

AMERICAN STANDARD COMPANIES INC
Form 10-Q
July 27, 2005

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2005

OR

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

For the transition period from _____ to _____.

Commission file number 1-11415

AMERICAN STANDARD COMPANIES INC.

(Exact name of Registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or organization)

13-3465896
(I.R.S. Employer Identification No.)

One Centennial Avenue, P.O. Box 6820,
Piscataway, NJ
(Address of principal executive offices)

08855-6820
(Zip Code)

Registrant's telephone number, including area code (732) 980-6000

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

Indicate by check mark whether the registrant is an accelerated filer (as defined by Rule 12b-2 of the Exchange Act) Yes No

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

Common stock, \$.01 par value, outstanding at

July 21, 2005

210,822,655 shares

PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

American Standard Companies Inc. (the Company) is a Delaware corporation that owns all the outstanding common stock of American Standard Inc. and American Standard International Inc. (ASII), both Delaware corporations. American Standard or the Company will refer to the Company, or to the Company and American Standard Inc. and ASII including their subsidiaries, as the context requires.

AMERICAN STANDARD COMPANIES INC.**UNAUDITED SUMMARY CONSOLIDATED STATEMENT OF INCOME**

(Dollars in millions except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Sales	\$ 2,755.1	\$ 2,575.3	\$ 5,095.3	\$ 4,760.3
Cost and expenses				
Cost of sales	1,992.7	1,874.2	3,719.1	3,469.6
Selling and administrative expenses	481.3	433.4	931.4	854.3
Other expense	(0.5)	11.4	6.5	28.2
Interest expense	30.6	28.5	60.2	57.8
	2,504.1	2,347.5	4,717.2	4,409.9
Income before income taxes	251.0	227.8	378.1	350.4
Income taxes	43.1	68.1	45.3	106.1
Net income applicable to common shares	\$ 207.9	\$ 159.7	\$ 332.8	\$ 244.3
Net income per share				
Basic	\$ 0.98	\$ 0.75	\$ 1.56	\$ 1.13
Diluted	\$ 0.95	\$ 0.73	\$ 1.52	\$ 1.10
Cash dividends per share of common stock	\$ 0.15	\$ 0.0	\$ 0.30	\$ 0.0
Average common shares outstanding				
Basic	212,031,814	214,235,352	213,026,692	215,354,861
Diluted	217,858,345	220,035,235	218,956,273	221,132,378

See accompanying notes

AMERICAN STANDARD COMPANIES INC.

UNAUDITED SUMMARY CONSOLIDATED BALANCE SHEET

(Dollars in millions, except share data)

	June 30, 2005	December 31, 2004
Current assets:		
Cash and cash equivalents	\$ 277.2	\$ 229.4
Accounts receivable, less allowance for doubtful accounts: June 2005 - \$45.1; Dec. 2004 - \$46.2	1,325.4	1,154.5
Inventories:		
Finished products	706.5	658.0
Products in process	222.6	233.2
Raw materials	220.6	196.0
Retained interest in U.S. securitization program	209.8	122.6
Other current assets	271.9	296.1
Total current assets	3,234.0	2,889.8
Facilities, less accumulated depreciation:		
June 2005 - \$1,097.2; Dec. 2004 - \$1,123.7	1,562.0	1,616.6
Goodwill, less accumulated amortization:		
June 2005 - \$413.3; Dec. 2004 - \$447.0	1,172.8	1,267.7
Capitalized software costs, less accumulated amortization:		
June 2005 - \$293.8; Dec. 2004 - \$274.5	213.2	230.0
Debt issuance costs, net of accumulated amortization:		
June 2005 - \$30.7; Dec. 2004 - \$28.2	14.7	15.4
Long-term asbestos indemnity receivable	358.6	365.1
Other assets	423.9	457.2
Total assets	\$ 6,979.2	\$ 6,841.8
Current liabilities:		
Loans payable to banks	\$ 70.4	\$ 76.6
Current maturities of long-term debt	3.6	2.2
Accounts payable	962.6	887.2
Accrued payrolls	336.4	331.2
Current portion of warranties	168.9	155.1
Taxes on income	119.8	130.5
Other accrued liabilities	772.4	763.9
Total current liabilities	2,434.1	2,346.7
Long-term debt	1,590.0	1,429.1
Post-retirement benefits	714.8	744.1
Long-term portion of asbestos indemnity liability	673.3	683.4
Warranties	241.4	242.4
Other liabilities	415.9	465.8
Total liabilities	6,069.5	5,911.5
Shareholders' equity:		
Preferred stock, 2,000,000 shares authorized, none issued and outstanding		
Common stock, \$.01 par value, 560,000,000 shares authorized; shares issued: 251,769,287 in 2005; 251,768,741 in 2004; and shares outstanding: 210,834,567 in 2005; 214,947,988 in 2004	2.5	2.5
Capital surplus	817.5	794.5
Treasury stock, at cost: 40,934,720 shares in 2005; 36,820,753 shares in 2004	(988.9)	(760.1)

