TORO CO
Form 10-Q
March 05, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Quarterly Period Ended January 29, 2010

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

Delaware	1-8649	41-0580470
(State of Incorporation)	(Commission File Number)	(I.R.S. Employer Identification Number)

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

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

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

Yes S No £

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes £ No £

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

Large accelerated filer S Accelerated filer £ Non-accelerated filer £ Smaller reporting

(Do not check if a smaller reporting company) company £

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

Yes £ No S

The number of shares of Common Stock outstanding as of February 26, 2010 was 33,626,015.

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

	Three Months Ended	
	January 29, 2010	January 30, 2009
Net sales	$331,358	$340,172
Cost of sales	214,967	221,912
Gross profit	116,391	118,260
Selling, general, and administrative expense	96,599	104,559
Earnings from operations	19,792	13,701
Interest expense	(4,245)	(4,358)
Other income, net	901	810
Earnings before income taxes	16,448	10,153
Provision for income taxes	5,530	3,422
Net earnings	$10,918	$6,731
Basic net earnings per share of common stock	$0.32	$0.19
Diluted net earnings per share of common stock	$0.32	$0.18
Weighted-average number of shares of common stock outstanding – Basic	34,030	36,366
Weighted-average number of shares of common stock outstanding – Diluted	34,294	36,805

See accompanying notes to condensed consolidated financial statements.

THE TORO COMPANY AND SUBSIDIARIES
Condensed Consolidated Balance Sheets (Unaudited)
(Dollars in thousands)

	January 29, 2010	January 30, 2009	October 31, 2009
ASSETS			
Cash and cash equivalents	$158,210	$35,597	$187,773
Receivables, net	167,260	297,962	143,709
Inventories, net	191,071	238,704	176,275
Prepaid expenses and other current assets	18,441	23,813	14,914
Deferred income taxes	58,316	55,311	59,467
Total current assets	593,298	651,387	582,138
Property, plant, and equipment	560,001	526,938	551,747
Less accumulated depreciation	394,074	359,211	385,031
	165,927	167,727	166,716
Deferred income taxes	3,572	6,454	3,585
Other assets	12,774	7,686	10,512
Goodwill	86,427	86,385	86,407
Other intangible assets, net	22,636	18,548	23,324
Total assets	$884,634	$938,187	$872,682
LIABILITIES AND STOCKHOLDERS' EQUITY			
Current portion of long-term debt	$3,985	$3,377	$3,765
Short-term debt	700	25,000	4,529
Accounts payable	109,556	89,561	91,074
Accrued liabilities	205,651	214,403	217,433
Total current liabilities	319,892	332,341	316,801
Long-term debt, less current portion	224,062	226,396	225,046
Deferred revenue	7,904	8,785	8,510
Other long-term liabilities	7,526	6,227	7,113
Stockholders' equity:			
Preferred stock, par value $1.00 per share, authorized 1,000,000 voting and 850,000 non-voting shares, none issued and outstanding	—	—	—
Common stock, par value $1.00 per share, authorized 100,000,000 shares, issued and outstanding 33,615,011 shares as of January 29, 2010, 35,804,195 shares as of January 30, 2009, and 33,369,486 shares as of October 31, 2009	33,615	35,804	33,369
Retained earnings	300,750	342,081	291,246
Accumulated other comprehensive loss	(9,115)	(13,447)	(9,403)
Total stockholders' equity	325,250	364,438	315,212
Total liabilities and stockholders' equity	$884,634	$938,187	$872,682

