HORTON D R INC /DE/
Form 10-Q
July 26, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the Quarterly Period Ended June 30, 2016
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 1-14122

D.R. Horton, Inc.
(Exact name of registrant as specified in its charter)

Delaware	75-2386963
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
301 Commerce Street, Suite 500, Fort Worth, Texas	76102
(Address of principal executive offices)	(Zip Code)

(817) 390-8200
(Registrant’s telephone number, including area code)
Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes ý No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, 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 ý 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 ý	Accelerated filer ¨	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 ý

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 – 372,285,773 shares as of July 20, 2016

D.R. HORTON, INC. AND SUBSIDIARIES
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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
D.R. HORTON, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	June 30, 2016	September 30, 2015
	(In millions)	
	(Unaudited)	
ASSETS		
Homebuilding:		
Cash and cash equivalents	$862.9	$ 1,355.9
Restricted cash	11.8	9.7
Inventories:		
Construction in progress and finished homes	4,371.4	3,501.2
Residential land and lots — developed and under development	3,948.6	4,065.3
Land held for development	155.5	202.3
Land held for sale	28.7	38.2
	8,504.2	7,807.0
Deferred income taxes, net of valuation allowance of $9.2 million and $10.1 million at June 30, 2016 and September 30, 2015, respectively	505.1	558.1
Property and equipment, net	151.7	144.0
Other assets	422.8	456.2
Goodwill	87.2	87.2
	10,545.7	10,418.1
Financial Services:		
Cash and cash equivalents	43.9	27.9
Mortgage loans held for sale	634.5	631.0
Other assets	109.1	74.0
	787.5	732.9
Total assets	$11,333.2	$ 11,151.0
LIABILITIES		
Homebuilding:		
Accounts payable	$568.2	$ 473.0
Accrued expenses and other liabilities	909.8	929.2
Notes payable	2,797.1	3,333.6
	4,275.1	4,735.8
Financial Services:		
Accounts payable and other liabilities	41.1	41.9
Mortgage repurchase facility	504.2	477.9
	545.3	519.8
Total liabilities	4,820.4	5,255.6
Commitments and contingencies (Note K)		
EQUITY		
Preferred stock, $.10 par value, 30,000,000 shares authorized, no shares issued	—	—
Common stock, $.01 par value, 1,000,000,000 shares authorized, 379,371,827 shares issued and 372,171,756 shares outstanding at June 30, 2016 and 375,847,442 shares issued and 368,647,371 shares outstanding at September 30, 2015	3.8	3.8
Additional paid-in capital	2,839.3	2,733.8

Retained earnings	3,803.4	3,289.6
Treasury stock, 7,200,071 shares at June 30, 2016 and September 30, 2015, at cost	(134.3)	(134.3)
Accumulated other comprehensive income	—	1.4
Stockholders’ equity	6,512.2	5,894.3
Noncontrolling interests	0.6	1.1
Total equity	6,512.8	5,895.4
Total liabilities and equity	$11,333.2	$ 11,151.0

See accompanying notes to consolidated financial statements.