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Retained Earnings	1,415.6	1,146.6
Accumulated other comprehensive income:		
Foreign currency translation effects	(186.0)	(102.8)
Deferred gain on hedge contracts, net of tax	2.5	9.3
Minimum pension liability adjustment, net of tax	(153.5)	(159.7)
	<u> </u>	<u> </u>
Total shareholders' equity	909.7	930.3
	<u> </u>	<u> </u>
Total liabilities and shareholders' equity	\$ 6,979.2	\$ 6,841.8
	<u> </u>	<u> </u>

See accompanying notes

AMERICAN STANDARD COMPANIES INC.

UNAUDITED SUMMARY CONSOLIDATED STATEMENT OF CASH FLOWS

(Dollars in millions)

	Six months ended June 30,	
	2005	2004
Cash provided by:		
Operating activities:		
Net income	\$ 332.8	\$ 244.3
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	90.2	83.5
Amortization of capitalized software and other intangibles	43.2	43.6
Equity in earnings of unconsolidated joint ventures, net of dividends received	(13.7)	(10.5)
Non-cash stock compensation	32.1	30.0
Other	(5.7)	(0.7)
Changes in assets and liabilities:		
Accounts receivable	(209.7)	(301.0)
Inventories	(99.3)	(71.6)
Accounts payable	109.0	193.0
Other accrued liabilities and taxes	77.2	104.1
Post-retirement benefits	20.8	19.5
Net asbestos indemnity liability	(3.6)	1.3
Other current and long-term assets	(74.3)	(92.4)
Other long-term liabilities	(21.2)	13.7
Net cash provided by operating activities	<u>277.8</u>	<u>256.8</u>
Investing activities:		
Purchases of property, plant and equipment	(118.9)	(67.2)
Investments in affiliated companies and other businesses	(12.9)	—
Investments in capitalized software	(23.3)	(18.5)
Loan to unconsolidated joint venture, net	4.0	(19.2)
Proceeds from sales of property, plant and equipment	22.3	9.9
Net cash used by investing activities	<u>(128.8)</u>	<u>(95.0)</u>
Financing activities:		
Proceeds from issuance of long-term debt	200.6	0.2
Repayments of long-term debt	(208.8)	(0.6)
Net change in revolving credit facilities	220.6	136.9
Net change in other short-term debt	(5.6)	21.7
Purchases of treasury stock	(264.2)	(222.6)
Dividend payments	(63.8)	—
Proceeds from exercise of stock options	21.8	19.0
Proceeds from settlement of foreign exchange forward contracts	(1.5)	5.7
Other	4.5	3.7
Net cash used by financing activities	<u>(96.4)</u>	<u>(36.0)</u>
Effect of exchange rate changes on cash and cash equivalents	<u>(4.8)</u>	<u>0.1</u>
Net increase in cash and cash equivalents	47.8	125.9

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Cash and cash equivalents at beginning of period	229.4	111.7
Cash and cash equivalents at end of period	\$ 277.2	\$ 237.6
Cash interest paid	\$ 56.5	\$ 55.1
Cash taxes paid	\$ 65.4	\$ 78.7
	See accompanying notes	

AMERICAN STANDARD COMPANIES INC.

NOTES TO FINANCIAL STATEMENTS

Note 1. Basis of Financial Statement Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments, including normal recurring items, considered necessary for a fair presentation of financial data have been included. Certain reclassifications of amounts reported in prior years have been made to conform to the 2005 classifications. The results of operations for interim periods are not necessarily indicative of the results that may be expected for the entire year. The condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and accompanying notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2004.