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended January 29, 2010	Three Months Ended January 30, 2009
Cash flows from operating activities:		
Net earnings	$10,918	$6,731
Adjustments to reconcile net earnings to net cash used in operating activities:		
Equity losses from affiliates	143	32
Provision for depreciation, amortization, and impairment losses	11,248	10,389
Loss on disposal of property, plant, and equipment	45	18
Stock-based compensation expense	1,579	874
(Increase) decrease in deferred income taxes	(331)	238
Changes in operating assets and liabilities:		
Receivables, net	(28,629)	(42,970)
Inventories, net	(13,099)	(32,586)
Prepaid expenses and other assets	(3,492)	(4,947)
Accounts payable, accrued expenses, deferred revenue, and other long-term liabilities	11,082	(10,306)
Net cash used in operating activities	(10,536)	(72,527)
Cash flows from investing activities:		
Purchases of property, plant, and equipment	(10,218)	(9,499)
Proceeds from asset disposals	100	6
Increase in investment in affiliates	(3,118)	—
Decrease (increase) in other assets	533	(567)
Acquisition, net of cash acquired	(1,812)	—
Net cash used in investing activities	(14,515)	(10,060)
Cash flows from financing activities:		
Increase in short-term debt	—	22,675
Repayments of long-term debt, net of costs	(750)	(1,005)
Excess tax benefits from stock-based awards	2,078	2,023
Proceeds from exercise of options	4,986	2,073
Purchases of Toro common stock	(3,682)	(1,579)
Dividends paid on Toro common stock	(6,129)	(5,456)
Net cash (used in) provided by financing activities	(3,497)	18,731
Effect of exchange rates on cash	(1,015)	94
Net decrease in cash and cash equivalents	(29,563)	(63,762)
Cash and cash equivalents as of the beginning of the fiscal period	187,773	99,359
Cash and cash equivalents as of the end of the fiscal period	$158,210	$35,597

See accompanying notes to condensed consolidated financial statements.

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THE TORO COMPANY AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements (Unaudited)
January 29, 2010

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and do not include all the information and notes required by U.S. generally accepted accounting principles (GAAP) for complete financial statements. Unless the context indicates otherwise, the terms “company” and “Toro” refer to The Toro Company and its consolidated subsidiaries. In the opinion of management, the unaudited condensed consolidated financial statements include all adjustments, consisting primarily of recurring accruals, considered necessary for a fair presentation of the financial position and results of operations. Certain amounts from prior periods’ financial statements have been reclassified to conform to this period’s presentation. Since the company’s business is seasonal, operating results for the three months ended January 29, 2010 cannot be annualized to determine the expected results for the fiscal year ending October 31, 2010. Additional factors that could cause our actual results to differ materially from our expected results, including any forward-looking statements made in this report, are described in our most recently filed Annual Report on Form 10-K (Item 1A) and later in this report under Item 2, Management’s Discussion and Analysis of Financial Condition and Results of Operations–Forward-Looking Information.

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

For further information, refer to the consolidated financial statements and notes included in the company’s Annual Report on Form 10-K for the fiscal year ended October 31, 2009. The policies described in that report are used for preparing quarterly reports.

Accounting Policies

In preparing the consolidated financial statements in conformity with U.S. GAAP, management must make decisions that impact the reported amounts of assets, liabilities, revenues, expenses, and the related disclosures, including disclosures of contingent assets and liabilities. Such decisions include the selection of the appropriate accounting principles to be applied and the assumptions on which to base accounting estimates. Estimates are used in determining, among other items, sales promotions and incentives accruals, inventory valuation, warranty accruals, allowance for doubtful accounts, pension and postretirement accruals, self-insurance accruals, useful lives for intangible assets, and future cash flows associated with impairment testing for goodwill and other long-lived assets. These estimates and assumptions are based on management’s best estimates and judgments. Management evaluates its estimates and assumptions on an ongoing basis using historical experience and other factors that management believes to be reasonable under the circumstances, including the current economic environment. Management adjusts such estimates and assumptions when facts and circumstances dictate. A number of these factors are discussed in our Annual Report on Form 10-K (Item 1A. Risk Factors) for the fiscal year ended October 31, 2009, which include, among others, economic conditions, foreign currency exchange rate impact, commodity costs, credit conditions, and consumer spending and confidence levels, all of which may increase the uncertainty inherent in such estimates and assumptions. As future events and their effects cannot be determined with precision, actual amounts could differ significantly from those estimated at the time the consolidated financial statements are prepared. Changes in those estimates resulting from changes in the economic environment will be reflected in the consolidated financial statements in future periods.

Acquisition and Divestiture

On December 1, 2009, during the first quarter of fiscal 2010, the company's wholly owned domestic distribution company completed the acquisition of certain assets and the assumption of certain liabilities of one of the company's independent Midwestern-based distribution companies.

During the first quarter of fiscal 2009, the company completed the sale of a portion of the operations of our company-owned distributorship.

This acquisition and divestiture were immaterial based on the company's consolidated financial condition and results of operations.