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D.R. HORTON, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2016	2015	2016	2015
	(In millions, except per share data) (Unaudited)			
Homebuilding:				
Revenues:				
Home sales	$3,118.7	$2,857.9	$8,145.6	$7,417.4
Land/lot sales and other	30.1	18.5	65.2	50.6
	3,148.8	2,876.4	8,210.8	7,468.0
Cost of sales:				
Home sales	2,486.5	2,288.9	6,512.1	5,948.8
Land/lot sales and other	28.4	16.1	56.2	44.1
Inventory and land option charges	8.1	15.4	16.0	34.0
	2,523.0	2,320.4	6,584.3	6,026.9
Gross profit:				
Home sales	632.2	569.0	1,633.5	1,468.6
Land/lot sales and other	1.7	2.4	9.0	6.5
Inventory and land option charges	(8.1)	(15.4)	(16.0)	(34.0)
	625.8	556.0	1,626.5	1,441.1
Selling, general and administrative expense	280.4	257.8	782.0	738.2
Other (income)	(3.8)	(3.9)	(16.8)	(13.9)
Homebuilding pre-tax income	349.2	302.1	861.3	716.8
Financial Services:				
Revenues	83.1	74.4	205.4	183.6
General and administrative expense	56.4	46.0	153.5	124.6
Interest and other (income)	(2.7)	(3.3)	(7.2)	(8.8)
Financial services pre-tax income	29.4	31.7	59.1	67.8
Income before income taxes	378.6	333.8	920.4	784.6
Income tax expense	128.8	112.4	317.8	272.8
Net income	$249.8	$221.4	$602.6	$511.8
Other comprehensive income, net of income tax:				
Debt securities collateralized by residential real estate:				
Net change in unrealized gain	—	—	1.2	—
Reclassification adjustment for net gain realized in net income	—	—	(2.6)	—
Comprehensive income	$249.8	$221.4	$601.2	$511.8
Basic net income per common share	$0.67	$0.60	$1.63	$1.40
Net income per common share assuming dilution	$0.66	$0.60	$1.61	$1.39
Cash dividends declared per common share	$0.08	$0.0625	$0.24	$0.1875

See accompanying notes to consolidated financial statements.

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D.R. HORTON, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Nine Months Ended June 30,	
	2016	2015
	(In millions) (Unaudited)	
OPERATING ACTIVITIES		
Net income	$602.6	$511.8
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	41.4	39.7
Amortization of discounts and fees	4.1	4.1
Stock based compensation expense	36.8	31.7
Excess income tax benefit from employee stock awards	(6.3)	(7.3)
Deferred income taxes	46.7	20.7
Inventory and land option charges	16.0	34.0
Gain on sale of debt securities collateralized by residential real estate	(4.5)	—
Changes in operating assets and liabilities:		
Increase in construction in progress and finished homes	(879.1)	(252.1)
Decrease (increase) in residential land and lots – developed, under development, held for development and held for sale	151.3	(120.7)
Increase in other assets	(4.6)	(3.2)
Increase in mortgage loans held for sale	(3.5)	(91.5)
Increase in accounts payable, accrued expenses and other liabilities	87.7	21.4
Net cash provided by operating activities	88.6	188.6
INVESTING ACTIVITIES		
Purchases of property and equipment	(65.2)	(43.3)
Increase in restricted cash	(2.1)	(1.7)
Net principal decrease (increase) of other mortgage loans and real estate owned	4.3	(6.3)
Proceeds from sale (purchases) of debt securities collateralized by residential real estate	35.8	(14.8)
Payments related to acquisition of a business	—	(68.7)
Net cash used in investing activities	(27.2)	(134.8)
FINANCING ACTIVITIES		
Proceeds from notes payable	26.3	1,560.8
Repayment of notes payable	(543.9)	(1,433.5)
Proceeds from stock associated with certain employee benefit plans	61.8	24.0
Excess income tax benefit from employee stock awards	6.3	7.3
Cash dividends paid	(88.9)	(68.6)
Net cash (used in) provided by financing activities	(538.4)	90.0
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(477.0)	143.8
Cash and cash equivalents at beginning of period	1,383.8	661.8
Cash and cash equivalents at end of period	$906.8	$805.6
Supplemental disclosures of non-cash activities:		
Notes payable issued for inventory	$4.2	$8.1
Stock issued under employee incentive plans	$19.9	$8.3
Accrual for holdback payment related to acquisition	$—	$2.0

See accompanying notes to consolidated financial statements.

