
UNITED STATES
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 SEPTEMBER 30, 2007

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 001-15149

LENNOX INTERNATIONAL INC.

Incorporated pursuant to the Laws of the State of DELAWARE

Internal Revenue Service Employer Identification No. 42-0991521

2140 LAKE PARK BLVD.
RICHARDSON, TEXAS
75080
(972-497-5000)

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 a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Securities Exchange Act of 1934.

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Securities Exchange Act of 1934).
Yes No

As of October 24, 2007, the number of shares outstanding of the registrant's common stock, par value \$.01 per share, was 63,962,882.

LENNOX INTERNATIONAL INC.
FORM 10-Q
For the Three and Nine Months Ended September 30, 2007

INDEX

	<u>Page</u>
<u>Part I. Financial Information</u>	
<u>Item 1. Financial Statements</u>	
<u>Consolidated Balance Sheets – September 30, 2007 (Unaudited) and December 31, 2006</u>	3
<u>Consolidated Statements of Operations (Unaudited) – Three Months and Nine Months Ended September 30, 2007 and 2006</u>	4
<u>Consolidated Statements of Stockholders' Equity – Nine Months Ended September 30, 2007 (Unaudited) and Year Ended December 31, 2006</u>	5
<u>Consolidated Statements of Cash Flows (Unaudited) – Nine Months Ended September 30, 2007 and 2006</u>	6
<u>Notes to Consolidated Financial Statements (Unaudited)</u>	7
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	20
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	31
<u>Item 4. Controls and Procedures</u>	32
<u>Part II. Other Information</u>	
<u>Item 1. Legal Proceedings</u>	33
<u>Item 1A. Risk Factors</u>	33
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	33
<u>Item 5. Other Items</u>	34
<u>Item 6. Exhibits</u>	34
<u>Certification of the Principal Executive Officer</u>	
<u>Certification of the Principal Financial Officer</u>	
<u>Certification Pursuant to 18 U.S.C. Section 1350</u>	

PART I — FINANCIAL INFORMATION**Item 1. Financial Statements.****LENNOX INTERNATIONAL INC. AND SUBSIDIARIES**

CONSOLIDATED BALANCE SHEETS
As of September 30, 2007 and December 31, 2006
(In millions, except share and per share data)

	September 30, 2007 (unaudited)	December 31, 2006
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 93.5	\$ 144.3
Short-term investments	25.1	—
Accounts and notes receivable, net	630.8	502.6
Inventories, net	358.7	305.5
Deferred income taxes	20.1	22.2
Other assets	51.1	43.8
Total current assets	1,179.3	1,018.4
PROPERTY, PLANT AND EQUIPMENT, net	306.4	288.2
GOODWILL, net	262.4	239.8
DEFERRED INCOME TAXES	108.3	104.3
OTHER ASSETS	78.4	69.1
TOTAL ASSETS	\$ 1,934.8	\$ 1,719.8
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Short-term debt	\$ 3.8	\$ 1.0
Current maturities of long-term debt	61.3	11.4
Accounts payable	349.4	278.6
Accrued expenses	346.4	326.3
Income taxes payable	25.4	33.8
Total current liabilities	786.3	651.1
LONG-TERM DEBT	95.4	96.8
POSTRETIREMENT BENEFITS, OTHER THAN PENSIONS	12.1	12.9
PENSIONS	47.0	49.6
OTHER LIABILITIES	124.3	105.0
Total liabilities	1,065.1	915.4
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY:		
Preferred stock, \$.01 par value, 25,000,000 shares authorized, no shares issued or outstanding	—	—
Common stock, \$.01 par value, 200,000,000 shares authorized, 81,326,014 shares and 76,974,791 shares issued for 2007 and 2006, respectively	0.8	0.8
Additional paid-in capital	750.4	706.6
Retained earnings	417.6	312.5
Accumulated other comprehensive income (loss)	61.8	(5.1)
Treasury stock, at cost, 16,883,456 shares and 9,818,904 shares for 2007 and 2006, respectively	(360.9)	(210.4)
Total stockholders' equity	869.7	804.4
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 1,934.8	\$ 1,719.8

The accompanying notes are an integral part of these consolidated financial statements.

