M I HOMES INC
Form 10-Q
October 26, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2010

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

Commission File Number 1-12434

M/I HOMES, INC.
(Exact name of registrant as specified in it charter)

Ohio	31-1210837
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

3 Easton Oval, Suite 500, Columbus, Ohio 43219
(Address of principal executive offices) (Zip Code)
(614) 418-8000
(Registrant's telephone number, including area code)

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.
Common shares, par value $.01 per share: 18,523,335 shares outstanding as of October 21, 2010.

M/I HOMES, INC.
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M/I HOMES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except par values)	September 30, 2010 (Unaudited)	December 31, 2009
ASSETS:		
Cash	$43,894	$109,930
Restricted cash	48,108	22,302
Mortgage loans held for sale	32,446	34,978
Inventory	487,986	420,289
Property and equipment - net	17,453	18,998
Investment in unconsolidated limited liability companies	11,102	10,299
Income tax receivable	4,298	30,135
Other assets	11,937	16,897
TOTAL ASSETS	$657,224	$663,828
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES:		
Accounts payable	$53,863	$38,262
Customer deposits	4,420	3,831
Other liabilities	48,331	56,426
Community development district obligations	7,406	8,204
Obligation for consolidated inventory not owned	—	616
Note payable bank - financial services operations	23,773	24,142
Note payable — other	5,932	6,160
Senior notes — net of discount of $384 and $576, respectively, at September 30, 2010 and December 31, 2009	199,616	199,424
TOTAL LIABILITIES	343,341	337,065
Commitments and contingencies	—	—
SHAREHOLDERS' EQUITY:		
Preferred shares — $.01 par value; authorized 2,000,000 shares; issued 4,000 shares	96,325	96,325
Common shares — $.01 par value; authorized 38,000,000 shares; issued 22,101,723 shares at September 30, 2010 and December 31, 2009	221	221
Additional paid-in capital	139,772	137,492
Retained earnings	148,635	163,847
Treasury shares — at cost — 3,578,388 and 3,580,987 shares, respectively, at September 30, 2010 and December 31, 2009	(71,070)	(71,122)
TOTAL SHAREHOLDERS' EQUITY	313,883	326,763
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$657,224	$663,828

See Notes to Unaudited Condensed Consolidated Financial Statements.

M/I HOMES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
(In thousands, except per share amounts)	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)
Revenue	$135,609	$152,738	$451,402	$365,033
Costs, expenses and other loss:				
Land and housing	108,659	131,416	373,030	320,929
Impairment of inventory and investment in unconsolidated limited liability companies	1,796	14,962	11,206	32,484
General and administrative	13,148	14,414	39,601	42,831
Selling	11,735	11,601	36,482	30,339
Interest	1,952	1,298	6,172	6,305
Other loss	—	—	—	941
Total costs, expenses and other loss	137,290	173,691	466,491	433,829
Loss before income taxes	(1,681)	(20,953)	(15,089)	(68,796)
Provision for income taxes	389	121	123	309
Net loss	$(2,070)	$(21,074)	$(15,212)	$(69,105)
Loss per common share:				
Basic	$(0.11)	$(1.14)	$(0.82)	$(4.29)
Diluted	$(0.11)	$(1.14)	$(0.82)	$(4.29)
Weighted average shares outstanding:				
Basic	18,523	18,514	18,523	16,127
Diluted	18,523	18,514	18,523	16,127

See Notes to Unaudited Condensed Consolidated Financial Statements.

M/I HOMES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY

	Nine Months Ended September 30, 2010 (Unaudited)							
	Preferred Shares		Common Shares		Additional			Total
	Shares		Shares		Paid-in	Retained	Treasury	Shareholders'
(Dollars in thousands)	Outstanding	Amount	Outstanding	Amount	Capital	Earnings	Shares	Equity
Balance at December 31, 2009	4,000	$96,325	18,520,736	$221	$137,492	$163,847	$(71,122)	$ 326,763
Net loss	—	—	—	—	—	(15,212)	—	(15,212)
Income tax benefit from stock options and deferred compensation distributions	—	—	—	—	(14)	—	—	(14)
Stock options exercised	—	—	600	—	(7)	—	12	5
Stock-based compensation expense	—	—	—	—	2,179	—	—	2,179
Deferral of executive and director compensation	—	—	—	—	162	—	—	162
Executive and director deferred compensation distributions	—	—	1,999	—	(40)	—	40	—
Balance at September 30, 2010	4,000	$96,325	18,523,335	$221	$139,772	$148,635	$(71,070)	$ 313,883

See Notes to Unaudited Condensed Consolidated Financial Statements.