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D.R. HORTON, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)
June 30, 2016

NOTE A – BASIS OF PRESENTATION

The accompanying unaudited, consolidated financial statements include the accounts of D.R. Horton, Inc. and all of its 100% owned, majority-owned and controlled subsidiaries (which are collectively referred to as the Company, unless the context otherwise requires). All intercompany accounts, transactions and balances have been eliminated in consolidation. The financial statements have been prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, these financial statements reflect all adjustments considered necessary to present fairly the results for the interim periods shown, including normal recurring accruals and other items. These financial statements, including the consolidated balance sheet as of September 30, 2015, which was derived from audited financial statements, do not include all of the information and notes required by GAAP for complete financial statements and 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 fiscal year ended September 30, 2015.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ materially from those estimates.

Cash and Cash Equivalents

The Company considers all highly liquid investments with an initial maturity of three months or less when purchased to be cash equivalents. Proceeds from home closings held for the Company’s benefit at title companies are included in homebuilding cash and cash equivalents in the consolidated balance sheets.

Cash balances of the Company’s captive insurance subsidiary, which are expected to be used to fund the subsidiary’s operations and pay future anticipated legal claims, were $41.1 million and $40.5 million at June 30, 2016 and September 30, 2015, respectively, and are included in homebuilding cash and cash equivalents in the consolidated balance sheets.

Seasonality

Historically, the homebuilding industry has experienced seasonal fluctuations; therefore, the operating results for the three and nine months ended June 30, 2016 are not necessarily indicative of the results that may be expected for the fiscal year ending September 30, 2016 or subsequent periods.

Recent Accounting Pronouncements

In May 2014, the FASB issued ASU 2014-09, “Revenue from Contracts with Customers,” which is a comprehensive new revenue recognition model that will replace most existing revenue recognition guidance. The core principle of this guidance is that an entity should recognize revenue for the transfer of goods or services equal to the amount that it expects to be entitled to receive for those goods or services. The guidance is effective for the Company beginning October 1, 2018 and allows for full retrospective or modified retrospective methods of adoption. The Company is currently evaluating the impact of this guidance on its consolidated financial position, results of operations and cash flows.

In August 2014, the FASB issued ASU 2014-15, “Presentation of Financial Statements - Going Concern,” which provides guidance about management’s responsibility to evaluate whether there is substantial doubt about the entity’s ability to continue as a going concern and to provide related footnote disclosures. This guidance is intended to reduce the diversity in the timing and content of footnote disclosures. The guidance is effective for the Company in its fiscal year ending September 30, 2017 and is not expected to have any impact on its consolidated financial position, results of operations or cash flows.

In February 2015, the FASB issued ASU 2015-02, “Consolidation,” which changes the analysis that a reporting entity must perform to determine whether it should consolidate certain types of legal entities. The guidance is effective for the Company beginning October 1, 2016 and is not expected to have a material impact on its consolidated financial position, results of operations or cash flows.

In July 2015, the FASB issued ASU 2015-11, “Simplifying the Measurement of Inventory,” which simplifies the subsequent measurement of inventory, excluding inventory measured using the last-in, first-out or retail inventory methods. The guidance specifies that inventory currently measured at the lower of cost or market, where market could be determined with different methods, should now be measured at the lower of cost or net realizable value. The guidance is effective for the Company beginning October 1, 2017 and is not expected to have a material impact on its consolidated financial position, results of operations or cash flows.

In September 2015, the FASB issued ASU 2015-16, “Business Combinations: Simplifying the Accounting for Measurement-Period Adjustments,” which requires that an acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The guidance is effective for the Company beginning October 1, 2016 and is not expected to have a material impact on its consolidated financial position, results of operations or cash flows.

In February 2016, the FASB issued ASU 2016-02, “Leases,” which requires that lease assets and liabilities be recognized on the balance sheet, and that key information about leasing arrangements be disclosed. The guidance is effective for the Company beginning October 1, 2019, although early adoption is permitted. The Company is currently evaluating the impact of this guidance on its consolidated financial position, results of operations and cash flows.

In March 2016, the FASB issued ASU 2016-09, “Compensation - Stock Compensation,” which simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The guidance is effective for

the Company beginning October 1, 2017, although early adoption is permitted. The Company is currently evaluating the impact of this guidance on its consolidated financial position, results of operations and cash flows.

