an $1.035 billion ("Aggregate Credit Commitment") unsecured, 5-year credit facility ("Credit Facility") with 15 banks which extends to August 1, 2018. Up to 75% of the Aggregate Credit Commitment is available for letters of credit. The Credit Facility has an accordion feature under which the Company may, subject to certain conditions set forth in the agreement, increase the Credit Facility up to a maximum aggregate amount of $2.0 billion. The Company may select interest rates for the Credit Facility equal to (i) the London Interbank Offering Rate ("LIBOR") plus an applicable margin or (ii) the lenders' base rate plus an applicable margin, which in each case is based on the Company's credit rating and leverage ratio. At April 30, 2014, the interest rate on outstanding borrowings under the Credit Facility was 1.85% per annum. The Company is obligated to pay an undrawn commitment fee which is based on the average daily unused amount of the Aggregate Credit Commitment and the Company's credit ratings and leverage ratio. Any proceeds from borrowings under the Credit Facility may be used for general corporate purposes. The Company and substantially all of its 100% owned home building subsidiaries are guarantors under the Credit Facility.

Under the terms of the Credit Facility, the Company is not permitted to allow its maximum leverage ratio (as defined in the Credit Facility) to exceed 1.75 to 1.00 and is required to maintain a tangible net worth (as defined in the Credit Facility) of no less than approximately $2.45 billion. Under the terms of the Credit Facility, at April 30, 2014, the

Company’s leverage ratio was approximately 0.81 and its tangible net worth was approximately $3.65 billion. Based upon the minimum tangible net

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worth requirement at April 30, 2014, the Company's ability to repurchase its common stock is limited to approximately $1.71 billion.

At April 30, 2014, the Company had $95.0 million outstanding borrowings under the Credit Facility and had outstanding letters of credit of approximately $90.8 million. As part of the Shapell acquisition, the Company borrowed $370.0 million under the Credit Facility on February 3, 2014, of which $275.0 million was repaid as of April 30, 2014.

Senior Unsecured Term Loan

On February 3, 2014, the Company entered into a 5-year senior, $485.0 million, unsecured term loan facility (the "Term Loan Facility") with ten banks. The full amount of the Term Loan Facility was borrowed by the Company on February 3, 2014. The Company may select interest rates for the Term Loan Facility equal to (i) LIBOR plus an applicable margin, (ii) the base rate (which is defined as the greatest of (a) SunTrust Bank's prime rate, (b) the federal funds effective rate plus 0.5% and (c) one-month LIBOR plus 1%) plus an applicable margin or (iii) the federal funds / Euro rate (which is defined as the greater of (a) the sum of the federal funds effective rate plus an applicable margin plus 0.25% and (b) one-month LIBOR), with the applicable margin, in each case, based on the Company's leverage ratio. At April 30, 2014, the interest rate on the Term Loan Facility was 1.56% per annum.

The Company and substantially all of its 100% owned home building subsidiaries are guarantors under the Term Loan Facility. The Term Loan Facility contains substantially the same financial covenants as the Company's Credit Facility. The Term Loan Facility will mature, and amounts owing under it will become due and payable, on February 3, 2019.

364-Day Senior Unsecured Revolving Credit Facility

On February 4, 2014, the Company entered into a 364-day senior unsecured revolving credit facility (the "364-Day Facility") with five banks. The 364-Day Facility provides for an unsecured revolving credit facility to be made available to the Company, from time to time after February 4, 2014 and prior to February 3, 2015, in the amount of $500.0 million. The Company intends for this facility to remain undrawn and its purpose is to provide the Company additional liquidity should unforeseen circumstances arise. The Company may select interest rates for the 364-Day Facility equal to (i) LIBOR plus an applicable margin, (ii) the base rate (which is defined as the greatest of (a) Citibank's prime rate, (b) the federal funds effective rate plus 0.5% and (c) one-month LIBOR plus 1%) plus an applicable margin or (iii) the federal funds / Euro rate (which is defined as the greater of (a) the sum of the federal funds effective rate plus an applicable margin plus 0.25% and (b) one-month LIBOR), with the applicable margin, in each case, based on the Company's leverage ratio. The Company is obligated to pay an undrawn commitment fee.

The Company and substantially all of its 100% owned home building subsidiaries are guarantors under the 364-Day Facility. The 364-Day Facility contains substantially the same financial covenants as the Company's Credit Facility. The 364-Day Facility will terminate, and amounts owed under the 364-Day Facility will become due and payable, on February 3, 2015.

At April 30, 2014, the Company had no outstanding borrowings under the 364-Day Facility.

Loans Payable - Other

The Company's loans payable - other represent purchase money mortgages on properties the Company had acquired that the seller had financed and various revenue bonds that were issued by government entities on behalf of the Company to finance community infrastructure and the Company's manufacturing facilities. At April 30, 2014, the weighted-average interest rate on the Company's loans payable - other was 4.64% per annum.