Preparation of the financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Management believes the most complex and sensitive judgments, because of their significance to the consolidated financial statements, result primarily from the need to make estimates about the effects of matters that are inherently uncertain. Management's Discussion and Analysis and Notes 2 and 14 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the calendar year 2004, describe the most significant accounting estimates and policies used in preparation of the Consolidated Financial Statements. Actual results in these areas could differ materially from management's estimates. There have been no significant changes in the Company's assumptions regarding critical accounting estimates during the first half of 2005.

Note 2. Comprehensive Income

Total comprehensive income consisted of the following (dollars in millions):

	Three months ended		Six months ended	
	June 30,		June 30,	
	2005	2004	2005	2004
Net income	\$ 207.9	\$ 159.7	\$ 332.8	\$ 244.3
Foreign currency translation effects	(40.0)	(12.2)	(83.2)	(5.4)
Deferred (loss) on hedge contracts, net of tax	(7.7)	(12.0)	(6.8)	(3.3)
Minimum pension liability adjustment, net of tax	3.5	(0.3)	6.2	(0.5)
Total comprehensive income	\$ 163.7	\$ 135.2	\$ 249.0	\$ 235.1

Note 3. Earnings Per Share

Basic earnings per share have been computed using the weighted average number of common shares outstanding. The average number of outstanding shares of common stock used in computing diluted earnings per share for the three months ended June 30, 2005 and 2004 included 5,826,531 and 5,799,883 weighted average incremental shares, respectively, for the assumed exercise of stock options; the six-month periods ended June 30, 2005 and 2004 included 5,929,581 and 5,777,517 weighted average incremental shares, respectively. For the three and six-month periods ended June 30, 2005 and 2004, 831,874, 34,476, 437,203 and 18,100 shares, respectively, associated with options to purchase shares of the Company's common stock were excluded from the diluted earnings per share calculation due to their antidilutive effect.

Note 4. Capital Stock

On June 20, 2005 a dividend of \$0.15 per share of common stock was paid to shareholders of record as of June 1, 2005, totaling \$31.7 million. On March 25, 2005 a dividend of \$0.15 per share of common stock was paid to shareholders of record as of February 28, 2005 totaling \$32.1 million. On July 11, 2005, the Board of Directors approved the payment of a dividend of \$0.15 per share of common stock to be paid on September 20, 2005, to shareholders of record on September 1, 2005.

Following is a summary of net shares outstanding and shares issued or reacquired during the first and second quarters of 2005.

	Number of Shares of Common Stock		
	Total Shares	Treasury Shares	Net Shares Outstanding
Balance, December 31, 2004	251,768,741	(36,820,753)	214,947,988
Shares issued upon exercise of stock options		893,784	893,784
Stock purchased for treasury		(3,352,800)	(3,352,800)
Shares issued to ESOP		355,249	355,249
Shares issued to ESPP	289	51,402	51,691
Other shares issued or (reacquired), net		(111,082)	(111,082)
Balance, March 31, 2005	251,769,030	(38,984,200)	212,784,830
Shares issued upon exercise of stock options		310,289	310,289
Stock purchased for treasury		(2,719,000)	(2,719,000)
Shares issued to ESOP		376,488	376,488
Shares issued to ESPP	257	67,392	67,649
Other shares issued or (reacquired), net		14,311	14,311
Balance, June 30, 2005	251,769,287	(40,934,720)	210,834,567

The Company accounts for all purchases of treasury stock under the cost method as defined in Accounting Principles Board Opinion Number 6, *Status of Accounting Research Bulletins* with the costs of such share purchases reflected in treasury stock in the accompanying consolidated balance sheets. When shares are reissued they are recorded at the average price paid for shares acquired since the inception of the share buy back programs.