LENNOX INTERNATIONAL INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
For the Three Months and Nine Months Ended September 30, 2007 and 2006
(Unaudited, in millions, except per share data)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2007	2006	2007	2006
NET SALES	\$ 1,029.8	\$ 1,020.3	\$ 2,863.1	\$ 2,841.7
COST OF GOODS SOLD	736.2	763.5	2,075.8	2,105.5
Gross profit	293.6	256.8	787.3	736.2
OPERATING EXPENSES:				
Selling, general and administrative expenses	194.3	200.8	582.7	589.9
(Gains), losses and other expenses, net	(1.2)	(3.0)	(5.2)	(47.3)
Restructuring charges	4.3	4.5	14.2	13.1
Equity in earnings of unconsolidated affiliates	(2.7)	(2.5)	(8.9)	(7.5)
Operational income	98.9	57.0	204.5	188.0
INTEREST EXPENSE, net	1.9	1.2	4.8	3.6
OTHER EXPENSE (INCOME), net	0.2	0.1	0.3	0.1
Income before income taxes	96.8	55.7	199.4	184.3
PROVISION FOR INCOME TAXES	35.6	20.1	69.3	59.4
Net income	<u>\$ 61.2</u>	<u>\$ 35.6</u>	<u>\$ 130.1</u>	<u>\$ 124.9</u>
NET INCOME PER SHARE:				
Basic	\$ 0.92	\$ 0.51	\$ 1.93	\$ 1.77
Diluted	\$ 0.88	\$ 0.49	\$ 1.84	\$ 1.67
AVERAGE SHARES OUTSTANDING:				
Basic	66.6	69.5	67.4	70.7
Diluted	69.8	72.9	70.7	74.6
CASH DIVIDENDS DECLARED PER SHARE	\$ 0.13	\$ 0.11	\$ 0.39	\$ 0.33

The accompanying notes are an integral part of these consolidated financial statements.

LENNOX INTERNATIONAL INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
For the Nine Months Ended September 30, 2007 (unaudited) and the Year Ended December 31, 2006
(In millions, except per share data)