Senior Notes

At April 30, 2014, the Company, through Toll Brothers Finance Corp, had eight issues of Senior Notes outstanding with an aggregate principal amount of $2.66 billion.

In March 2014, the Company repaid the $268.0 million of outstanding 4.95% Senior Notes due March 15, 2014.

In November 2013, the Company issued $350.0 million principal amount of 4.0% Senior Notes due 2018 (the "4.0% Senior Notes") and $250.0 million principal amount of 5.625% Senior Notes due 2024 (the "5.625% Senior Notes"). The Company received $596.2 million of net proceeds from the issuance of the 4.0% Senior Notes and the 5.625% Senior Notes.

In September 2013, the Company repaid the $104.8 million of outstanding 5.95% Senior Notes due September 15, 2013.

In April 2013, the Company issued $300.0 million principal amount of 4.375% Senior Notes due 2023 (the “4.375% Senior Notes”) at par. The Company received $298.1 million of net proceeds from this issuance of 4.375% Senior Notes.

In May 2013, the Company issued an additional $100.0 million principal amount of 4.375% Senior Notes at a price equal to 103% of par value. The Company received $102.3 million of net proceeds from this additional issuance of 4.375% Senior Notes.

In November 2012, the Company repaid the $59.1 million of outstanding 6.875% Senior Notes due November 15, 2012.

Mortgage Company Loan Facility

In July 2013, TBI Mortgage Company ("TBI Mortgage"), the Company's wholly-owned mortgage subsidiary, amended its Master Repurchase Agreement (the "Repurchase Agreement") with Comerica Bank. The purpose of the Repurchase Agreement is to finance the origination of mortgage loans by TBI Mortgage and it is accounted for as a secured borrowing under ASC 860, "Transfers and Servicing." The Repurchase Agreement, as amended, provides for loan purchases of up to $50 million, subject to certain sublimits. In addition, the Repurchase Agreement provides for an accordion feature under which TBI Mortgage may request that the aggregate commitments under the Repurchase Agreement be increased to an amount up to $75 million for a short period of time. The Repurchase Agreement, as amended, expires on July 22, 2014 and bears interest at LIBOR plus 2.00% per annum, with a minimum rate of 3.00%. At April 30, 2014, the Company had $56.8 million of outstanding borrowings under the Repurchase Agreement.

7. Accrued Expenses

Accrued expenses at April 30, 2014 and October 31, 2013 consisted of the following (amounts in thousands):

	April 30, 2014	October 31, 2013
Land, land development and construction	$136,781	$152,674
Compensation and employee benefit	111,664	111,561
Insurance and litigation	92,814	89,104
Warranty	52,579	43,819
Interest	37,444	25,675
Commitments to unconsolidated entities	4,259	3,804
Other	104,132	96,350
	$539,673	$522,987

The Company accrues for expected warranty costs at the time each home is closed and title and possession are transferred to the home buyer. Warranty costs are accrued based upon historical experience. The table below provides, for the periods indicated, a reconciliation of the changes in the Company's warranty accrual (amounts in thousands):

	Six months ended April 30,		Three months ended April 30,	
	2014	2013	2014	2013
Balance, beginning of year	$43,819	$41,706	$42,688	$41,241
Additions - homes closed during the year	7,302	5,223	4,205	2,934
Addition - Shapell liabilities acquired	9,244		9,244	
Increase (decrease) in accruals for homes closed in prior years	1,421	(478)	1,077	(212)
Charges incurred	(9,207)	(5,342)	(4,635)	(2,854)
Balance, end of year	$52,579	$41,109	$52,579	$41,109

8. Income Taxes

The table below provides, for the periods indicated, reconciliations of the Company's effective tax rate from the federal statutory tax rate (amounts in thousands):

	Six months ended April 30,			
	2014		2013	
	$	%*	$	%*
Federal tax provision at statutory rate	57,652	35.0	17,253	35.0
State tax provision, net of federal benefit	7,851	4.8	2,051	4.2
Domestic production activities deduction	(4,251)	(2.6)		
Other permanent differences	(2,338)	(1.4)		
Reversal of accrual for uncertain tax positions	(9,112)	(5.5)		
Accrued interest on anticipated tax assessments	1,126	0.7	1,982	4.0
Increase in unrecognized tax benefits	5,406	3.3		
Valuation allowance – reversed	(1,226)	(0.7)	(1,277)	(2.6)
Other	(1,191)	(0.7)	179	0.4
Income tax provision	53,917	32.7	20,188	41.0

	Three months ended April 30,			
	2014		2013	
	$	%*	$	%*
Federal tax provision at statutory rate	32,719	35.0	14,339	35.0
State tax provision, net of federal benefit	4,866	5.2	1,705	4.2
Domestic production activities deduction	(2,417)	(2.6)		
Other permanent differences	(1,324)	(1.4)		
Reversal of accrual for uncertain tax positions	(9,112)	(9.7)		
Accrued interest on anticipated tax assessments	340	0.4	817	2.0
Increase in unrecognized tax benefits	5,406	5.8		
Valuation allowance – reversed	(778)	(0.8)	(1,061)	(2.6)
Other	(1,438)	(1.5)	494	1.2
Income tax provision	28,262	30.2	16,294	39.8

* Due to rounding, amounts may not add.