M/I HOMES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30,	
	2010	2009
(In thousands)	(Unaudited)	(Unaudited)
OPERATING ACTIVITIES:		
Net loss	$(15,212)	$(69,105)
Adjustments to reconcile net loss to net cash (used in) provided by operating activities:		
Inventory valuation adjustments and abandoned land transaction write-offs	11,603	27,076
Impairment of investment in unconsolidated limited liability companies	—	6,896
Mortgage loan originations	(301,419)	(275,655)
Proceeds from the sale of mortgage loans	305,430	275,748
Fair value adjustment of mortgage loans held for sale	(1,479)	592
Net loss from property disposals	7	942
Bad debt expense	—	1,223
Depreciation	3,859	3,887
Amortization of intangibles, debt discount and debt issue costs	1,935	1,901
Stock-based compensation expense	2,179	2,337
Deferred income tax benefit	(5,684)	(27,532)
Deferred tax asset valuation allowance	5,684	27,532
Income tax receivable	25,837	39,456
Excess tax expense from stock-based payment arrangements	14	103
Equity in undistributed income of unconsolidated limited liability companies	(155)	(10)
Write-off of unamortized debt discount and financing costs	311	554
Change in assets and liabilities:		
Cash held in escrow	(9,358)	(4,278)
Inventory	(81,562)	(12,891)
Other assets	6,780	2,205
Accounts payable	15,601	22,922
Customer deposits	589	2,145
Accrued compensation	(1,141)	(3,682)
Other liabilities	(6,806)	2,651
Net cash (used in) provided by operating activities	(42,987)	25,017
INVESTING ACTIVITIES:		
Restricted cash	(16,448)	(66,858)
Purchase of property and equipment	(1,455)	(3,695)
Proceeds from the sale of property	—	7,878
Investment in unconsolidated limited liability companies	(661)	(1,068)
Return of investment from unconsolidated limited liability companies	13	61
Net cash used in investing activities	(18,551)	(63,682)
FINANCING ACTIVITIES:		
Repayments of bank borrowings - net	(369)	(8,456)
Principal repayments of note payable-other and community development district bond obligations	(246)	(10,710)

Net proceeds from the issuance of common stock	—	52,568
Debt issue costs	(3,874)	(2,122)
Payments on capital lease obligations	—	(91)
Proceeds from exercise of stock options	5	61
Excess tax benefit from stock-based payment arrangements	(14)	(103)
Net cash (used in) provided by financing activities	(4,498)	31,147
Net decrease in cash	(66,036)	(7,518)
Cash balance at beginning of period	109,930	32,518
Cash balance at end of period	$43,894	$25,000
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the year for:		
Interest — net of amount capitalized	$372	$662
Income taxes	$274	$168
NON-CASH TRANSACTIONS DURING THE YEAR:		
Community development district infrastructure	$(780)	$(1,362)
Consolidated inventory not owned	$(616)	$(4,826)
Distribution of single-family lots from unconsolidated limited liability companies	$—	$2
Deferral of executive and director compensation	$162	$138
Executive and director deferred compensation distributions	$40	$211

See Notes to Unaudited Condensed Consolidated Financial Statements.

M/I HOMES, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. Basis of Presentation

The accompanying Unaudited Condensed Consolidated Financial Statements (the “financial statements”) of M/I Homes, Inc. and its subsidiaries (the “Company”) and notes thereto have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission for interim financial information. The financial statements include the accounts of M/I Homes, Inc. and its subsidiaries. All intercompany transactions have been eliminated. Results for the interim period are not necessarily indicative of results for a full year. In the opinion of management, the accompanying financial statements reflect all adjustments (all of which are normal and recurring in nature) necessary for a fair presentation of financial results for the interim periods presented. These financial statements should be read in conjunction with the Consolidated Financial Statements and Notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 (the “2009 Form 10-K”).

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during that period. Actual results could differ from these estimates and have a significant impact on the financial condition and results of operations and cash flows. With regard to the Company, estimates and assumptions are inherent in calculations relating to valuation of inventory and investment in unconsolidated limited liability companies (“Unconsolidated LLCs”), property and equipment depreciation, valuation of derivative financial instruments, accounts payable on inventory, accruals for costs to complete inventory, accruals for warranty claims, accruals for self-insured general liability claims, litigation, accruals for health care and workers' compensation, accruals for guaranteed or indemnified loans, stock-based compensation expense, income taxes, and contingencies. Items that could have a significant impact on these estimates and assumptions include the risks and uncertainties listed in “Item 1A. Risk Factors” in Part I of our 2009 Form 10-K, as the same may be updated from time to time in our subsequent filings with the Securities and Exchange Commission.