	Common Stock Issued		Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock at Cost	Total Stockholders' Equity	Comprehensive Income (Loss)
	Shares	Amount						
BALANCE AT DECEMBER 31, 2005	74.7	\$ 0.7	\$ 649.3	\$ 191.0	\$ 0.4	\$ (47.0)	\$ 794.4	
Impact of adjustments recorded under provisions of SAB No. 108	—	—	—	(12.4)	—	—	(12.4)	
ADJUSTED BALANCE AT JANUARY 1, 2006	74.7	\$ 0.7	\$ 649.3	\$ 178.6	\$ 0.4	\$ (47.0)	\$ 782.0	
Net income	—	—	—	166.0	—	—	166.0	\$ 166.0
Dividends, \$0.46 per share	—	—	—	(32.1)	—	—	(32.1)	—
Foreign currency translation adjustments, net	—	—	—	—	20.8	—	20.8	20.8
Minimum pension liability adjustments, net of tax benefit of \$2.0	—	—	—	—	4.0	—	4.0	4.0
Stock-based compensation expense	—	—	24.4	—	—	—	24.4	—
Derivatives, net of tax provision of \$1.0	—	—	—	—	(1.9)	—	(1.9)	(1.9)
Common stock issued	2.3	0.1	19.7	—	—	—	19.8	—
Treasury stock purchases	—	—	—	—	—	(163.4)	(163.4)	—
Tax benefits of stock-based compensation	—	—	13.2	—	—	—	13.2	—
Comprehensive income	—	—	—	—	—	—	—	\$ 188.9
Adjustments resulting from adoption of SFAS No. 158, net of tax benefit of \$15.0	—	—	—	—	(28.4)	—	(28.4)	
BALANCE AT DECEMBER 31, 2006	<u>77.0</u>	<u>\$ 0.8</u>	<u>\$ 706.6</u>	<u>\$ 312.5</u>	<u>\$ (5.1)</u>	<u>\$ (210.4)</u>	<u>\$ 804.4</u>	
Impact of adoption of FIN No. 48	—	—	—	1.2	—	—	1.2	
ADJUSTED BALANCE AT JANUARY 1, 2007	77.0	\$ 0.8	\$ 706.6	\$ 313.7	\$ (5.1)	\$ (210.4)	\$ 805.6	
Net income	—	—	—	130.1	—	—	130.1	\$ 130.1
Dividends, \$0.39 per share	—	—	—	(26.2)	—	—	(26.2)	—
Foreign currency translation adjustments, net	—	—	—	—	57.1	—	57.1	57.1
Stock-based compensation expense	—	—	16.6	—	—	—	16.6	—
Reversal of previously recorded stock-based compensation expense related to share-based awards canceled in restructuring	—	—	(1.4)	—	—	—	(1.4)	—
Derivatives, net of tax provision of \$5.2	—	—	—	—	9.8	—	9.8	9.8
Common stock issued	4.3	—	18.6	—	—	—	18.6	—
Treasury stock purchases	—	—	—	—	—	(150.5)	(150.5)	—
Tax benefits of stock-based compensation	—	—	16.3	—	—	—	16.3	—
Other tax related items	—	—	(6.3)	—	—	—	(6.3)	—
Comprehensive income	—	—	—	—	—	—	—	\$ 197.0
BALANCE AT SEPTEMBER 30, 2007	<u>81.3</u>	<u>\$ 0.8</u>	<u>\$ 750.4</u>	<u>\$ 417.6</u>	<u>\$ 61.8</u>	<u>\$ (360.9)</u>	<u>\$ 869.7</u>	

The accompanying notes are an integral part of these consolidated financial statements.

LENNOX INTERNATIONAL INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Nine Months Ended September 30, 2007 and 2006
(Unaudited, in millions)

	For the Nine Months Ended September 30,	
	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 130.1	\$ 124.9
Adjustments to reconcile net income to net cash provided by operating activities:		
Minority interest	0.3	0.3
Equity in earnings of unconsolidated affiliates	(8.9)	(7.5)
Dividends from affiliates	—	1.3
Restructuring expenses, net of cash paid	8.0	9.8
Unrealized loss on futures contracts	1.1	5.3
Stock-based compensation expense	16.6	17.6
Depreciation and amortization	35.9	32.8
Capitalized interest	(1.2)	(0.6)
Deferred income taxes	5.1	(21.6)
Other losses, (gains) and expenses, net	10.7	1.2
Changes in assets and liabilities, net of effects of acquisitions:		
Accounts and notes receivable	(111.3)	(93.3)
Inventories	(45.1)	(96.9)
Other current assets	(6.7)	5.1
Accounts payable	67.4	69.3
Accrued expenses	3.7	(2.6)
Income taxes payable	(2.4)	40.7
Long-term warranty, deferred income and other liabilities	7.2	(1.0)
Net cash provided by operating activities	110.5	84.8
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from the disposal of property, plant and equipment	0.5	0.8
Purchases of property, plant and equipment	(44.5)	(49.8)
Additional investment in affiliates	—	(5.4)
Purchases of short-term investments	(32.4)	—
Proceeds from sales and maturities of short-term investments	7.4	—
Net cash used in investing activities	(69.0)	(54.4)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Short-term borrowings (payments), net	2.8	(0.6)
Long-term borrowings (payments), net	48.5	(0.1)
Proceeds from stock option exercises	18.6	15.1
Payments of deferred financing costs	(0.3)	(0.3)
Repurchases of common stock	(150.5)	(128.8)
Excess tax benefits related to share-based payments	14.5	8.8
Cash dividends paid	(35.0)	(31.2)
Net cash (used in) financing activities	(101.4)	(137.1)
DECREASE IN CASH AND CASH EQUIVALENTS	(59.9)	(106.7)
EFFECT OF EXCHANGE RATES ON CASH AND CASH EQUIVALENTS	9.1	2.6
CASH AND CASH EQUIVALENTS, beginning of period	144.3	213.5
CASH AND CASH EQUIVALENTS, end of period	<u>\$ 93.5</u>	<u>\$ 109.4</u>
Supplementary disclosures of cash flow information:		
Cash paid during the period for:		
Interest	<u>\$ 6.5</u>	<u>\$ 5.4</u>
Income taxes (net of refunds)	<u>\$ 57.2</u>	<u>\$ 33.0</u>
Non-cash items:		
Impact of adjustments recorded under provisions of SAB No. 108	<u>\$ —</u>	<u>\$ (12.4)</u>
Impact of adoption of FIN No. 48	<u>\$ 1.2</u>	<u>\$ —</u>