The Company currently operates in 20 states and is subject to various state tax jurisdictions. The Company estimates its state tax liability based upon the individual taxing authorities' regulations, estimates of income by taxing jurisdiction, and the Company's ability to utilize certain tax-saving strategies. Based on the Company's estimate of the allocation of income or loss among the various taxing jurisdictions and changes in tax regulations and their impact on the Company's tax strategies, the Company estimated its rate for the full fiscal year for state income taxes at 7.3% and 6.5% for fiscal 2014 and 2013, respectively.

For state tax purposes, due to past and projected losses in certain jurisdictions where the Company does not have carryback potential and/or cannot sufficiently forecast future taxable income, the Company has recognized net cumulative valuation allowances against its state deferred tax assets of $54.5 million and $55.7 million as of April 30, 2014 and October 31, 2013, respectively.

9. Stock-Based Benefit Plans

The Company grants stock options, restricted stock, and various types of restricted stock units to its employees and its non-employee directors. Additionally, the Company has an employee stock purchase plan that allows employees to purchase Company stock at a discount.

Beginning in fiscal 2012, the Company changed the mix of stock-based compensation to its employees (other than certain senior executives) by reducing the number of stock options it grants and, in their place, issued non-performance based restricted stock units ("RSUs") as a form of compensation. The Company also replaced its stock price-based restricted stock unit ("Stock Price-Based RSUs") awards for certain senior executives with a performance-based restricted stock ("Performance-Based RSUs") award program.

Information regarding the amount of total stock-based compensation expense and tax benefit recognized by the Company, for the periods indicated, is as follows (amounts in thousands):

	Six months ended April 30,		Three months ended April 30,	
	2014	2013	2014	2013
Total stock-based compensation expense recognized	$12,294	$10,027	$4,625	$4,343
Income tax benefit recognized	$4,619	$3,666	$1,647	$1,588

At April 30, 2014 and October 31, 2013, the aggregate unamortized value of outstanding stock-based compensation awards was approximately $33.1 million and $19.9 million, respectively.

Information about the Company's more significant stock-based compensation programs is outlined below.

Stock Options

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

The weighted-average assumptions and the fair value used for stock option grants in fiscal 2014 and 2013 were as follows:

	2014	2013
Expected volatility	36.44% - 44.71%	44.04% - 48.13%
Weighted-average volatility	42.71%	46.70%
Risk-free interest rate	1.45% - 2.71%	0.64% - 1.56%
Expected life (years)	4.55 - 9.02	4.48 - 8.88
Dividends	none	none
Weighted-average grant date fair value per share of options granted	$14.26	$13.05

Stock compensation expense, related to stock options, for the periods indicated, was as follows (amounts in thousands):

	2014	2013
Six months ended April 30,	$5,660	$4,835
Three months ended April 30,	$1,630	$1,360

Performance-Based Restricted Stock Units

The Executive Compensation Committee of the Company's Board of Directors ("Executive Compensation Committee") approved awards of Performance-Based RSUs relating to shares of the Company's common stock to certain of its senior management. The Performance-Based RSUs are based on the attainment of certain performance metrics of the Company in the fiscal year of grant if the performance targets are met. The number of shares underlying the Performance-Based RSUs that will be issued to the recipients may range from 90% to 110% of the base award depending on the Company's actual performance as compared to the target performance goals. The Performance-Based RSUs vest over a four-year period provided the recipients continue to be employed by the Company or serve on the board of directors of the Company (as applicable) as specified in the award document.

The value of the Performance-Based RSUs was determined to be equal to the estimated number of shares of the Company's common stock to be issued multiplied by the closing price of the Company's common stock on the New York Stock Exchange ("NYSE") on the later of the date the performance goals were approved by the Executive Compensation Committee, or on the date the Performance-Based RSUs were granted ("Valuation Date"). The Company evaluates the performance goals quarterly and estimates the number of shares underlying the Performance-Based RSUs that are probable of being issued. Information regarding the issuance, valuation assumptions and amortization of the Company's Performance-Based RSUs issued in the six-month periods ended April 30, 2014 and 2013 is provided below.

	2014	2013
Number of shares underlying Performance-Based RSUs to be issued	284,037	302,511
Closing price of the Company's common stock on Valuation Date	$35.16	$37.78
Aggregate fair value of Performance-Based RSUs issued (in thousands)	$9,987	$11,429
Performance-Based RSU expense recognized in the six months ended April 30, (in thousands)	$4,453	$2,588
Performance-Based RSU expense recognized in the three months ended April 30, (in thousands)	$2,382	$2,074

Note: The fiscal 2014 number of shares underlying Performance-Based RSUs to be issued and their aggregate fair value is estimated.