Comprehensive Income

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

(Dollars in thousands)	Three Months Ended January 29, 2010	Three Months Ended January 30, 2009
Net earnings	$10,918	$6,731
Other comprehensive income (loss):		
Cumulative translation adjustments	(2,132)	(1,756)
Pension liability adjustment, net of tax	671	—
Unrealized gain (loss) on derivative instruments, net of tax	1,749	(3,147)
Comprehensive income	$11,206	$1,828

Stock-Based Compensation

Under the company's stock option plans, option awards are granted with an exercise price equal to the closing price of the company's common stock on the date of grant, as reported by the New York Stock Exchange. Options are generally granted to non-employee directors, officers, and other key employees in the first quarter of the company's fiscal year. Option awards vest one-third each year over a three-year period and have a ten-year term. Compensation expense equal to the grant date fair value is generally recognized for these awards over the vesting period. However, if a director has served on the company's Board of Directors for ten full fiscal years or longer, the fair value of the options granted is fully expensed as of the date of the grant. Similarly, options granted to officers and other key employees are also subject to accelerated expensing if the option holder meets the retirement definition set forth in The Toro Company 2000 Stock Option Plan. In that case, the fair value of the options is expensed in the year of grant because the option holder must be employed as of the end of the fiscal year in which the options are granted in order for the option to continue to vest following retirement. The company also has a long-term incentive plan called The Toro Company Performance Share Plan. Under this plan, key employees are granted the right to receive shares of common stock or deferred performance share units, contingent on the achievement of performance goals of the company, which are generally measured over a three-year period. The number of shares of common stock a participant receives will be increased (up to 200 percent of target levels) or reduced (down to zero) based on the level of achievement of performance goals and vest over a three-year period. Performance share awards are granted in the first quarter of the company's fiscal year. Compensation expense is recognized for these awards on a straight-line basis over the vesting period based on the fair value as of the date of grant and the probability of achieving performance goals. Total compensation expense for option and performance share awards for the first quarter of each of fiscal 2010 and 2009 was $1.6 million and $0.9 million, respectively.

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

	Fiscal 2010	Fiscal 2009
Expected life of option in years	6	6
Expected volatility	33.00% - 33.07%	30.57% - 30.60%
Weighted-average volatility	33.00%	30.60%
Risk-free interest rate	2.509% - 2.865%	2.26% - 3.155%
Expected dividend yield	1.52% - 1.68%	1.53%- 1.81%
Weighted-average dividend yield	1.54%	1.79%

The weighted-average fair value of options granted during the first quarter of each of fiscal 2010 and 2009 was $12.33 per share and $7.93 per share, respectively. The fair value of performance share awards granted during the first quarter of each of fiscal 2010 and 2009 was $40.73 per share and $28.62 per share, respectively.

Inventories

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

Inventories were as follows:

(Dollars in thousands)	January 29, 2010	January 30, 2009	October 31, 2009
Raw materials and work in process	$61,937	$66,039	$56,679
Finished goods and service parts	179,277	222,968	169,739
Total FIFO value	241,214	289,007	226,418
Less: adjustment to LIFO value	50,143	50,303	50,143
Total	$191,071	$238,704	$176,275

Per Share Data

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

	Three Months Ended	
(Shares in thousands)	January 29, 2010	January 30, 2009
Basic		
Weighted-average number of shares of common stock	34,022	36,350
Assumed issuance of contingent shares	8	16
Weighted-average number of shares of common stock and assumed issuance of contingent shares	34,030	36,366
Diluted		
Weighted-average number of shares of common stock and assumed issuance of contingent shares	34,030	36,366
Effect of dilutive securities	264	439
Weighted-average number of shares of common stock, assumed issuance of contingent shares, and effect of dilutive securities	34,294	36,805

Options to purchase an aggregate of 742,607 and 1,521,421 shares of common stock outstanding as of January 29, 2010 and January 30, 2009, respectively, were excluded from the diluted net earnings per share calculations because their exercise prices were greater than the average market price of the company's common stock during the same respective periods.