NOTE 2. Cash and Restricted Cash

The table below is a summary of our cash balances at September 30, 2010 and December 31, 2009:

(In thousands)	September 30, 2010	December 31, 2009
Homebuilding	$29,700	$96,464
Financial services	14,194	13,466
Unrestricted cash	$43,894	$109,930
Restricted cash	48,108	22,302
Total cash	$92,002	$132,232

Restricted cash primarily consists of homebuilding cash the Company had designated as collateral at September 30, 2010 and December 31, 2009 in accordance with the four secured Letter of Credit Facilities that were entered into in July 2009 and the one secured Letter of Credit Facility entered into in June 2010 (collectively, as amended, the “Letter of Credit Facilities”). Restricted cash also includes cash held in escrow of $12.5 million and $3.1 million at September 30, 2010 and December 31, 2009, respectively.

NOTE 3. Impact of New Accounting Standards

In January 2010, the Financial Accounting Standards Board issued Accounting Standards Update ("ASU") No. 2010-06, Fair Value Measurements and Disclosures (Topic 820) — Improving Disclosures about Fair Value Measurements ("ASU 2010-06"), which amends Accounting Standards Codification 820 to require the disclosure of additional information related to fair value measurement and provide clarification to existing requirements for fair value measurement disclosure. ASU 2010-06 was effective for the Company beginning January 1, 2010. The Company's disclosures conform to the requirements of ASU 2010-06. Refer to Note 4 for additional discussion of fair value measurements.

NOTE 4. Fair Value Measurements

There are three measurement input levels for determining fair value: Level 1, Level 2, and Level 3. Fair values determined by Level 1 inputs utilize quoted prices in active markets for identical assets or liabilities that the Company has the ability to access. Fair values determined by Level 2 inputs utilize inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals. Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability.

Assets Measured on a Recurring Basis

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

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

The fair value is based on published prices for mortgage-backed securities with similar characteristics, and the buyup fees received or buydown fees to be paid upon securitization of the loan. The buyup and buydown fees are calculated pursuant to contractual terms with investors. To calculate the effects of interest rate movements, the Company utilizes applicable published mortgage-backed security prices, and multiplies the price movement between the rate lock date and the balance sheet date by the notional loan commitment amount. The Company sells the majority of its loans on a servicing released basis, and receives a servicing release premium upon sale. Thus, the value of the servicing rights included in the fair value measurement is based upon contractual terms with investors and depends on the loan type. The Company applies a fallout rate to IRLCs when measuring the fair value of rate lock commitments. Fallout is defined as locked loan commitments for which the Company does not close a mortgage loan and is based on management's judgment and historical experience.

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

Mortgage loans held for sale are closed at cost, which includes all fair value measurements.

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

Some IRLCs are committed to a specific third-party investor through the use of best-efforts whole loan delivery commitments matching the exact terms of the IRLC loan. The notional amount of the committed IRLCs and the best-efforts contracts was $3.6 million at September 30, 2010. At September 30, 2010, the fair value of the committed IRLCs resulted in an asset of less than $0.1 million and the related best-efforts contracts resulted in a liability of less than $0.1 million. For the three and nine months ended September 30, 2010, we recognized income of less than $0.1 million and $0.1 million, respectively, relating to marking these committed IRLCs and the related best-efforts contracts to market.

Uncommitted IRLCs are considered derivative instruments and are fair value adjusted, with the resulting gain or loss recorded in current earnings. At September 30, 2010, the notional amount of the uncommitted IRLCs was $43.4 million. The fair value adjustment related to these uncommitted IRLCs, which is based on quoted market prices, resulted in an asset of $0.3 million at September 30, 2010. For the three and nine months ended September 30, 2010, we recognized expense of $0.4 million and income of $0.3 million, respectively, relating to marking the uncommitted IRLCs to market.

Forward Sales of Mortgage-Backed Securities. Forward sales of mortgage-backed securities ("FMBSs") are used to protect uncommitted IRLC loans against the risk of changes in interest rates between the lock date and the funding date. FMBSs related to uncommitted IRLCs are classified and accounted for as non-designated derivative instruments and are recorded at fair value, with gains and losses recorded in current earnings. At September 30, 2010, the notional amount under these FMBSs was $43.0 million, and the related fair value adjustment, which is based on quoted market prices, resulted in an asset of $0.1 million. For the three and nine months ended September 30, 2010, we recognized income of $0.7 million and expense of $0.6 million, respectively, relating to marking these FMBSs to market.

Mortgage Loans Held for Sale: Mortgage loans held for sale consist primarily of single-family residential loans collateralized by the underlying property. During the intervening period between when a loan is closed and when it is sold to an investor, the interest rate risk is covered through the use of a best-efforts contract or by FMBSs.

The notional amount of the best-efforts contracts and related mortgage loans held for sale was $4.1 million at September 30, 2010. The fair value of the best-efforts contracts and related mortgage loans held for sale resulted in a net liability of $0.1 million at September 30, 2010. For the three and nine months ended September 30, 2010, we recognized income of less than $0.1 million and $0.7 million, respectively, relating to marking these best-efforts contracts and the related mortgage loans held for sale to market.