Information regarding the aggregate number of outstanding Performance-Based RSUs and the aggregate unamortized value of the outstanding Performance-Based RSUs, as of the date indicated, is provided below.

	April 30, 2014	October 31, 2013
Aggregate outstanding Performance-Based RSUs	956,725	672,687
Cumulative unamortized value of Performance-Based RSUs (in thousands)	$13,653	$8,120

Stock Price-Based Restricted Stock Units

Information regarding the amortization of the Company's Stock Price-Based RSUs, for the periods indicated, is provided below (amounts in thousands):

	2014	2013
Six months ended April 30,	$231	$979
Three months ended April 30,	$—	$416

Information regarding the aggregate number of outstanding Stock Price-Based RSUs and aggregate unamortized value of the outstanding Stock Price-Based RSUs, as of the date indicated, is provided below:

	April 30, 2014	October 31, 2013
Aggregate outstanding Stock Price-Based RSUs	—	306,000
Cumulative unamortized value of Stock Price-Based RSUs (in thousands)	$—	$231

In December 2013 and 2012, the Company distributed 306,000 and 200,000 shares, respectively, of stock pursuant to a Stock Price-Based RSU award.

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Non-Performance Based Restricted Stock Units

The Company issued RSUs to various officers, employees and non-employee directors. The value of the RSUs was determined to be equal to the number of shares of the Company's common stock to be issued pursuant to the RSUs, multiplied by the closing price of the Company's common stock on the NYSE on the date the RSUs were awarded.

Information regarding these RSUs issued in the six months ended April 30, 2014 and 2013 is as follows:

	2014	2013
Number of RSUs issued	99,336	94,080
Closing price of the Company's common stock on date of issuance	$35.16	$32.22
Aggregate fair value of RSUs issued (in thousands)	$3,493	$3,031

Information regarding the amortization of the Company's RSUs, for the periods indicated, is as follows (amounts in thousands):

	2014	2013
Six months ended April 30,	$1,902	$1,584
Three months ended April 30,	$591	$472

Information regarding the aggregate number of outstanding RSUs and aggregate unamortized value of the outstanding RSUs, as of the date indicated, is as follows:

	April 30, 2014	October 31, 2013
Aggregate outstanding RSUs	307,606	225,252
Cumulative unamortized value of RSUs (in thousands)	$3,248	$1,706

10. Employee Retirement Plans

The Company has two unfunded supplemental retirement plans ("SRPs"). The table below provides, for the periods indicated, costs recognized and payments made related to its SRPs (amounts in thousands):

	Six months ended April 30,		Three months ended April 30,	
	2014	2013	2014	2013
Service cost	$235	$236	$117	$117
Interest cost	636	521	318	261
Amortization of prior service cost	322	422	161	211
Amortization of unrecognized losses	6	72	3	36
Total costs	$1,199	$1,251	$599	$625
Benefits paid	$444	$444	$211	$211

11. Accumulated Other Comprehensive (Loss) Income

The tables below provide, for the periods indicated, the components of accumulated other comprehensive (loss) income (amounts in thousands):

	Six months ended April 30, 2014							
	Employee Retirement Plans	Available-for-Sale Securities	Derivative Instruments		Total			
Balance, beginning of period	$(2,112)	$ (5)	$ (270)		$ (2,387)			
Other comprehensive (loss) income before reclassifications	(77)	(29)	365		259			
Gross amounts reclassified from accumulated other comprehensive income (loss)	328	(6)			322			
Income tax (expense) benefit	(95)	13	(142	2.4%	5,434	1.6%	3,119	0.8%
Total operating expenses	$35,789	30.5%	$38,173	29.7%	$107,325	31.6%	$ 113,920	28.2%

As a result of declines in certain markets that we serve, we initiated a plan in September 2011 to re-align our manufacturing and research and development activities to be closer to our customers and reduce production costs. These initiatives include headcount reductions, facilities closures, and asset impairments. Completion of the plan is expected during the fourth quarter of 2012 and is expected to result in annual savings in excess of $30.0 million.

Research and Development

The markets we serve constantly present opportunities to develop products for new or emerging applications and require technological changes driving for higher performance, lower cost, and other attributes that we expect may advance our customers’ products. We believe that continued and timely development of new and differentiated products, as well as enhancements to existing products to support customer requirements, are critical for us to compete in the markets we serve.

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Accordingly, we devote significant personnel and financial resources to the development of new products and the enhancement of existing products, and we expect these investments to continue. All of our research and development costs have been expensed as incurred, except those incurred as a result of a business acquisition.
Research and development expenses for the three months ended September 30, 2012 were $14.6 million, or 12.4% of sales, as compared to $17.6 million, or 13.7% of sales, for the three months ended September 30, 2011. Research and development expenses for the nine months ended September 30, 2012 were $44.2 million, or 13.0% of sales, as compared to $50.6 million, or 12.5% of sales, for the nine months ended September 30, 2011. The decrease in research and development expenses in the three months and nine months ended September 30, 2012 as compared to the same periods in 2011 was primarily driven by lower personnel costs as a result of headcount reductions under our restructuring plan.