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NOTE B – SEGMENT INFORMATION

The Company is a national homebuilder that is primarily engaged in the acquisition and development of land and the construction and sale of residential homes, with operations in 78 markets in 26 states across the United States. The Company designs, builds and sells single-family detached homes on lots it develops and on fully developed lots purchased ready for home construction. To a lesser extent, the Company also builds and sells attached homes, such as townhomes, duplexes, triplexes and condominiums. Periodically, the Company sells land and lots to other developers and homebuilders where it has excess land and lot positions or for other strategic reasons. The homebuilding segments generate most of their revenues from the sale of completed homes and to a lesser extent from the sale of land and lots.

The Company’s financial services segment primarily provides mortgage financing and title agency services to homebuyers in many of the Company’s homebuilding markets. The Company sells substantially all of the mortgages it originates and the related servicing rights to third-party purchasers. The financial services segment primarily generates its revenues from originating and selling mortgages and collecting fees for title insurance agency and closing services.

The Company’s 39 homebuilding operating divisions and its financial services operations are its operating segments. The homebuilding operating segments are aggregated into six reporting segments and the financial services operating segment is its own reporting segment. The Company’s reportable homebuilding segments are: East, Midwest, Southeast, South Central, Southwest and West. These reporting segments have homebuilding operations located in the following states:

East:	Delaware, Georgia (Savannah only), Maryland, New Jersey, North Carolina, Pennsylvania, South Carolina and Virginia
Midwest:	Colorado, Illinois and Minnesota
Southeast:	Alabama, Florida, Georgia, Mississippi and Tennessee
South Central:	Louisiana, Oklahoma and Texas
Southwest:	Arizona and New Mexico
West:	California, Hawaii, Nevada, Oregon, Utah and Washington

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D.R. HORTON, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) – (Continued)
June 30, 2016

The accounting policies of the reporting segments are described throughout Note A included in the Company's annual report on Form 10-K for the fiscal year ended September 30, 2015. Financial information relating to the Company's reporting segments is as follows:

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2016	2015	2016	2015
	(In millions)			
Revenues				
Homebuilding revenues:				
East	$391.2	$367.4	$998.3	$946.9
Midwest	179.9	205.4	465.2	480.3
Southeast	913.3	775.5	2,436.9	2,041.0
South Central	816.1	715.1	2,123.4	1,923.1
Southwest	93.0	96.7	246.8	243.0
West	755.3	716.3	1,940.2	1,833.7
Homebuilding revenues	3,148.8	2,876.4	8,210.8	7,468.0
Financial services revenues	83.1	74.4	205.4	183.6
Total revenues	$3,231.9	$2,950.8	$8,416.2	$7,651.6
Inventory Impairments				
East	$4.2	$2.1	$7.4	$2.1
Midwest	—	—	—	—
Southeast	—	1.4	0.2	8.7
South Central	1.0	0.8	1.0	1.4
Southwest	—	—	—	—
West	—	7.4	0.3	11.4
Total inventory impairments	$5.2	$11.7	$8.9	$23.6
Income Before Income Taxes (1)				
Homebuilding pre-tax income:				
East	$40.4	$30.3	$90.9	$69.7
Midwest	13.5	21.5	29.5	36.5
Southeast	107.8	80.7	279.5	197.4
South Central	109.5	78.9	263.1	205.1
Southwest	0.9	5.2	5.6	8.3
West	77.1	85.5	192.7	199.8
Homebuilding pre-tax income	349.2	302.1	861.3	716.8
Financial services pre-tax income	29.4	31.7	59.1	67.8
Income before income taxes	$378.6	$333.8	$920.4	$784.6

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(1) Expenses maintained at the corporate level consist primarily of interest and property taxes, which are capitalized and amortized to cost of sales or expensed directly, and the expenses related to operating the Company's corporate office. The amortization of capitalized interest and property taxes is allocated to each segment based on the segment's cost of sales, while those expenses associated with the corporate office are allocated to each segment

based on the segment's inventory balances.