The notional amounts of both the FMBSs and the related mortgage loans held for sale were $28.0 million at September 30, 2010. The FMBSs are classified and accounted for as non-designated derivative instruments, with gains and losses recorded in current earnings. As of September 30, 2010, the related fair value adjustment for marking these FMBSs to market resulted in a liability of $0.1 million. For the three and nine months ended September 30, 2010, we recognized income of $1.3 million and expense of $0.2 million, respectively, relating to marking these FMBSs to market.

The table below shows the level and measurement of assets and liabilities measured on a recurring basis at September 30, 2010:

Description of asset or liability (In thousands)	Fair Value Measurements September 30, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Mortgage loans held for sale	$331	$—	$331	$—
Forward sales of mortgage-backed securities	5	—	5	—
Interest rate lock commitments	329	—	329	—
Best-efforts contracts	(81)	—	(81)	—
Total	$584	$—	$584	$—

Assets Measured on a Non-Recurring Basis

The Company assesses inventory for recoverability on a quarterly basis by reviewing for impairment whenever events or changes in local or national economic conditions indicate that the carrying amount of an asset may not be recoverable. In conducting our quarterly review for indicators of impairment on a community level, we evaluate, among other things, the margins on homes that have been delivered, margins on sales contracts in backlog, projected margins with regard to future home sales over the life of the community, projected margins with regard to future land sales, and the value of the land itself. We pay particular attention to communities in which inventory is moving at a slower than anticipated absorption pace, and communities whose average sales price and/or margins are trending downward and are anticipated to continue to trend downward. From this review, we identify communities whose carrying values may exceed their undiscounted cash flows. We also evaluate communities where management intends to lower the sales price or offer incentives in order to improve absorptions even if the community's historical results do not indicate a potential for impairment. For those communities deemed to be impaired, the impairment recognized is measured by the amount by which the carrying amount of the communities exceeds the fair value of the communities. In addition, due to the fact that the estimates and assumptions included in the Company's cash flow models are based upon historical results and projected trends, unexpected changes in market conditions may lead the Company to incur additional impairment charges in the future.

Our determination of fair value is based on projections and estimates, which are Level 3 measurement inputs. Our analysis is completed at a phase level within each community; therefore, changes in local conditions may affect one or several of our communities. For all of the categories discussed below, the key assumptions relating to the valuations are dependent on project-specific local market and/or community conditions and are inherently uncertain.

Because each inventory asset is unique, there are numerous inputs and assumptions used in our valuation techniques. Local market-specific factors that may impact these projected assumptions include:

- historical project results such as average sales price and sales pace, if closings have occurred in the project;
- competitors' local market and/or community presence and their competitive actions;
- project specific attributes such as location desirability and uniqueness of product offering;
- potential for alternative product offerings to respond to local market conditions;
- current local market economic and demographic conditions and related trends and forecasts; and
- community-specific strategies regarding speculative homes.

These, and other local market-specific factors that may impact project assumptions discussed above, are considered by personnel in our homebuilding divisions as they prepare or update the forecasted assumptions for each community. Quantitative and qualitative factors other than home sales prices could significantly impact the potential for future impairments. The sales objectives can differ between communities, even within a given sub-market. For example, facts and circumstances in a given community may lead us to price our homes with the objective of yielding a higher sales absorption pace, while facts and circumstances in another community may lead us to price our homes to minimize deterioration in our gross margins, although it may result in a slower sales absorption pace. Furthermore, the key assumptions included in our estimated future undiscounted cash flows may be interrelated. For example, a decrease in estimated base sales price or an increase in home sales incentives may result in a corresponding increase in sales absorption pace. Additionally, a decrease in the average sales price of homes to be sold and closed in future reporting periods for one community that has not been generating what management believes to be an adequate sales absorption pace may impact the estimated cash flow assumptions of a nearby community. Changes in our key assumptions, including estimated construction and development costs, absorption pace, selling strategies, or discount rates, could materially impact future cash flow and fair value estimates. As of September 30, 2010, we utilized discount rates ranging from 13% to 16% in determining the fair value of our inventory and investments in Unconsolidated LLCs.

Operating Communities: For existing operating communities, the recoverability of assets is measured on a quarterly basis by comparing the carrying amount of the assets to future undiscounted net cash flows expected to be generated by the assets based on home sales. These estimated cash flows are developed based primarily on management's assumptions relating to the specific community. The significant assumptions used to evaluate the recoverability of assets include: the timing of development and/or marketing phases; projected sales price and sales pace of each existing or planned community; the estimated land development, home construction, and selling costs of the community; overall market supply and demand; the local market; and competitive conditions. Management reviews these assumptions on a quarterly basis. While we consider available information to determine what we believe to be our best estimates as of the end of a reporting period, these estimates are subject to change in future reporting periods as facts and circumstances change. These assumptions vary widely across different communities and geographic areas and are largely dependent on local market conditions. Some of the most critical assumptions in the Company's cash flow models are projected absorption pace for home sales, sales prices, and costs to build and deliver homes on a community by community basis.