Note 5. Stock-Based Compensation

The Company has three employee stock-based compensation plans the 2002 Omnibus Incentive Plan, the Stock Incentive Plan and the Employee Stock Purchase Plan (ESPP), which, are described in Note 12 of Notes to Financial Statements in the Company's 2004 Annual Report on Form 10-K. Under the first two plans, the Company has granted options to employees and directors to acquire a fixed number of shares of the Company's common stock at a specified price, and also has made grants of restricted shares. Under the ESPP, employees are entitled to purchase shares of the Company's common stock at a discount of 15% from the market price on the date of purchase. The Company accounts for these plans under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related Interpretations. Compensation cost is not recorded for substantially all options granted because the option exercise price was equal to the market value of the underlying common stock on the date of grant. Additionally, compensation cost is not recorded for the 15% discount on shares purchased under the ESPP, which is not considered compensation expense under APB 25. Compensation cost is recorded for the fair value of restricted share awards and is amortized straight line over the vesting period of the award.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation (dollars in millions except per share data).

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2005	2004	2005	2004
Net income, as reported	\$ 207.9	\$ 159.7	\$ 332.8	\$ 244.3
Deduct: Total stock-based compensation expense, net of tax, determined under fair value method for all stock option awards and discounts under ESPP	5.1	4.5	10.5	9.6
Pro forma net income	\$ 202.8	\$ 155.2	\$ 322.3	\$ 234.7
Earnings per share:				
Basic as reported	\$.98	\$.75	\$ 1.56	\$ 1.13
Basic pro forma	\$.96	\$.72	\$ 1.51	\$ 1.09
Diluted as reported	\$.95	\$.73	\$ 1.52	\$ 1.10
Diluted pro forma	\$.94	\$.71	\$ 1.48	\$ 1.06

The weighted average fair value per option for grants made during the three months and six months ended June 30, 2005 was \$10.14 and for the corresponding periods of 2004 was \$12.55. The fair value of the stock options was estimated at the date of grant using the Black-Scholes option-pricing model with the following assumptions: risk-free interest rate of 3.74% in 2005 and 3.12% in 2004; volatility of 23.0% and 32.2% in 2005 and 2004, respectively; an expected average life of 5 years in 2005 and 2004; and a dividend yield of 1.38% and zero in 2005 and 2004, respectively.

Note 6. Warranties, Guarantees, Commitments and Contingencies

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Products sold by the Company are covered by a basic limited warranty with terms and conditions that vary depending upon the product and country in which they are sold. Limited

warranties cover the equipment, parts and, in limited circumstances labor, necessary to satisfy the warranty obligation for a period ranging from one to ten years generally, and for the lifetime of certain bath and kitchen faucets. The Company estimates the costs that may be incurred under its warranty obligations and records a liability in the amount of such costs at the time product revenue is recognized. Factors that affect the Company's warranty liabilities include the number of units sold, historical and anticipated rates of warranty claims, and cost per claim. At least once a quarter the Company assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. Costs to satisfy warranty claims are charged as incurred to the accrued warranty liability.

The Company also sells a variety of extended warranty contracts for up to ten years on certain air conditioning products. Revenues from the sales of extended warranties are deferred and amortized on a straight-line basis over the terms of the contracts or based upon historical experience. Actual costs to satisfy claims on extended warranty contracts are charged to cost of sales as incurred and were \$10.4 million and \$9.3 million for the three months ended June 30, 2005 and 2004, respectively, and \$18.9 million and \$17.8 million for the six-months ended June 30, 2005 and 2004, respectively. Total warranty expense was \$47.3 million and \$60.5 million for the three months ended June 30, 2005 and 2004, respectively, and \$99.1 million and \$101.5 million for the six-month periods then ended, respectively.

Following is a summary of changes in the Company's product warranty liability for the three and six-months ended June 30, 2005 and 2004 (dollars in millions).

	Three Months Ended June 30,		Six Months Ended June 30,	
	2005	2004	2005	2004
Balance of basic limited warranty costs accrued and deferred income on extended warranty contracts, beginning of period	\$ 408.9	\$ 364.6	\$ 397.5	\$ 356.0
Warranty costs accrued	38.4	37.5	78.6	64.0
Deferred income on extended warranty contracts sold	18.9	16.6	36.5	31.4
Warranty claims settled	(37.0)	(30.1)	(72.5)	(55.8)
Amortization of deferred income on extended warranty contracts	(13.9)	(12.1)	(25.2)	(24.1)
Increases (decreases) in warranty estimates made in prior periods, including foreign exchange translation effects, net	(5.0)	14.1	(4.6)	19.1
Balance of basic warranty costs accrued and deferred income on extended warranty contracts, end of period	410.3	390.6	410.3	390.6
Current portion included in current liabilities	(168.9)	(172.0)	(168.9)	(172.0)
Long-term warranty liability	\$ 241.4	\$ 218.6	\$ 241.4	\$ 218.6