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D.R. HORTON, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) – (Continued)
June 30, 2016

	June 30, 2016	September 30, 2015
	(In millions)	
Homebuilding Inventories (1)		
East	$879.6	$ 817.3
Midwest	457.4	474.5
Southeast	2,046.9	1,876.7
South Central	2,125.8	1,909.0
Southwest	363.9	312.4
West	2,372.3	2,165.3
Corporate and unallocated (2)	258.3	251.8
Total homebuilding inventories	$8,504.2	$ 7,807.0

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(1) Homebuilding inventories are the only assets included in the measure of homebuilding segment assets used by the Company’s chief operating decision makers.
(2) Corporate and unallocated consists primarily of capitalized interest and property taxes.

NOTE C – INVENTORY

At June 30, 2016, the Company reviewed the performance and outlook for all of its land inventories and communities for indicators of potential impairment and performed detailed impairment evaluations and analyses when necessary. The Company performed detailed impairment evaluations of communities and land inventories with a combined carrying value of $201.9 million and recorded impairment charges of $5.2 million during the three months ended June 30, 2016, primarily related to the expected sale of a parcel of land in the East region. During the nine months ended June 30, 2016, impairment charges totaled $8.9 million. There were $11.7 million and $23.6 million of impairment charges recorded in the three and nine months ended June 30, 2015, respectively.

During the three and nine months ended June 30, 2016, the Company wrote off $2.9 million and $7.1 million, respectively, of earnest money deposits and pre-acquisition costs related to land option contracts that the Company expects to terminate. During the three and nine months ended June 30, 2015, the Company wrote off $3.7 million and $10.4 million, respectively, of these deposits and costs.

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D.R. HORTON, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) – (Continued)
June 30, 2016

NOTE D – NOTES PAYABLE

The Company’s notes payable at their principal amounts, net of any unamortized discounts and debt issuance costs, consist of the following:

	June 30, 2016	September 30, 2015
	(In millions)	
Homebuilding:		
Unsecured:		
Revolving credit facility, maturing 2020	$—	$ —
5.625% senior notes due 2016	—	170.1
6.5% senior notes due 2016	—	372.5
4.75% senior notes due 2017	349.3	348.7
3.625% senior notes due 2018	398.7	398.2
3.75% senior notes due 2019	497.8	497.3
4.0% senior notes due 2020	497.0	496.4
4.375% senior notes due 2022	347.6	347.4
4.75% senior notes due 2023	298.1	297.9
5.75% senior notes due 2023	397.2	397.0
Other secured notes	11.4	8.1
	$2,797.1	$ 3,333.6
Financial Services:		
Mortgage repurchase facility, maturing 2017	$504.2	$ 477.9

Debt issuance costs that were deducted from the carrying amounts of the senior notes totaled $14.3 million and $17.3 million at June 30, 2016 and September 30, 2015, respectively.

Homebuilding:

The Company has a $975 million senior unsecured revolving credit facility with an uncommitted accordion feature that could increase the size of the facility to $1.25 billion, subject to certain conditions and availability of additional bank commitments. The facility also provides for the issuance of letters of credit with a sublimit equal to approximately 50% of the revolving credit commitment. Letters of credit issued under the facility reduce the available borrowing capacity. The interest rate on borrowings under the revolving credit facility may be based on either the Prime Rate or London Interbank Offered Rate (LIBOR) plus an applicable margin, as defined in the credit agreement governing the facility. The maturity date of the facility is September 7, 2020. At June 30, 2016, there were no borrowings outstanding and $93.2 million of letters of credit issued under the revolving credit facility.