Goodwill

The changes in the net carrying amount of goodwill for the first quarter of fiscal 2010 were as follows:

(Dollars in thousands)	Professional	Residential

	Segment	Segment	Total
Balance as of October 31, 2009	$ 75,514	$ 10,893	$ 86,407
Translation adjustment	8	12	20
Balance as of January 29, 2010	$ 75,522	$ 10,905	$ 86,427

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Other Intangible Assets

The components of other amortizable intangible assets were as follows:

(Dollars in thousands) January 29, 2010	Estimated Life (Years)	Gross Carrying Amount	Accumulated Amortization	Net
Patents	5-13	$8,653	$ (6,733)	$1,920
Non-compete agreements	2-10	2,839	(1,610)	1,229
Customer related	10-13	6,532	(1,584)	4,948
Developed technology	2-10	12,789	(3,531)	9,258
Other		800	(800)	—
Total amortizable		31,613	(14,258)	17,355
Non-amortizable - trade name		5,281	—	5,281
Total other intangible assets, net		$36,894	$ (14,258)	$22,636

(Dollars in thousands) October 31, 2009	Estimated Life (Years)	Gross Carrying Amount	Accumulated Amortization	Net
Patents	5-13	$8,654	$ (6,641)	$2,013
Non-compete agreements	2-10	2,839	(1,517)	1,322
Customer related	10-13	6,549	(1,458)	5,091
Developed technology	2-10	12,799	(3,182)	9,617
Other		800	(800)	—
Total amortizable		31,641	(13,598)	18,043
Non-amortizable - trade name		5,281	—	5,281
Total other intangible assets, net		$36,922	$ (13,598)	$23,324

Amortization expense for intangible assets during the first quarter of fiscal 2010 was $0.7 million. Estimated amortization expense for the remainder of fiscal 2010 and succeeding fiscal years is as follows: fiscal 2010 (remainder), $1.9 million; fiscal 2011, $2.5 million; fiscal 2012, $2.5 million; fiscal 2013, $2.3 million; fiscal 2014, $1.9 million; fiscal 2015, $1.8 million; and after fiscal 2015, $4.5 million.

Investment in Joint Venture

On August 12, 2009, the company and TCF Inventory Finance, Inc. (TCFIF), a subsidiary of TCF National Bank, established a joint venture in the form of a Delaware limited liability company named Red Iron Acceptance, LLC (Red Iron) to provide inventory financing, including floor plan and open account receivable financing, to distributors and dealers of the company's products in the U.S. and to select distributors of the company's products in Canada. The initial term of the joint venture will continue until October 31, 2014, subject to unlimited automatic two-year extensions thereafter. Either the company or TCFIF may elect not to extend the initial term or any subsequent term by giving one-year notice to the other party of its intention not to extend the term. Red Iron began financing floor plan receivables during the company's fourth quarter of fiscal 2009.

The company sells to Red Iron certain inventory receivables, including floor plan and open account receivables, from distributors and dealers of the company's products, at a purchase price equal to the face value of the receivables. As the company sells receivables to Red Iron, the company derecognizes non-recourse receivables from its books upon receipt of cash from Red Iron for receivables sold. During the first quarter of fiscal 2010, the company sold to Red Iron open account receivables for customers whose floor plan receivables were sold to Red Iron during the fourth quarter of fiscal 2009, as well as for customers whose floor plan receivables were previously financed by a third party financing company, in the aggregate amount of $18.1 million.

The company owns 45 percent of Red Iron and TCFIF owns 55 percent of Red Iron. The company accounts for its investment in Red Iron under the equity method of accounting. Each of the company and TCFIF contributed a specified amount of the estimated cash required to enable Red Iron to purchase the company's inventory financing receivables and to provide financial support for Red Iron's inventory financing programs. Red Iron borrows the remaining requisite estimated cash utilizing a $450 million secured revolving credit facility established under a credit agreement between Red Iron and TCFIF. The company's total investment in Red Iron as of January 29, 2010 was $6.5 million. The company has not guaranteed the outstanding indebtedness of Red Iron. The company has agreed to repurchase products repossessed by Red Iron, up to a maximum aggregate amount of $7.5 million in a calendar year. In addition, the company provided recourse to Red Iron for certain outstanding receivables, which amounted to $0.7 million as of January 29, 2010.

Red Iron purchased $177.6 million of receivables from the company during the first quarter of fiscal 2010, which includes the initial purchase of open accounts receivable in the aggregate amount of $18.1 million. As of January 29, 2010, Red Iron's total assets were $127.9 million and total liabilities were $113.0 million. Red Iron's net loss from operations through January 29, 2010 was $0.9 million.