Selling, General and Administrative

Our selling expenses support domestic and international sales and marketing activities that include personnel, trade shows, advertising, third-party sales representative commissions, and other selling and marketing activities. Our general and administrative expenses support our worldwide corporate, legal, tax, financial, governance, administrative, information systems, and human resource functions in addition to our general management.
Selling, general and administrative ("SG&A") expenses increased $0.3 million in the three months ended September 30, 2012 as compared to the same period in 2011. SG&A expenses decreased $3.8 million in the nine months ended September 30, 2012 as compared to the same period in 2011.The increase for the three months ended September 30, 2012 as compared to the same period in 2011 is due to incentive compensation accruals in the current period based on company performance as compared to plan targets. This was offset by reductions in commissions resulting from lower sales in the current year, travel and purchased services. The decrease for the nine months of 2012 as compared to the nine months of 2011 is primarily the result of reductions in commissions due to lower sales and purchased services, including information technology and legal expenses.

Amortization Expense

Amortization of intangible assets expense was $1.4 million for the three months ended September 30, 2012, compared to $1.0 million for the same period ending September 30, 2011. Amortization expense was $4.1 million for the nine months ended September 30, 2012, compared to $2.8 million for the same period ending September 30, 2011. The increase in amortization is due to in process research and development projects that were placed in service throughout 2011 and the first quarter of 2012. These projects were in process at the acquisition date of PV Powered and were recorded as non-amortizing intangible assets at the acquisition date. As the projects were completed they began amortizing over their estimated useful lives.

Restructuring Charges

In September 2011, we announced several initiatives designed to realign our manufacturing and research and development activities in order to foster growth and enhance profitability. These initiatives are designed to align research and development activities with the location of our customers and reduce production costs. As part of this plan, we reduced our global headcount by 233 people or 13.9% of our total headcount, consolidated our facilities by terminating a lease and exiting several additional leases, and recorded impairments for assets no longer in use due to the restructuring of our business. These activities resulted in $3.0 million and $5.4 million of charges in the three months and nine months ended September 30, 2012, respectively. Over the next 3 months, we expect to implement the remainder of the restructuring plan as we consolidate certain facilities and centralize other activities. We expect these initiatives to result in additional charges of approximately $2.0 million to $3.0 million.

Other Income, net

Other income, net consists primarily of interest income and expense, foreign exchange gains and losses, gains and losses on sales of fixed assets, and other miscellaneous items.
Other income, net was $0.1 million for the three months ended September 30, 2012 as compared to a $0.3 million loss in the same period of 2011. Other income, net was $2.3 million for the nine months ended September 30, 2012 as compared to $0.5 million in the same period of 2011. The increase in 2012 as compared to 2011 for the nine month period is due to gains on our sale of fixed assets of $1.9 million recognized in the nine months ended September 30, 2012.

Provision for Income Taxes

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We recorded an income tax provision from continuing operations for the three months ended September 30, 2012 of $4.3 million compared to $3.2 million for the three months ended September 30, 2011, resulting in effective tax rates of 42.7% and 31.1%, respectively. For the nine months ended September 30, 2012, we recorded an income tax provision of $8.8 million compared to $13.4 million for the nine months ended September 30, 2011, resulting in effective tax rates of 36.6% and 25.3%, respectively. Our effective tax rate for 2012 has increased from 2011 because 2012 projected earnings are being taxed in higher tax rate jurisdictions.

Our future effective income tax rate depends on various factors, such as changes in tax laws, regulations, accounting principles, or interpretations thereof and the geographic composition of our pre-tax income. We carefully monitor these factors and adjust our effective income tax rate accordingly.

Discontinued Operations

On October 15, 2010, we completed the sale of our gas flow control business, which includes the Aera® mass flow control and related product lines to Hitachi, for $43.3 million. Assets and liabilities sold include, without limitation, inventory, real property in Hachioji, Japan, equipment, certain contracts, intellectual property rights related to the gas flow control business, and certain warranty liability obligations. The results of continuing operations were reduced by the revenue and costs associated with the gas flow control business which are included in the Income from discontinued operations, net of income taxes, in our Condensed Consolidated Statements of Operations.

Impact of Inflation

In recent years, inflation has not had a significant impact on our operations. However, we continuously monitor operating price increases, particularly in connection with the supply of component parts used in our manufacturing process. To the extent permitted by competition, we pass increased costs on to our customers by increasing sales prices over time. From time to time, we may also receive pressure from customers to decrease sales prices due to reductions in the cost structure of our products from cost improvement initiatives and decreases in component part prices. Sales price increases and decreases, however, were not significant in any of the periods presented herein.