In order to arrive at the assumed absorption pace for home sales included in the Company's cash flow models, the Company analyzes the historical absorption pace in the community as well as other communities in the geographic area. In addition, the Company analyzes internal and external market studies and trends, which generally include, but are not limited to, statistics on population demographics, unemployment rates, and availability of competing products in the geographic area where a community is located. When analyzing the Company's historical absorption pace for home sales and corresponding internal and external market studies, the Company places greater emphasis on more current metrics and trends such as the absorption pace realized in its most recent quarters, as well as forecasted population demographics, unemployment rates, and availability of competing products.

In order to determine the assumed sales prices included in its cash flow models, the Company analyzes the historical sales prices realized on homes it delivered in the community and other communities in the geographic area as well as the sales prices included in its current backlog for such communities. In addition, the Company analyzes internal and external market studies and trends, which generally include, but are not limited to, statistics on sales prices in neighboring communities and sales prices on similar products in non-neighboring communities in the geographic area where the community is located. When analyzing its historical sales prices and corresponding market studies, the Company places greater emphasis on more current metrics and trends. Ultimately, upon this analysis, the Company sets a current sales price for each house type in the community, using the aforementioned information, which it believes will achieve an acceptable gross margin and sales pace in the community. This price becomes the price published to the sales force for use in its sales efforts. The Company then uses the average of these “published” sales prices in its cash flow models.

In order to arrive at the Company's assumed costs to build and deliver homes, the Company generally assumes a cost structure reflecting contracts currently in place with its vendors and subcontractors adjusted for any anticipated cost reduction initiatives or increases in cost structure. With respect to overhead included in the cash flow models, the Company uses forecasted rates included in the Company's annual budget for the overall market area adjusted for actual experience that is materially different than budgeted rates.

Future Communities: For raw land, land under development, or lots that management anticipates will be utilized for future homebuilding activities, the recoverability of assets is measured by comparing the carrying amount of the assets to future undiscounted cash flows expected to be generated by the assets based on home sales, consistent with the evaluations performed for operating communities discussed above.

For raw land, land under development, or lots that management intends to market for sale to a third party, but that do not meet all of the criteria to be classified as land held for sale as discussed below, the recoverability of the assets is determined based on either the estimated net sales proceeds expected to be realized on the sale of the assets or the estimated fair value determined using cash flow valuation techniques.

If the Company has not yet determined whether raw land, land under development, or lots will be utilized for future homebuilding activities or marketed for sale to a third party, the Company assesses the recoverability of the inventory using a probability-weighted approach.

Land Held for Sale: Land held for sale includes land that meets all of the following six criteria: (1) management, having the authority to approve the action, commits to a plan to sell the asset; (2) the asset is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets; (3) an active program to locate a buyer and other actions required to complete the plan to sell the asset have been initiated; (4) the sale of the asset is probable, and transfer of the asset is expected to qualify for recognition as a completed sale, within one year; (5) the asset is being actively marketed for sale at a price that is reasonable in relation to its current fair value; and (6) actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn. The Company records land held for sale at the lower of its carrying value or fair value less costs to sell. In performing an impairment evaluation for land held for sale, management considers, among other things, prices for land in recent comparable sales transactions, market analysis and recent bona fide offers received from outside third parties, as well as actual contracts. If the estimated fair value less the costs to sell an asset is less than the current carrying value, the asset is written down to its estimated fair value less costs to sell.

Investment In Unconsolidated Limited Liability Companies: The Company evaluates its investment in Unconsolidated LLCs for potential impairment on a quarterly basis. If the fair value of the investment is less than the investment's carrying value and the Company has determined that the decline in value is other than temporary, the Company would write down the value of the investment to fair value. The determination of whether an investment's fair value is less than the carrying value requires management to make certain assumptions regarding the amount and timing of future contributions to the Unconsolidated LLC, the timing of distribution of lots to the Company from the Unconsolidated LLC, the projected fair value of the lots at the time of distribution to the Company, and the estimated proceeds from, and timing of, the sale of land or lots to third parties. In determining the fair value of investments in Unconsolidated LLCs, the Company evaluates the projected cash flows associated with each Unconsolidated LLC. As of September 30, 2010, the Company used a discount rate of 16% in determining the fair value of investments in Unconsolidated LLCs. In addition to the assumptions management must make to determine if the investment's fair value is less than the carrying value, management must also use judgment in determining whether the impairment is other than temporary. The factors management considers are: (1) the length of time and the extent to which the market value has been less than cost; (2) the financial condition and near-term prospects of the Company; and (3) the intent and ability of the Company to retain its investment in the Unconsolidated LLC for a period of time sufficient to allow for any anticipated recovery in market value. In situations where the investments are 100% equity financed by the partners, and the joint venture simply distributes lots to its partners, the Company evaluates “other than temporary” by preparing an undiscounted cash flow model as described above for operating communities. If such model results in positive value versus carrying value, and the fair value of the investment is less than the investment's carrying value, the Company determines that the impairment is temporary; otherwise, the Company determines that the impairment is other than temporary and impairs the investment. Because of the high degree of judgment involved in developing these assumptions, it is possible that the Company may determine the investment is not impaired in the current period but, due to passage of time or change in market conditions leading to changes in assumptions, impairment could occur.