The Company has commitments and performance guarantees, including energy savings guarantees totaling \$63.9 million as of June 30, 2005, extending from 2005 to 2022, under long-term service and maintenance contracts related to its air conditioning equipment and system controls. Through June 30, 2005 the Company has experienced one insignificant loss under such energy savings guarantees and considers the probability of any significant future losses to be unlikely and has therefore not recorded a liability for such guarantees.

The Company fully and unconditionally guarantees the payment obligations under all the Company's Senior Notes that were issued by its wholly owned subsidiary American Standard Inc. See Note 10 of Notes to Financial Statements. The Company also guarantees other debt obligations issued by other subsidiaries, including obligations under a \$48.3 million Euro-denominated credit facility and \$36.2 million of Euro-denominated Senior Bonds (both at June 30, 2005 exchange rates).

The income tax provision for the second quarter of 2005 was \$43.1 million, or 17.2% of pre-tax income, compared with a provision of \$68.1 million, or 29.9% of pre-tax income in the second quarter of 2004. The reduction to the effective income tax rate resulted primarily from the resolution of tax audits. The tax provision for the first six-months of 2005 was \$45.3 million, or 12.0% of pre-tax income, compared with a provision of \$106.1 million or 30.3% of pre-tax income for the six-months ended June 30, 2004. The effective income tax rate for the first six-months of 2005 was impacted by the resolution of tax audits, tax contingencies and the impact of certain non-U.S. tax planning initiatives on prior tax years recorded in the first six-months of 2005.

The Company and certain of its subsidiaries are parties to a number of pending legal and tax proceedings. The Company is also subject to federal, state and local environmental laws and regulations and is involved in environmental proceedings concerning the investigation and remediation of various sites, including certain facilities in the process of being closed. In those instances where it is probable as a result of such proceedings that the Company will incur costs that can be reasonably determined, the Company has recorded a liability.

In October 1999, in *Haynes Trane Service Agency, Inc. and Frederick M. Haynes v. American Standard, Inc., d/b/a the Trane Company*, in the United States District Court for the District of Colorado, verdicts were returned against the Company for a total of \$18 million on the claim that it wrongfully terminated distribution agreements. On August 28, 2002, the appellate court ruled in favor of the Company and vacated the \$18 million judgment. The appellate court also reinstated the Company's counterclaims including fraud, and remanded to the trial court limited portions of Haynes' initial claims. Currently, a new trial on such claims is scheduled for November 2005.

As previously reported, in November 2004 the Company was contacted by the European Commission as part of an industry-wide investigation into alleged infringement of European Union competition regulations relating to the distribution of bath and kitchen fixtures and fittings in certain European countries. Because the investigation is in its early stages, and the Company has not been accused of any wrong-doing, the Company is unable to reasonably estimate the loss or range of loss that may result from the investigation. However, the Company believes that the resolution of this matter will not have a material adverse affect on the financial condition or liquidity of the Company.

On February 23, 2005, the Company received a grand jury subpoena from the Antitrust Division of the U.S. Department of Justice seeking information primarily related to the sale and marketing of bathroom fittings by its European affiliates from January 1997 to the present. Also in February 2005, the Company was named as a defendant in several lawsuits filed in the United States District Court for the Eastern District of Pennsylvania and in various state courts in the State of California alleging that the Company and certain of its competitors conspired to fix prices for fittings and fixtures in the U.S. The federal cases were thereafter consolidated, and in June 2005 an amended complaint was filed in the federal actions alleging that the Company conspired to fix prices for fixtures in the U.S. The amended complaint deletes reference to fittings and identifies a somewhat different group of alleged co-conspirator co-defendants. The Company is cooperating fully with the Justice Department investigation and is vigorously defending itself against these civil lawsuits.