Liquidity and Capital Resources

LIQUIDITY

We believe that adequate liquidity and cash generation is important to the execution of our strategic initiatives. Our ability to fund our operations, acquisitions, capital expenditures, and product development efforts may depend on our ability to generate cash from operating activities which is subject to future operating performance, as well as general economic, financial, competitive, legislative, regulatory, and other conditions, some of which may be beyond our control. Our primary sources of liquidity are our available cash, investments, and cash generated from current operations as well as our credit facility noted below.

At September 30, 2012, we had $173.7 million in cash, cash equivalents, and marketable securities. We believe that our current cash levels and our cash flows from future operations will be adequate to meet anticipated working capital needs, anticipated levels of capital expenditures, and contractual obligations for the next twelve months.

On October 12, 2012, we entered into a Credit Agreement (the "Credit Agreement") with Wells Fargo Bank, National Association which provides for a secured revolving credit facility ("Credit Facility") of up to $50.0 million. Borrowings under the Credit Facility are subject to a borrowing base based upon our accounts receivable and inventory and are available for various corporate purposes. The Credit Facility provides us further flexibility for execution of our strategic plans. For more information on the Credit Agreement see "Note 20. Credit Facility" as set forth in Part I Item 1 of this Form 10-Q.

On October 30, 2012, we announced a $25.0 million share repurchase program authorized by our Board of Directors. The repurchase program will occur over the next twelve months, requires no minimum number of shares to be repurchased, and may be discontinued at any time.

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CASH FLOWS

A summary of our cash provided by and used in operating, investing and financing, activities is as follows (in thousands):

	Nine Months Ended September 30,	
	2012	2011
Net cash provided by operating activities	$92,250	$26,652
Net cash used in investing activities	(1,522)	(27,602)
Net cash provided by (used in) financing activities	(55,153)	1,081
Effect of currency translation on cash	(2,180)	1,208
Increase in cash and cash equivalents	33,395	1,339
Cash and cash equivalents, beginning of the period	117,639	130,914
Cash and cash equivalents, end of the period	$151,034	$132,253

2012 CASH FLOWS COMPARED TO 2011

Net cash provided by operating activities

Net cash provided by operating activities for the nine months ended September 30, 2012 was $92.3 million, compared to $26.7 million for the same period ended September 30, 2011. The increase of $65.6 million in net cash flows from operating activities is primarily due to improved collections of accounts receivable coupled with a smaller increase in inventory in 2012 as compared to the same period in 2011.

Net cash provided by investing activities

Net cash used in investing activities for the nine months ended September 30, 2012 was $1.5 million, a decrease of $26.1 million from the same period ended September 30, 2011. The reduction in cash used for investing activities in 2012 is the result of lower capital expenditures as compared to the same period in 2011 and additional proceeds from the sale of marketable securities. Capital expenditures for the nine months ended September 30, 2012 were down $8.0 million compared to the same period in 2011. Prior year expenditures included the expansion of production capacity for solar inverters and additions for test equipment related to research and development activities. We expect to fund future capital expenditures with cash generated from operations. Net proceeds and purchases of marketable securities provided $3.0 million of cash in 2012 as compared to using $13.0 million of cash in 2011. Movement of cash between marketable securities and cash and cash equivalents is related to our cash needs at a point in time and may fluctuate from one period to the next.

Net cash provided by (used in) financing activities

Net cash used in financing activities in the nine months ended September 30, 2012 was $55.2 million, a $56.2 million change from the cash provided by financing activities of $1.1 million in the same period of 2011. In November 2011 we announced a $75.0 million share repurchase program, which was completed during the second quarter of 2012. During the nine months ended September 30, 2012, 4.7 million shares were repurchased for $57.1 million of cash. The exercise of stock options provided $2.7 million of cash in 2012 as compared to $1.8 million in 2011.

Effect of currency translation on cash

During the nine months ended September 30, 2012, currency translation had a negative $2.2 million impact on cash compared to a positive impact of $1.2 million in the same period of 2011. The functional currencies of our worldwide operations primarily include U.S. dollar ("USD"), Japanese Yen ("JPY"), Chinese Yuan ("CNY"), New Taiwan Dollar ("TWD"), South Korean Won ("KRW"), British Pound ("GBP") and Euro ("EUR"). Our purchasing and sales activities are primarily denominated in USD, JPY, CNY and EUR. The change in these key currency rates during the nine months ended September 30, 2012 and 2011 are as follows:

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From	To	Nine Months Ended September 30, 2012		2011	
CNY	USD	0.3	%	3.4	%
EUR	USD	(0.6	)%	1.0	%
JPY	USD	(0.7	)%	5.8	%
KRW	USD	4.4	%	(4.5	)%
TWD	USD	3.6	%	(4.3	)%
GBP	USD	4.3	%	0.4	%

Off Balance Sheet Arrangements

We have no off-balance sheet arrangements or variable interest entities.

Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in conformity with U.S. GAAP requires us to make judgments, assumptions and estimates that affect the amounts reported in the Condensed Consolidated Financial Statements and accompanying notes. Note 1 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2011 describes the significant accounting policies and methods used in the preparation of our Consolidated Financial Statements. Our critical accounting estimates, discussed in the Management's Discussion and Analysis of Financial Condition and Results of Operations in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2011, include estimates for allowances for doubtful accounts, determining useful lives for depreciation and amortization, the valuation of assets and liabilities acquired in business combinations, assessing the need for impairment charges for identifiable intangible assets and goodwill, establishing warranty reserves, accounting for income taxes, and assessing excess and obsolete inventories. Such accounting policies and estimates require significant judgments and assumptions to be used in the preparation of the Condensed Consolidated Financial Statements and actual results could differ materially from the amounts reported based on variability in factors affecting these estimates.

Our management discusses the development and selection of our critical accounting policies and estimates with the Audit Committee of our Board of Directors at least annually. Our management also internally discusses the adoption of new accounting policies or changes to existing policies at interim dates, as it deems necessary or appropriate.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk

Our market risk exposure relates to changes in interest rates in our investment portfolio. We generally place our investments with high-credit quality issuers and by policy are averse to principal loss and seek to protect and preserve our invested funds by limiting default risk, market risk, and reinvestment risk. As of September 30, 2012, our investments consisted primarily of commercial paper, certificates of deposit, corporate bonds/notes, municipal bonds/notes, and agency bonds/notes, all with maturity of less than 2 years.

As a measurement of the sensitivity of our portfolio and assuming that our investment portfolio balances remain constant, a hypothetical decrease of 100 basis points (1%) in interest rates would decrease annual pre-tax earnings by approximately $0.2 million.

Foreign Currency Exchange Rate Risk

We are impacted by changes in foreign currency exchange rates through sales and purchasing transactions when we sell products and purchase materials in currencies different from the currency in which product and manufacturing costs were incurred. Our purchasing and sales activities are primarily denominated in the USD, JPY, CNY and EUR. As these currencies fluctuate against each other, and other currencies, we are exposed to foreign currency exchange rate risk on sales, purchasing transactions and labor.

Our reported financial results of operations, including the reported value of our assets and liabilities, are also impacted by changes in foreign currency exchange rates. Assets and liabilities of many of our subsidiaries outside the U.S. are translated at period end rates of exchange for each reporting period. Operating results and cash flow statements are translated at weighted-average rates of exchange during each reporting period. Although these translation changes have no immediate cash impact, the translation changes may impact future borrowing capacity, and overall value of our net assets.

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From time to time, we enter into foreign currency exchange rate contracts to hedge against changes in foreign currency exchange rates on assets and liabilities expected to be settled at a future date. Market risk arises from the potential adverse effects on the value of derivative instruments that result from a change in foreign currency exchange rates. We minimize our market risk applicable to foreign currency exchange rate contracts by establishing and monitoring parameters that limit the types and degree of our derivative contract instruments. We enter into derivative contract instruments for risk management purposes only. We do not enter into or issue derivatives for trading or speculative purposes.

Currency exchange rates vary daily and often one currency strengthens against the USD while another currency weakens. Because of the complex interrelationship of the worldwide supply chains and distribution channels, it is difficult to quantify the impact of a change in one or more particular exchange rates.

See the “Risk Factors” set forth in Part I, Item 1A of our Annual Report on Form 10-K for more information about the market risks to which we are exposed. There have been no material changes in our exposure to market risk from December 31, 2011.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

We have established disclosure controls and procedures, which are designed to ensure that information required to be disclosed in reports filed or submitted under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported, within the time periods specified in the Securities and Exchange Commission’s rules and forms. These disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports that we file or submit under the Act is accumulated and communicated to management, including our Principal Executive Officer (Garry Rogerson, Chief Executive Officer) and Principal Financial Officer (Danny C. Herron, Executive Vice President & Chief Financial Officer), as appropriate, to allow timely decisions regarding required disclosures.