The table below shows the level and measurement of assets and liabilities measured on a non-recurring basis at September 30, 2010:

Description of asset or liability (In thousands)	Fair Value Measurements September 30, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Inventory	$3,786	$—	$—	$3,786
Total fair value measurements	$3,786	$—	$—	$3,786

NOTE 5. Risk Management and Derivatives

As described in Note 4 above, in the normal course of business, our financial services segment is exposed to interest rate risk, and the Company uses derivatives to help manage this risk.

To meet the financing needs of our home-buying customers, M/I Financial Corp., our wholly-owned subsidiary ("M/I Financial"), is party to IRLCs, which are extended to customers who have applied for a mortgage loan and meet certain defined credit and underwriting criteria. These IRLCs are considered derivative financial instruments. M/I Financial manages interest rate risk related to its IRLCs and mortgage loans held for sale through the use of FMBSs, use of best-efforts whole loan delivery commitments, and the occasional purchase of options on FMBSs in accordance with Company policy. These FMBSs, options on FMBSs, and IRLCs covered by FMBSs are considered non-designated derivatives.

Certain IRLCs and mortgage loans held for sale are committed to third party investors through the use of best-efforts whole loan delivery commitments. The IRLCs and related best-efforts whole loan delivery commitments, which generally are highly effective from an economic standpoint, are considered non-designated derivatives, and are accounted for at fair value, with gains or losses recorded in financial services revenue. Under the terms of these best-efforts whole loan delivery commitments covering mortgage loans held for sale, the specific committed mortgage loans held for sale are identified and matched to specific delivery commitments on a loan-by-loan basis. The delivery commitments and loans held for sale are recorded at fair value, with changes in fair value recorded in financial services revenue.

All derivatives are recognized on the balance sheet at their fair value. The total notional amount of the Company's derivatives as of September 30, 2010 and December 31, 2009 was $125.8 million and $126.1 million, respectively. Refer to Note 4 above for further discussion of our derivative instruments.

The following tables set forth the fair value of the Company's derivative instruments and their location within the Unaudited Condensed Consolidated Balance Sheets for the periods indicated:

	Asset Derivatives At September 30, 2010		Liability Derivatives At September 30, 2010	
Description of Derivatives	Balance Sheet Location	Fair Value (in thousands)	Balance Sheet Location	Fair Value (in thousands)
Forward sales of mortgage-backed securities	Other assets	$5	Other liabilities	$—
Interest rate lock commitments	Other assets	329	Other liabilities	—
Best-efforts contracts	Other assets	—	Other liabilities	81

Total fair value measurements		$334		$81

Description of Derivatives	Asset Derivatives At December 31, 2009		Liability Derivatives At December 31, 2009	
	Balance Sheet Location	Fair Value (in thousands)	Balance Sheet Location	Fair Value (in thousands)
Forward sales of mortgage-backed securities	Other assets	$833	Other liabilities	$—
Interest rate lock commitments	Other assets	—	Other liabilities	145
Best-efforts contracts	Other assets	308	Other liabilities	—
Total fair value measurements		$1,141		$145

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The following tables set forth the amount of gain (loss) recognized on our derivative instruments and their location in the Unaudited Condensed Consolidated Statements of Operations for the periods indicated:

Description of Derivatives	Three Months Ended September 30, 2010 (in thousands)	Nine Months Ended September 30, 2010 (in thousands)	Location of Gain (Loss) Recognized on Derivatives
Forward sales of mortgage-backed securities	$1,956	$(828)	Financial Services Revenue
Interest rate lock commitments	(373)	474	Financial Services Revenue
Best-efforts contracts	22	(389)	Financial Services Revenue
Total gain (loss) recognized on derivatives	$1,605	$(743)	

Description of Derivatives	Three Months Ended September 30, 2009 (in thousands)	Nine Months Ended September 30, 2009 (in thousands)	Location of Gain (Loss) Recognized on Derivatives
Forward sales of mortgage-backed securities	$(2,341)	$(230)	Financial Services Revenue
Interest rate lock commitments	1,240	382	Financial Services Revenue
Best-efforts contracts	(99)	(349)	Financial Services Revenue
Total loss recognized on derivatives	$(1,200)	$(197)	