The accompanying notes are an integral part of these consolidated financial statements.

LENNOX INTERNATIONAL INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. General:

References in this Quarterly Report on Form 10-Q to “we,” “our,” “us,” “LII” or the “Company” refer to Lennox International Inc. and its subsidiaries, unless the context requires otherwise.

Basis of Presentation

The accompanying unaudited Consolidated Balance Sheet as of September 30, 2007, the accompanying unaudited Consolidated Statements of Operations for the three months and nine months ended September 30, 2007 and 2006, the accompanying unaudited Consolidated Statement of Stockholders' Equity for the nine months ended September 30, 2007 and the accompanying unaudited Consolidated Statements of Cash Flows for the nine months ended September 30, 2007 and 2006 should be read in conjunction with LII's audited consolidated financial statements and footnotes as of December 31, 2006 and 2005 and for each year in the three year period ended December 31, 2006. The accompanying unaudited consolidated financial statements of LII have been prepared in accordance with generally accepted accounting principles for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, the accompanying consolidated financial statements contain all material adjustments, consisting principally of normal recurring adjustments, necessary for a fair presentation of the Company's financial position, results of operations and cash flows. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to applicable rules and regulations, although the Company believes that the disclosures herein are adequate to make the information presented not misleading. The operating results for the interim periods are not necessarily indicative of the results that may be expected for a full year.

The Company's fiscal year ends on December 31 and the Company's quarters are each comprised of 13 weeks. For convenience, throughout these financial statements, the 13 weeks comprising each three-month period are denoted by the last day of the respective calendar quarter.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that 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 from those estimates.

Reclassifications

Certain prior-period balances in the accompanying condensed consolidated financial statements have been reclassified to conform to the current period's presentation of financial information. Shipping and handling costs related to post-production activities are included as a component of Gross Profit in the accompanying Consolidated Statements of Operations. Such costs were previously reported as part of Selling, General and Administrative Expenses.

Recently Adopted Accounting Pronouncements

Effective January 1, 2007, the Company adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement 109* (“FIN No. 48”). FIN No. 48 clarifies the accounting for income taxes by prescribing a minimum threshold that a tax position is required to meet before being recognized in the financial statements. FIN No. 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting for interim periods, disclosure and transition. For more information see Note 10.

[Table of Contents](#)

2. Accounts and Notes Receivable:

Accounts and Notes Receivable have been reported in the accompanying Consolidated Balance Sheets net of allowance for doubtful accounts of \$18.9 million and \$16.7 million as of September 30, 2007 and December 31, 2006, respectively. As of September 30, 2007 and December 31, 2006, no accounts receivable were sold under the Company's ongoing asset securitization arrangement. Additionally, none of the accounts receivable reported in the accompanying Consolidated Balance Sheets at September 30, 2007 and December 31, 2006 represent retained interests in securitized receivables that have restricted disposition rights per the terms of the asset securitization agreement and would not be available to satisfy obligations to creditors. The Company has no significant concentration of credit risk within its accounts and notes receivable.