Segment Data

The presentation of segment information reflects the manner in which management organizes segments for making operating decisions and assessing performance. On this basis, the company has determined it has three reportable business segments: professional, residential, and distribution. The distribution segment, which consists of a wholly owned domestic distribution company, has been combined with our corporate activities and elimination of intersegment revenues and expenses that is shown as "Other" in the following tables.

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

(Dollars in thousands)

Three months ended January 29, 2010	Professional	Residential	Other	Total
Net sales	$ 212,800	$ 116,756	$ 1,802	$ 331,358
Intersegment gross sales	2,112	262	(2,374)	—
Earnings (loss) before income taxes	25,810	13,427	(22,789)	16,448
Total assets	436,521	180,922	267,191	884,634

Three months ended January 30, 2009	Professional	Residential	Other	Total
Net sales	$ 229,369	$ 107,024	$ 3,779	$ 340,172
Intersegment gross sales	1,970	769	(2,739)	—
Earnings (loss) before income taxes	30,129	4,840	(24,816)	10,153
Total assets	500,937	210,398	226,852	938,187

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

(Dollars in thousands)	Three Months Ended January 29, 2010	Three Months Ended January 30, 2009
Corporate expenses	$ (17,944)	$ (22,378)
Finance charge revenue	—	178
Elimination of corporate financing expense	—	1,515
Interest expense	(4,245)	(4,358)
Other	(600)	227
Total	$ (22,789)	$ (24,816)

Warranty Guarantees

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

Warranty provisions, claims, and changes in estimates for the first quarter of each of fiscal 2010 and 2009 were as follows:

(Dollars in thousands) Three Months Ended	Beginning Balance	Warranty Provisions	Warranty Claims	Changes in Estimates	Ending Balance
January 29, 2010	$54,273	$6,764	$(7,089)	$827	$54,775
January 30, 2009	$58,770	$7,502	$(8,131)	$732	$58,873

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Postretirement Benefit and Deferred Compensation Plans

The following table presents the components of net periodic benefit costs of the company's postretirement medical and dental benefit plan:

(Dollars in thousands)	Three Months Ended January 29, 2010	Three Months Ended January 30, 2009
Service cost	$55	$54
Interest cost	101	175
Prior service cost	(48)	(48)
Amortization of losses	30	48
Net expense	$138	$229

As of January 29, 2010, the company contributed approximately $0.1 million to its postretirement medical and dental benefit plan in fiscal 2010. The company expects to contribute a total of $0.3 million in fiscal 2010, including contributions made through January 29, 2010.

The company maintains The Toro Company Investment, Savings and Employee Stock Ownership Plan for eligible employees. The company's expenses under this plan were $3.4 million for the first quarter of fiscal 2010 and $3.8 million for the first quarter of fiscal 2009.

The company also offers participants in the company's deferred compensation plans the option to invest their deferred compensation in multiple investment options. The fair value of the investment in the deferred compensation plans as of January 29, 2010 was $14.9 million, which reduced the company's deferred compensation liability reflected in accrued liabilities on the consolidated balance sheet.

Effective December 31, 2009, the company amended The Toro Company Retirement Plan for Office and Hourly Employees such that no additional benefits will be earned under this plan after December 31, 2009. This amendment resulted in a curtailment adjustment of $0.7 million, which reduced the company's pension expense in the first quarter of fiscal 2010.

Income Taxes

The company is subject to U.S. federal income tax, as well as income tax of numerous state and foreign jurisdictions. The company is generally no longer subject to U.S. federal tax examinations for taxable years before fiscal 2006 and with limited exceptions, state and foreign income tax examinations for fiscal years before 2005. The Internal Revenue Service is currently examining the company's income tax returns for the 2006 and 2007 fiscal years. It is possible that the examination phase of the audit may conclude in the next 12 months, and the related unrecognized tax benefits for tax positions taken may change from those recorded as liabilities for uncertain tax positions in the company's financial statements as of January 29, 2010. Although the outcome of this matter cannot currently be determined, the company believes adequate provisions have been made for any potential unfavorable financial statement impact.

As of January 29, 2010 and January 30, 2009, the company had $6.0 million and $5.5 million, respectively, of liabilities recorded related to unrecognized tax benefits. Accrued interest and penalties on these unrecognized tax benefits were $1.0 million and $0.8 million as of January 29, 2010 and January 30, 2009, respectively. The company recognizes potential interest and penalties related to income tax positions as a component of the provision for income taxes. To the extent interest and penalties are not assessed with respect to uncertain tax positions, the amounts accrued will be revised and reflected as an adjustment to the provision for income taxes. Included in the liability balance as of January 29, 2010 are approximately $4.0 million of unrecognized tax benefits that, if recognized, will affect the company's effective tax rate.