NOTE 6. Inventory

A summary of the Company's inventory as of September 30, 2010 and December 31, 2009 is as follows:

(In thousands)	September 30, 2010	December 31, 2009
Single-family lots, land and land development costs	$258,657	$232,127
Land held for sale	—	4,300
Homes under construction	199,129	158,998
Model homes and furnishings - at cost (less accumulated depreciation: September 30, 2010 - $3,460; December 31, 2009 - $3,069)	20,802	14,726
Community development district infrastructure	7,406	8,186
Land purchase deposits	1,992	1,336
Consolidated inventory not owned	—	616
Total inventory	$487,986	$420,289

Single-family lots, land and land development costs include raw land that the Company has purchased to develop into lots, costs incurred to develop the raw land into lots, and lots for which development has been completed but which have not yet been used to start construction of a home.

Land held for sale includes land that meets the six criteria discussed above in Note 4. The Company records land held for sale at the lower of its carrying value or fair value less costs to sell.

Homes under construction include homes that are in various stages of construction. As of September 30, 2010 and December 31, 2009, we had 630 homes (with a carrying value of $77.0 million) and 545 homes (with a carrying value of $59.4 million), respectively, included in homes under construction that were not subject to a sales contract.

Model homes and furnishings include homes that are under construction or have been completed and are being used as sales models. The amount also includes the net book value of furnishings included in our model homes. Depreciation on model home furnishings is recorded using an accelerated method over the estimated useful life of the assets, typically three years.

The Company assesses inventory for recoverability on a quarterly basis, by reviewing for impairment whenever events or changes in local or national economic conditions indicate that the carrying amount of an asset may not be recoverable. Refer to Note 4 and Note 7 for additional details relating to our procedures for evaluating our inventories for impairment.

Land purchase deposits include both refundable and non-refundable amounts paid to third party sellers relating to the purchase of land. On an ongoing basis, the Company evaluates the land option agreements relating to the land purchase deposits. In the period during which the Company makes the decision not to proceed with the purchase of land under an agreement, the Company writes off any deposits and accumulated pre-acquisition costs relating to such agreement. For the three and nine months ended

September 30, 2010, the Company wrote off $0.1 million and $0.4 million, respectively, in option deposits and pre-acquisition costs. Refer to Note 7 for additional details relating to write-offs of land option deposits and pre-acquisition costs.

NOTE 7. Valuation Adjustments and Write-offs

The Company assesses inventory for recoverability on a quarterly basis, by reviewing for impairment whenever events or changes in local or national economic conditions indicate that the carrying amount of an asset may not be recoverable.

Operating communities. For existing operating communities that may have impairment indicators, the recoverability of assets is measured by comparing the carrying amount of the assets to future undiscounted cash flows expected to be generated by the assets based on home sales. These estimated cash flows are developed based primarily on management's assumptions relating to the specific community. The significant assumptions used to evaluate the recoverability of assets include: the timing of development and/or marketing phases; projected sales price and sales pace of each existing or planned community; the estimated land development, home construction, and selling costs of the community; overall market supply and demand; the local market; and competitive conditions.

Future communities. For raw land, land under development, or lots that management anticipates will be utilized for future homebuilding activities, the recoverability of assets is measured by comparing the carrying amount of the assets to future undiscounted cash flows expected to be generated by the assets based on home sales, consistent with the evaluations performed for operating communities discussed above.

For raw land, land under development, or lots that management intends to market for sale to a third party, but that do not meet all of the criteria to be classified as land held for sale as discussed above in Note 4, the recoverability of the assets is determined based on either the estimated net sales proceeds expected to be realized on the sale of the assets or the estimated fair value determined using cash flow valuation techniques.

If the Company has not yet determined whether raw land, land under development, or lots will be utilized for future homebuilding activities or marketed for sale to a third party, the Company assesses the recoverability of the inventory using a probability-weighted approach.

Land held for sale. Land held for sale includes land that meets the six criteria discussed above in Note 4. The Company records land held for sale at the lower of its carrying value or fair value less costs to sell. Fair value is determined based on the expected third party sale proceeds.

Investments in Unconsolidated Limited Liability Companies. The Company assesses investments in Unconsolidated LLCs for impairment on a quarterly basis. When evaluating the Unconsolidated LLCs, if the fair value of the investment is less than the investment's carrying value, and the Company determines the decline in value is other than temporary, the Company would write down the investment to fair value. The Company's Unconsolidated LLCs engage in land acquisition and development activities for the purpose of selling or distributing (in the form of a capital distribution) developed lots to the Company and its partners in the entity, as further discussed in Note 9.

As of September 30, 2010, we utilized discount rates ranging from 13% to 16% in the above valuations. The discount rate used in determining each asset's fair value depends on the community's projected life, development stage, and the inherent risks associated with the related estimated cash flow stream, as well as current risk free rates available in the market and estimated market risk premiums.