The Company’s revolving credit facility imposes restrictions on its operations and activities, including requiring the maintenance of a minimum level of tangible net worth, a maximum allowable ratio of debt to tangible net worth and a borrowing base restriction if the Company’s ratio of debt to tangible net worth exceeds a certain level. These covenants are measured as defined in the credit agreement governing the facility and are reported to the lenders quarterly. A failure to comply with these financial covenants could allow the lending banks to terminate the availability of funds

under the revolving credit facility or cause any outstanding borrowings to become due and payable prior to maturity. In addition, the credit agreement governing the facility and the indentures governing the senior notes impose restrictions on the creation of secured debt and liens. At June 30, 2016, the Company was in compliance with all of the covenants, limitations and restrictions of its revolving credit facility and public debt obligations.

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The Company has an automatically effective universal shelf registration statement, filed with the Securities and Exchange Commission (SEC) in August 2015, registering debt and equity securities that the Company may issue from time to time in amounts to be determined.

On January 15, 2016, the Company repaid the $170.2 million principal amount of its 5.625% senior notes, which were due on that date. On April 15, 2016, the Company repaid the $372.7 million principal amount of its 6.5% senior notes, which were due on that date.

Effective August 1, 2015, the Board of Directors authorized the repurchase of up to $500 million of the Company’s debt securities effective through July 31, 2016. All of the $500 million authorization was remaining at June 30, 2016. In July 2016, the Board of Directors authorized the repurchase of up to $500 million of the Company’s debt securities through July 31, 2017, which replaced the previous authorization.

Financial Services:

The Company’s mortgage subsidiary, DHI Mortgage, has a mortgage repurchase facility that is accounted for as a secured financing. The mortgage repurchase facility provides financing and liquidity to DHI Mortgage by facilitating purchase transactions in which DHI Mortgage transfers eligible loans to the counterparties against the transfer of funds by the counterparties, thereby becoming purchased loans. DHI Mortgage then has the right and obligation to repurchase the purchased loans upon their sale to third-party purchasers in the secondary market or within specified time frames from 45 to 60 days in accordance with the terms of the mortgage repurchase facility. In February 2016, the mortgage repurchase facility was amended and its maturity date was extended to February 24, 2017. Additionally, new commitments were obtained from banks that increased the total capacity of the facility to $475 million. The amendment allows for the capacity to be increased further, without requiring additional commitments, from $475 million to $550 million during the last five days of any fiscal quarter and the first twenty-five days of the following fiscal quarter. The capacity of the facility can also be increased to $650 million subject to the availability of additional commitments. At June 30, 2016, the capacity of the facility was $600 million as a result of obtaining an increase in commitments for the period from June 24, 2016 through September 23, 2016.

As of June 30, 2016, $589.2 million of mortgage loans held for sale with a collateral value of $569.3 million were pledged under the mortgage repurchase facility. As a result of advance paydowns totaling $65.1 million, DHI Mortgage had an obligation of $504.2 million outstanding under the mortgage repurchase facility at June 30, 2016 at a 2.6% annual interest rate.

The mortgage repurchase facility is not guaranteed by D.R. Horton, Inc. or any of the subsidiaries that guarantee the Company’s homebuilding debt. The facility contains financial covenants as to the mortgage subsidiary’s minimum required tangible net worth, its maximum allowable ratio of debt to tangible net worth and its minimum required liquidity. These covenants are measured and reported to the lenders monthly. At June 30, 2016, DHI Mortgage was in compliance with all of the conditions and covenants of the mortgage repurchase facility.

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D.R. HORTON, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) – (Continued)
June 30, 2016

NOTE E – CAPITALIZED INTEREST

The Company capitalizes interest costs incurred to inventory during active development and construction (active inventory). Capitalized interest is charged to cost of sales as the related inventory is delivered to the buyer. During periods in which the Company's active inventory is lower than its debt level, a portion of the interest incurred is reflected as interest expense in the period incurred. During the first three quarters of fiscal 2016 and in fiscal 2015, the Company's active inventory exceeded its debt level and all interest incurred was capitalized to inventory.