As of the end of the period covered by this report, we conducted an evaluation, with the participation of management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the disclosure controls and procedures pursuant to the Exchange Act Rule 13a-15(b). Based upon this evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2012. The conclusions of the Chief Executive Officer and Chief Financial Officer from this evaluation were communicated to the Audit Committee. We intend to continue to review and document our disclosure controls and procedures, including our internal controls and procedures for financial reporting, and may from time to time make changes aimed at enhancing their effectiveness and to ensure that our systems evolve with our business.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting that occurred during the fiscal quarter covered by this Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION
ITEM 1. LEGAL PROCEEDINGS
We are involved in disputes and legal actions arising in the normal course of our business.
There have been no material developments in legal proceedings in which we are involved during the quarter ended September 30, 2012. For a description of previously reported legal proceedings refer to Part I, Item 3, "Legal Proceedings" of our Annual Report on Form 10-K for the year ended December 31, 2011.
ITEM 1A. RISK FACTORS
Item 1A, "Risk Factors," of our Annual Report on Form 10-K for the year ended December 31, 2011 describes some of the risks and uncertainties associated with our business. The risk factors set forth below update such disclosures. Other factors may also exist that we cannot anticipate or that we currently do not consider to be significant based on information that is currently available. These risks and uncertainties have the potential to materially affect our business, financial condition, results of operations, cash flows and future results. Such risks and uncertainties also may impact the accuracy of forward-looking statements included in this Form 10-Q and other reports we file with the Securities and Exchange Commission.
We are exposed to risks as a result of ongoing changes specific to the solar inverter industry.
A significant portion of our business is in the emerging solar inverter market, which, in addition to the general industry changes described above in the risk factor "The industries in which we compete are subject to volatile and unpredictable cycles," is also characterized by ongoing changes particular to the solar inverter industry. Our business is subject to changes in technology or demand for solar products arising from, among other things, adoption of our inverter products by our customers, compatibility of our solar inverter technology with our customers' products or certain solar panel providers, customers' and end-users' access to affordable financial capital, the cost and performance of solar technology compared to other energy sources, the adequacy of or changes in government energy policies, including the availability and amount of government incentives for solar power (such as feed-in tariffs and tax credits), the continuation of renewable portfolio standards, and the extent of investment or participation in solar by utilities or other companies that generate, transmit, or distribute power to end users. The current debt crisis in Europe and the resulting economic uncertainty and instability in the region could result in limited access to capital for our customers or changes to government incentives for renewable energy which could cause the delay or cancellation of current projects in the solar industry. Moreover, as European solar incentives continue to decline and the Euro devalues, European competitors will likely compete more aggressively in the United States against us. There is also increased market volatility as the size of utility scale solar projects is increasing to hundreds of megawatts of capacity. Such large-scale solar projects require significant financial resources on our part should we be selected as the supplier for solar inverters. We are continuing to see ever increasing requirements in the solar industry for delivery and performance guarantees related to solar inverters and associated liquidated damages provisions. This, combined with long product warranty periods, could result in financial exposure for our business if our solar inverters do not meet delivery, reliability or uptime requirements. Lastly, customers using our solar inverters are beginning to evaluate multi-year service agreements from us for onsite maintenance and support of our inverters and even the solar site. These agreements, however, are subject to annual renewal and may not be renewed by the customers.
If we do not successfully manage the risks resulting from these ongoing changes occurring in the solar industry, we may miss out on substantial opportunities for revenue and our business, financial condition, and results of operations could be materially and adversely affected.

We conduct manufacturing at only a few sites and our sites are not generally interchangeable.

Our power products for the semiconductor industry are manufactured in Shenzhen, PRC and Seoul, South Korea. Our thermal instrumentation products that are used in the semiconductor industry are manufactured in Vancouver, Washington. Each facility manufactures different products, and therefore, are not interchangeable. Labor disruptions, supply difficulties or natural or other uncontrollable occurrences at any of our manufacturing facilities could significantly reduce our productivity at such site and could prevent us from meeting our customers' requirements in a timely manner, or at all. Our losses from any such occurrence could significantly affect our operations and results of

operations for a prolonged period of time.

Our PV Powered solar inverters are manufactured in Bend, Oregon. Our Solaron inverter products are manufactured at our Fort Collins, Colorado facility and we have entered into contract manufacturing relationships in the PRC and Canada, as well. While manufacturing could be shifted to a different manufacturing location for the Solaron and PV Powered inverters if a

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labor disruption, supply difficulty or natural or other uncontrollable occurrence occurred, it may take significant time to transition to another site, and delivery times and costs would likely increase, preventing us from meeting our customers' requirements in a timely manner, or at all. To the extent that local content requirements exist, we may also be limited in such transitions.

Our restructuring and other cost-reduction efforts have included transitioning manufacturing operations to our facility in Shenzhen from other manufacturing facilities, such as Fort Collins and Bend, which renders us increasingly reliant upon our Shenzhen facility. A disruption in manufacturing at our Shenzhen facility, from whatever cause, could have a significantly adverse effect on our ability to fulfill customer orders, our ability to maintain customer relationships, our costs to manufacture our products and, as a result, our results of operations and financial condition.

We maintain significant amounts of cash in international locations.

Given the global nature of our business, we have both domestic and international concentrations of cash and investments. The value of our cash, cash equivalents, and marketable securities can be negatively affected by liquidity, credit deterioration, financial results, economic risk, political risk, sovereign risk or other factors. As a result, we could incur a significant impairment of our cash, cash equivalents, and marketable securities, which could materially adversely affect our financial condition and results of operations.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

31.1	Certification of the Chief Executive Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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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 thereunto duly authorized.

ADVANCED ENERGY INDUSTRIES, INC.

Dated: November 6, 2012

/s/ Danny Herron
Danny C. Herron
Executive Vice President and Chief Financial Officer

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