On February 16, 2005, the French Competition Council issued a statement of objections (notification de griefs) addressed to more than 100 separate enterprises, including a Bath and Kitchen subsidiary of the Company, and to various trade associations and purchasing organizations active in the sanitary, heating, air-conditioning and canalization equipment and installation sectors. The addressees of the statement of objections are alleged to have restricted the distribution of products to large do-it-yourself retailers and to small installer cooperatives in France in the period 1993 through 1998 in violation of the French and European Union competition regulations. The Company is cooperating fully with this investigation.

While the Company cannot predict the outcome of these matters with certainty, the Company believes that the resolution of the Justice Department and French Competition Council investigations and the civil lawsuits against the Bath & Kitchen business referenced above will not, individually or in the aggregate, have a material adverse effect on the financial condition, results of operations or liquidity of the Company.

Over the years, the Company has been named as a defendant in numerous lawsuits alleging various asbestos-related personal injury claims arising primarily from sales of boilers and railroad brake shoes.

In these asbestos-related lawsuits, the Company is usually named as one of a large group of defendants, often in excess of one hundred companies. Many of these lawsuits involve multiple claimants, do not specifically identify the injury or disease for which damages are sought and/or do not allege a connection between any Company product and a claimed injury or disease. As a result, numerous lawsuits have been placed and may remain on inactive or deferred dockets, which some jurisdictions have established.

Prior to 2004, the Company recorded a liability only for filed asbestos claims. Costs associated with claims that might be filed against the Company in the future were not recorded because the Company did not believe its history and experience with asbestos-related litigation was sufficient to allow it to make a reasonable estimate of this liability. Because of stabilization in the rate at which new claims are being filed and the Company's added experience in resolving claims, the Company now believes a reasonable estimate of this liability can be made.

In the fourth quarter of 2004, the Company retained Dr. Francine F. Rabinovitz of Hamilton, Rabinovitz & Alschuler, Inc. (HR&A) to assist it in calculating an estimate of the Company's total liability for pending and unasserted potential future asbestos-related claims. Dr. Rabinovitz is a respected expert in performing complex calculations such as this. She has been involved in a number of asbestos-related valuations of current and future liabilities, and her valuation methodologies have been accepted by numerous courts.

The methodology used by HR&A to project the Company's total liability for pending and unasserted potential future asbestos-related claims relied upon and included the following factors:

HR&A's interpretation of a widely accepted forecast of the population likely to have been exposed to asbestos

epidemiological studies estimating the number of people likely to develop asbestos-related diseases

HR&A's analysis of the number of people likely to file an asbestos-related personal injury claim against the Company based on such epidemiological data and the Company's claims history from 2000 - 2004

an analysis of the Company's pending cases, by type of injury claimed

an analysis of the Company's five-year history from 2000 - 2004 to determine the average settlement value of claims, by type of injury claimed

an adjustment for inflation in the future average settlement value of claims, at a 3% annual inflation rate

an analysis of the period over which the Company has and is likely to resolve asbestos-related claims against it in the future

Based on these factors, HR&A calculated a total estimated liability for the Company to resolve all pending and unasserted potential future claims through 2055, which is HR&A's reasonable best estimate of the time it will take to resolve asbestos-related claims, of \$699 million. This amount is on a pre-tax basis, not discounted for the time-value of money, and excludes legal fees.

As of June 30, 2005, the Company has a receivable for probable asbestos-related insurance recoveries of \$364.6 million. This represents amounts due to the Company for previously settled and paid claims and the probable reimbursements relating to its estimated liability for pending and future claims. In calculating this amount, the Company used the estimated asbestos liability for pending and projected future claims calculated by HR&A. It also considered the amount of insurance available, gaps in coverage, applicable deductibles, allocation methodologies, solvency ratings and credit-worthiness of the insurers, the published dividend rates of insolvent insurers, amounts already recovered from and the potential for settlements with insurers, and estimated annual legal fees.

The Company is in litigation against certain carriers whose policies it believes provide coverage for pending claims. The insurance carriers named in this suit are challenging the Company's right to recovery. While the Company cannot predict the outcome of this litigation with certainty, the Company believes that the amount recorded is probable of recovery based on its analysis of the coverage, the applicable law, historical trends in its and other insured parties' settlements with insurers and the likelihood of achieving a settlement with some or all of the insurers.