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A summary of the Company's valuation adjustments and write-offs for the three and nine months ended September 30, 2010 and 2009 is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In thousands)	2010	2009	2010	2009
Impairment of operating communities:				
Midwest	$141	$7,033	$276	$9,896
Florida	72	2,821	583	6,693
Mid-Atlantic	110	22	3,086	4,001
Total impairment of operating communities (a)	$323	$9,876	$3,945	$20,590
Impairment of future communities:				
Midwest	$—	$1,524	$2,837	$1,524
Florida	1,473	3,474	3,134	3,474
Mid-Atlantic	—	—	1,290	—
Total impairment of future communities (a)	$1,473	$4,998	$7,261	$4,998
Option deposits and pre-acquisition costs write-offs:				
Midwest	$5	$24	$94	$547
Florida	94	6	95	20
Mid-Atlantic	41	42	208	921
Total option deposits and pre-acquisition costs write-offs (b)	$140	$72	$397	$1,488
Impairment of investments in Unconsolidated LLCs:				
Midwest	$—	$—	$—	$72
Florida	—	88	—	6,824
Mid-Atlantic	—	—	—	—
Total impairment of investments in Unconsolidated LLCs (a)	$—	$88	$—	$6,896
Total impairments and write-offs of option deposits and pre-acquisition costs	$1,936	$15,034	$11,603	$33,972

(a) Amounts are recorded within Impairment of inventory and investment in unconsolidated limited liability companies in the Company's Unaudited Condensed Consolidated Statements of Operations.

(b) Amounts are recorded within General and administrative expenses in the Company's Unaudited Condensed Consolidated Statements of Operations.

NOTE 8. Capitalized Interest

The Company capitalizes interest during land development and home construction. Capitalized interest is charged to cost of sales as the related inventory is delivered to a third party. A summary of capitalized interest is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In thousands)	2010	2009	2010	2009
Capitalized interest, beginning of period	$21,470	$25,387	$23,670	$25,838
Interest capitalized to inventory	2,495	2,942	7,480	7,221
Capitalized interest charged to cost of sales	(2,719)	(3,363)	(9,904)	(8,093)
Capitalized interest, end of period	$21,246	$24,966	$21,246	$24,966

Interest incurred — net	$4,447	$4,240	$13,652	$13,526

NOTE 9. Investment in Unconsolidated Limited Liability Companies

At September 30, 2010, the Company had interests ranging from 33% to 50% in Unconsolidated LLCs that do not meet the criteria of variable interest entities because each of the entities had sufficient equity at risk to permit the entity to finance its activities without additional subordinated support from the equity investors, and one of these Unconsolidated LLCs has outside financing that is not guaranteed by the Company. These Unconsolidated LLCs engage in land acquisition and development activities for the purpose of selling or distributing (in the form of a capital distribution) developed lots to the Company and its partners in the entity. The Company's maximum exposure related to its investment in these entities as of September 30, 2010 was the amount invested of $11.1 million plus letters of credit and bonds totaling $0.8 million. Included in the Company's investment in Unconsolidated LLCs at September 30, 2010 and December 31, 2009 were $0.9 million and $0.8 million, respectively, of capitalized interest and other costs. The Company does not have a controlling interest in these Unconsolidated LLCs; therefore, they are recorded using the equity method of accounting.

The Company evaluates its investment in Unconsolidated LLCs for potential impairment on a quarterly basis. If the fair value of the investment (see Note 4) is less than the investment's carrying value, and the Company determines the decline in value was other than temporary, the Company would write down the investment to fair value.

NOTE 10. Guarantees and Indemnifications

Warranty

The Company offers a limited warranty program in conjunction with a thirty-year transferable structural limited warranty on homes closed after September 30, 2007. This warranty program covers construction defects and certain damage resulting from construction defects for a statutory period based on geographic market and state law (currently ranging from five to ten years for the states in which the Company operates) and includes a mandatory arbitration clause. Prior to this warranty program, the Company provided up to a two-year limited warranty on materials and workmanship and a twenty-year (for homes closed between September 1, 1989 and April 24, 1998) and a thirty-year (for homes closed after April 24, 1998) transferable limited warranty against major structural defects. Warranty expense is accrued as the home sale is recognized and is intended to cover estimated material and outside labor costs to be incurred during the warranty period. The accrual amounts are based upon historical experience and geographic location. Our warranty accruals are included in Other liabilities in the Company's Unaudited Condensed Consolidated Balance Sheets. A summary of warranty activity for the three and nine months ended September 30, 2010 and 2009 is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In thousands)	2010	2009	2010	2009
Warranty accrual, beginning of period	$8,478	$7,532	$8,657	$9,518
Warranty expense on homes delivered during the period	1,073	1,310	3,792	3,129
Changes in estimates for pre-existing warranties	159	234	139	(789)
Settlements made during the period	(1,596)			