The following table summarizes the Company's interest costs incurred, capitalized and expensed during the three and nine months ended June 30, 2016 and 2015:

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2016	2015	2016	2015
	(In millions)			
Capitalized interest, beginning of period	$214.5	$212.2	$208.0	$198.5
Interest incurred (1)	35.4	43.2	118.0	126.2
Interest charged to cost of sales	(43.3)	(42.8)	(119.4)	(112.1)
Capitalized interest, end of period	$206.6	$212.6	$206.6	$212.6

(1) Interest incurred includes interest incurred on the Company's financial services mortgage repurchase facility of $2.4 million and $5.9 million in the three and nine months ended June 30, 2016, respectively, and $2.1 million and $5.2 million in the same periods of 2015.

NOTE F – MORTGAGE LOANS

Mortgage Loans Held for Sale

Mortgage loans held for sale consist primarily of single-family residential loans collateralized by the underlying property. At June 30, 2016, mortgage loans held for sale had an aggregate fair value of $634.5 million and an aggregate outstanding principal balance of $609.3 million. At September 30, 2015, mortgage loans held for sale had an aggregate fair value of $631.0 million and an aggregate outstanding principal balance of $608.9 million. During the nine months ended June 30, 2016 and 2015, mortgage loans originated totaled $4.0 billion and $3.6 billion, respectively, and mortgage loans sold totaled $4.0 billion and $3.5 billion, respectively. The Company had gains on sales of loans and servicing rights of $59.8 million and $143.6 million during the three and nine months ended June 30, 2016, respectively, compared to $52.2 million and $125.7 million in the prior year periods. Net gains on sales of loans and servicing rights are included in financial services revenues in the consolidated statements of operations. Approximately 92% of the mortgage loans sold by DHI Mortgage during the nine months ended June 30, 2016 were sold to four major financial entities, one of which purchased 27% of the total loans sold.

To manage the interest rate risk inherent in its mortgage operations, the Company hedges its risk using derivative instruments, generally forward sales of mortgage-backed securities (MBS), which are referred to as "hedging instruments" in the following discussion. The Company does not enter into or hold derivatives for trading or

speculative purposes.

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Newly originated loans that have been closed but not committed to third-party purchasers are hedged to mitigate the risk of changes in their fair value. Hedged loans are committed to third-party purchasers typically within three days after origination. The notional amounts of the hedging instruments used to hedge mortgage loans held for sale vary in relationship to the underlying loan amounts, depending on the movements in the value of each hedging instrument relative to the value of the underlying mortgage loans. The fair value change related to the hedging instruments generally offsets the fair value change in the mortgage loans held for sale. The net fair value change, which for the three and nine months ended June 30, 2016 and 2015 was not significant, is recognized in financial services revenues in the consolidated statements of operations. At June 30, 2016 and September 30, 2015, the Company's mortgage loans held for sale that were not committed to third-party purchasers totaled $403.8 million and $385.3 million, respectively, and the notional amounts of the hedging instruments related to those loans totaled $403.6 million and $383.8 million, respectively.

Other Mortgage Loans and Loss Reserves

Mortgage loans are sold with limited recourse provisions derived from industry-standard representations and warranties in the relevant agreements. These representations and warranties primarily involve the absence of misrepresentations by the borrower or other parties, the appropriate underwriting of the loan and in some cases, a required minimum number of payments to be made by the borrower. The Company generally does not retain any other continuing interest related to mortgage loans sold in the secondary market. The majority of other mortgage loans consists of loans repurchased due to these limited recourse obligations. Typically, these loans are impaired and some become real estate owned through the foreclosure process. At June 30, 2016 and September 30, 2015, the Company's total other mortgage loans and real estate owned, before loss reserves, were as follows:

	June 30, 2016	September 30, 2015
	(In millions)	
Other mortgage loans	$40.7	$ 49.0
Real estate owned	0.5	0.6
	$41.2	$ 49.6

The Company has recorded reserves for estimated losses on other mortgage loans, real estate owned and future loan repurchase obligations due to the limited recourse provisions, all of which are recorded as reductions of financial services revenue. The loss reserve for loan repurchase and settlement obligations is estimated based on an analysis of loan repurchase requests received, actual repurchases and losses through the disposition of such loans or requests, discussions with mortgage purchasers and analysis of mortgages originated. The reserve balances at June 30, 2016 and September 30, 2015 were as follows:

	June 30, 2016	September 30, 2015
	(In millions)	
Loss reserves related to:		
Other mortgage loans	$3.9	$ 1.5
Real estate owned	—	0.1
Loan repurchase and settlement obligations – known and expected	2.2	9.8
	$6.1	$ 11.4

The decrease in the reserve balance is primarily due to the payment of a full settlement with a significant third-party purchaser for loans previously sold to them. Other mortgage loans and real estate owned net of the related loss reserves are included in financial services other assets, while loan repurchase obligations are included in financial services accounts payable and other liabilities in the accompanying consolidated balance sheets.

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Loan Commitments and Related Derivatives

The Company is party to interest rate lock commitments (IRLCs), which are extended to borrowers who have applied for loan funding and meet defined credit and underwriting criteria. At June 30, 2016 and September 30, 2015, the notional amount of IRLCs, which are accounted for as derivative instruments recorded at fair value, totaled $645.8 million and $370.9 million, respectively.

The Company manages interest rate risk related to its IRLCs through the use of best-efforts whole loan delivery commitments and hedging instruments. These instruments are considered derivatives in an economic hedge and are accounted for at fair value with gains and losses recognized in financial services revenues in the consolidated statements of operations. At June 30, 2016 and September 30, 2015, the notional amount of best-efforts whole loan delivery commitments totaled $46.8 million and $37.7 million, respectively, and the notional amount of hedging instruments related to IRLCs not yet committed to purchasers totaled $532.4 million and $297.2 million, respectively.

NOTE G – INCOME TAXES

The Company's income tax expense for the three and nine months ended June 30, 2016 was $128.8 million and $317.8 million, respectively, compared to $112.4 million and $272.8 million, respectively, in the same periods of fiscal 2015. The effective tax rate was 34.0% and 34.5% for the three and nine months ended June 30, 2016, respectively, compared to 33.7% and 34.8% in the prior year periods. The effective tax rates for all periods include an expense for state income taxes that was reduced by a tax benefit for the domestic production activities deduction and federal energy tax credits.

At June 30, 2016 and September 30, 2015, the Company had deferred tax assets, net of deferred tax liabilities, of $514.3 million and $568.2 million, respectively, partially offset by valuation allowances of $9.2 million and $10.1 million, respectively. The accounting for deferred taxes is based upon estimates of future results. Differences between the anticipated and actual outcomes of these future results could have a material impact on the Company's consolidated results of operations or financial position. Also, changes in existing federal and state tax laws and tax rates could affect future tax results and the valuation of the Company's deferred tax assets.

When assessing the realizability of deferred tax assets, the Company considers whether it is more likely than not that some portion or all of its deferred tax assets will not be realized. The realization of deferred tax assets is dependent upon the generation of sufficient taxable income in future periods. The Company records a valuation allowance when it determines it is more likely than not that a portion of the deferred tax assets will not be realized. The valuation allowance for both periods relates to the Company's state deferred tax assets for net operating loss (NOL) carryforwards. The valuation allowance as of September 30, 2015 also relates to certain state tax credit carryforwards. As of June 30, 2016, the Company believes it is more likely than not that a portion of its state NOL carryforwards will not be realized because some state NOL carryforward periods are too brief to realize the related deferred tax assets. The Company will continue to evaluate both the positive and negative evidence in determining the need for a valuation allowance with respect to its remaining state NOL carryforwards.

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NOTE H – EARNINGS PER SHARE

The following table sets forth the numerators and denominators used in the computation of basic and diluted earnings per share. Options to purchase 8.6 million shares of common stock were excluded from the computation of diluted earnings per share for the 2015 periods because their effect would have been antidilutive.

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2016	2015	2016	2015
	(In millions)			
Numerator:				
Net income				