The aggregate amount of the stated limits in insurance policies available to the Company for asbestos-related claims, acquired over many years and from many different carriers, is substantial, significantly exceeding the projected liability against the Company. However, limitations in that coverage, primarily due to gaps in coverage, deductibles associated with the policies and settlements for less than the full coverage limits with carriers in insolvency proceedings and carriers with questionable credit-worthiness (Gaps, Deductibles and Discounts,) are expected to result in the projected total liability to claimants and related expenses exceeding the probable insurance recovery. The Company settled with most of the insolvent carriers and carriers with poor credit quality whose policies it believes provide coverage for pending and projected future claims. 85% of the remaining recorded insurance recovery receivable is with carriers rated A or better by AM Best.

The amounts recorded by the Company for asbestos-related liability and insurance-related receivables are based on currently known facts. The Company's actual expenses or insurance recoveries could be significantly higher or lower than those recorded if assumptions used in the Company's or HR&A's calculations vary significantly from actual results. Key variables in these assumptions are identified above and include the number and type of new claims to be filed each year, the average cost of disposing of each such new claim, average annual defense costs, the resolution of coverage issues among insurance carriers including allocation methodologies, and the solvency risk with respect to the Company's insurance carriers. Furthermore, predictions with respect to these variables are subject to greater uncertainty as the projection period lengthens. Other factors that may affect the Company's liability and ability to recover under its insurance policies include uncertainties surrounding the litigation process from jurisdiction to jurisdiction and from case to case, reforms that may be made by state and federal courts, and the passage of state or federal tort reform legislation.

In February 2005, the Company reached agreement with Equitas, the London-based entity responsible for certain pre-1993 Lloyd's of London policies in its insurance coverage, in the amount of \$84.5 million. During the first half of 2005, \$13.2 million of this was received by the Company to cover asbestos and environmental costs, and \$71.3 million remains in a trust expiring January 3, 2007. If, during the trust period, there is federal legislation that takes asbestos claims out of the courts and requires Equitas to make a duplicate payment to the asbestos trust, the remaining balance in the trust less some allowance to the Company for claims settlements that may be made or have been made in the period January 1, 2005 through January 3, 2008, will be used by Equitas for the legislative payment. If there is no such legislation by January 3, 2007, the balance of funds in the trust, including accrued interest, will be disbursed to the Company.

From receipt of its first asbestos claim more than twenty years ago to June 30, 2005, the Company has resolved 29,820 claims. The total amount of all settlements paid by the Company and its insurance carriers is approximately \$59.6 million, for an average payment per claim of \$1,998. The table below provides additional information regarding asbestos-related claims filed against the Company, reflecting updated information for all periods.

	<u>2003</u>	<u>2004</u>	<u>Six Months Ended June 30, 2005</u>	<u>Total Pre 6/30/05</u>
Open Claims December 31	97,681	117,162	125,774	N/A
New claims filed	26,754	12,642	7,492	163,087
Claims settled	(547)	(700)	(332)	(8,436)
Claims dismissed	(6,711)	(3,329)	(3,056)	(21,384)
Inactive claims	(15)	(1)	(1)	(3,390)
Open Claims December 31	<u>117,162</u>	<u>125,774</u>		N/A
Open Claims June 30			<u>129,877</u>	

Because claims are frequently filed and settled in large groups, the amount and timing of settlements, as well as the number of open claims, can fluctuate significantly from period to period. This is demonstrated by the fact that approximately 40% of all claims filed against the Company were filed in a 20-plus year period prior to 2002, approximately 40% were filed in the 16-month period from January 2002 through April 2003, and the remaining 20% were spread relatively evenly over the next 26 months through June 2005. The Company believes that the dramatic increase in filings in the 16-month period from January 2002 through April 2003 was influenced by the bankruptcy filings of numerous asbestos defendants in asbestos-related litigation and the prospect of various forms of state and federal judicial and legislative reforms.

The Company does not believe that asbestos payments to claimants, net of insurance recoveries, will have a material adverse effect on its liquidity in any particular year or in the aggregate.