The company does not anticipate that the total amount of unrecognized tax benefits will significantly change during the next twelve months.

Derivative Instruments and Hedging Activities

The company is exposed to foreign currency exchange rate risk arising from transactions in the normal course of business, such as sales to third party customers, sales and loans to wholly owned foreign subsidiaries, foreign plant operations, and purchases from suppliers. The company actively manages the exposure of its foreign currency market risk by entering into various hedging instruments, authorized under company policies that place controls on these activities, with counterparties that are highly rated financial institutions. The company's hedging activities involve the primary use of forward currency contracts. The company uses

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derivative instruments only in an attempt to limit underlying exposure from foreign currency exchange rate fluctuations and to minimize earnings and cash flow volatility associated with foreign currency exchange rate changes. Decisions on whether to use such contracts are made based on the amount of exposure to the currency involved, and an assessment of the near-term market value for each currency. The company's policy does not allow the use of derivatives for trading or speculative purposes. The company's primary foreign currency exchange rate exposures are with the Euro, the Australian dollar, the Canadian dollar, the British pound, the Mexican peso, and the Japanese yen against the U.S. dollar.

Cash flow hedges. The company recognizes all derivative instruments as either assets or liabilities at fair value on its consolidated balance sheet and formally documents relationships between cash flow hedging instruments and hedged items, as well as its risk-management objective and strategy for undertaking hedge transactions. This process includes linking all derivatives to the forecasted transactions, such as sales to third parties and foreign plant operations. Changes in the fair value of outstanding derivative instruments that are designated and qualify as a cash flow hedge are recorded in other comprehensive income (OCI), except for the ineffective portion, until net earnings is affected by the variability of cash flows of the hedged transaction. Gains and losses on the derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in net earnings. The consolidated statement of earnings classification of effective hedge results is the same as that of the underlying exposure. Results of hedges of sales and foreign plant operations are recorded in net sales and cost of sales, respectively, when the underlying hedged transaction affects net earnings. The maximum amount of time the company hedges its exposure to the variability in future cash flows for forecasted trade sales and purchases is two years.

The company formally assesses at a hedge's inception and on an ongoing basis whether the derivatives that are used in the hedging transaction have been highly effective in offsetting changes in the cash flows of the hedged items and whether those derivatives may be expected to remain highly effective in future periods. When it is determined that a derivative is not, or has ceased to be, highly effective as a hedge, the company discontinues hedge accounting prospectively. When the company discontinues hedge accounting because it is no longer probable, but it is still reasonably possible that the forecasted transaction will occur by the end of the originally expected period or within an additional two-month period of time thereafter, the gain or loss on the derivative remains in accumulated other comprehensive loss (AOCL) and is reclassified to net earnings when the forecasted transaction affects net earnings. However, if it is probable that a forecasted transaction will not occur by the end of the originally specified time period or within an additional two-month period of time thereafter, the gains and losses that were accumulated in OCI are recognized immediately in net earnings. In all situations in which hedge accounting is discontinued and the derivative remains outstanding, the company carries the derivative at its fair value on the balance sheet, recognizing future changes in the fair value in other income, net. For the first quarter of fiscal 2010, there were no gains or losses on contracts reclassified into earnings as a result of the discontinuance of cash flow hedges. As of January 29, 2010, the notional amount outstanding of forward contracts designated as cash flow hedges was $60.3 million.

Derivatives not designated as hedging instruments. The company also enters into forward currency contracts to mitigate the change in fair value of specific assets and liabilities on the consolidated balance sheet. These contracts are not designated as hedging instruments. Accordingly, changes in the fair value of hedges of recorded balance sheet positions, such as cash, receivables, payables, intercompany notes, and other various contractual claims to pay or receive foreign currencies other than the functional currency, are recognized immediately in other income, net, on the consolidated statements of earnings together with the transaction gain or loss from the hedged balance sheet position.

The following table presents the fair value of the company's derivatives and consolidated balance sheet location.

	Asset Derivatives				Liability Derivatives			
	January 29, 2010		January 30, 2009		January 29, 2010		January 30, 2009	
(Dollars in thousands)	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value