Note 7. Effect of Recently Issued Accounting Standards

The Financial Accounting Standards Board (FASB) has recently issued several new Statements and Interpretations. Statement of Financial Accounting Standard No. 151 (FAS 151), *Inventory Costs, an Amendment of ARB No. 43, Chapter 4* and Statement No. 153 (FAS 153), *Exchanges of Nonmonetary Assets an Amendment of APB Opinion No. 29* were issued in 2004. FAS 151 will be effective for the Company in 2006 and requires that the cost of inventory exclude costs associated with abnormal amounts of idle capacity and spoilage. The Company is currently in the process of determining the impact and believes it will not be material. FAS 153 will be effective in mid-2005 and is not expected to materially impact the Company's financial statements. FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* (FIN 47), was issued in March 2005. This interpretation will be effective for the Company in the fourth quarter of 2005 and clarifies that an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation when incurred if the liability's fair value can be reasonably estimated. The Company is currently in the process of determining the impact and believes it will not be material. Statement No. 154 (FAS 154), *Accounting Changes and Error Corrections* was issued in the second quarter of 2005. Under FAS 154, entities will be required to report a change in accounting principle through retrospective application of the new accounting principle to all prior periods, unless impracticable to do so. A change in the method of applying an accounting principle is considered a change in accounting principle under the standard. In addition, any errors in the financial statements of a prior period discovered subsequent to their issuance shall be reported as a prior period adjustment by restating the prior period financial statements. This standard will be effective for accounting changes and corrections of errors made in 2006.

Statement of Financial Accounting Standard No. 123 (Revised 2004) (FAS 123), *Share Based Payments*, was issued on December 16, 2004. The new standard requires companies to recognize in their financial statements the cost of employee services received in exchange for valuable equity instruments issued. On April 14, 2005 the Securities Exchange Commission approved a rule delaying the effective date of FAS 123 for public companies. Under the rule, FAS 123 is now effective for annual periods beginning after June 15, 2005. If required, the Company plans to adopt FAS 123 in the first quarter of 2006 with retroactive adjustment for all prior periods presented using the pro-forma amounts disclosed in Note 5 of Notes to Financial Statements. The impact of adoption of FAS 123 cannot be determined at this time because it requires information including levels of share-based payments granted in the future. However, had we adopted FAS 123 in prior periods, the impact of that standard would have approximated the impact as described in the disclosure of pro-forma net income and earnings per share in Note 5 of Notes to Financial Statements.

Note 8. Operational Consolidation Expenses

During 2004 and 2005 the Company incurred charges related to operational consolidation activities consisting of previously announced plant reductions, severance, asset impairments and similar expenses as more fully described below. The Company expects to complete these plans by the middle of 2006.

During the second quarter of 2005, the Company recorded \$24.1 million of operational consolidation expenses, \$13.2 million was included in cost of sales and \$10.9 million was

included in selling and administrative expenses. \$21.2 million related to 2005 programs and \$2.9 million related to programs that were initiated in 2004. This compares to \$13.1 million of operational consolidation expenses incurred during the second quarter of 2004. During the first six months of 2005, the Company recorded \$44.5 million of operational consolidation expenses, \$30.0 million was included in cost of sales and \$14.5 million was included in selling and administrative expenses. \$36.4 million related to 2005 programs, \$8.6 million related to programs that were initiated prior to 2005 and \$0.5 related to a reversal as detailed below. The Company incurred \$13.1 million of operational consolidation expenses during the first six months of 2004. In addition, the Company recorded a \$0.2 million operational consolidation benefit in the first quarter of 2005 associated with the reversal of severance associated with a Bath and Kitchen plan initiated in 2003. There were no operational consolidation expense reversals in the second quarter of 2004 or the first six months of 2004.

The following is a summary of the operational consolidation programs outstanding as of June 30, 2005.

	Termination Payments and Other Employee Costs	Asset Impairments	Other	Total
2005 Operational Consolidation Programs				
Charges during the first six-months of 2005	\$ 23.8	\$ 11.7	\$ 0.9	\$ 36.4
Payments during the first six-months of 2005	(4.7)		(0.8)	(5.5)
Reversals during the first six-months of 2005	(0.5)			(0.5)
Non-cash write-offs during the first six-months of 2005		(11.7)		(11.7)
Balance as of June 30, 2005	\$ 18.6	\$	\$ 0.1	\$ 18.7
2004 Operational Consolidation Programs				
Balance as of December 31, 2004	\$ 13.0	\$	\$ 2.8	\$ 15.8
Charges during the first six-months of 2005	6.1	2.2	0.3	8.6
Payments during the first six-months of 2005				