3. Inventories:

Components of inventories are as follows (in millions):

	As of September 30, 2007	As of December 31, 2006
Finished goods	\$ 265.8	\$ 223.2
Work in process	11.3	8.1
Raw materials and repair parts	155.5	131.1
	432.6	362.4
Excess of current cost over last-in, first-out cost	(73.9)	(56.9)
Total inventories, net	<u>\$ 358.7</u>	<u>\$ 305.5</u>

Repair parts are primarily utilized in our service operations and to fulfill our warranty obligations.

4. Goodwill:

The Company evaluates the impairment of goodwill under the guidance of Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* for each of its reporting units. During the first quarter of 2007 and 2006, the Company performed its annual goodwill impairment test and determined that no impairment charge was required.

The changes in the carrying amount of goodwill for the nine months ended September 30, 2007, in total and by segment, are as follows (in millions):

Segment	Balance at December 31, 2006	Changes ⁽¹⁾	Balance at September 30, 2007
Residential Heating & Cooling	\$ 33.9	\$ —	\$ 33.9
Commercial Heating & Cooling	30.1	1.5	31.6
Service Experts	97.9	14.5	112.4
Refrigeration	77.9	6.6	84.5
Total	<u>\$ 239.8</u>	<u>\$ 22.6</u>	<u>\$ 262.4</u>

(1) Relate to changes in foreign currency translation rates.

5. Short-Term Investments:

As of September 30, 2007 the Company's captive insurance subsidiary (the "Captive") held approximately \$25.1 million in debt securities, consisting of U.S. Treasury securities, U.S. government agency securities, corporate bonds, commercial paper, and various securitized debt instruments. The Company did not hold these types of investments at December 31, 2006. In accordance with Statement of Financial Accounting Standards No. 115 (as amended), *Accounting for Certain Investments in Debt and Equity Securities*, the Company classifies these investments as available-for-sale and carries them at amortized cost, which approximates fair value. Any unrealized holding gains and losses are reported in Accumulated Other Comprehensive Income ("AOCI"), net of applicable taxes, until the gain or loss is realized. Unrealized losses included in AOCI in the accompanying Consolidated Balance Sheet as of September 30, 2007 were not material. Realized gains and losses from the sale of securities were also not material for the three months or nine months ended September 30, 2007. These instruments are not classified as cash and cash equivalents as their original maturity dates are greater than three months. The maturities of these securities range from October 2007 to February 2011. However, it is the

[Table of Contents](#)

Captive's intention that these investments be available to support its current operations as needed. Therefore, due to the liquidity of these investments, they are classified as current assets in the accompanying Consolidated Balance Sheets. The Company places its investments only in high credit quality financial instruments and limits the amount invested in any one institution or in any one instrument.

6. Cash, Lines of Credit and Financing Arrangements:

The following table summarizes the Company's outstanding debt obligations as of September 30, 2007 and the classification in the accompanying Consolidated Balance Sheet (in millions):

<u>Description of Obligation</u>	<u>Short-Term Debt</u>	<u>Current Maturities</u>	<u>Long-Term Maturities</u>	<u>Total</u>
Domestic promissory notes	\$ —	\$ 61.1	\$ 46.1	\$ 107.2
Domestic revolving credit facility	—	—	48.5	48.5
Other foreign obligations	3.8	0.2	0.8	4.8
Total Debt	<u>\$ 3.8</u>	<u>\$ 61.3</u>	<u>\$ 95.4</u>	<u>\$ 160.5</u>

As of September 30, 2007, the Company had a domestic revolving credit facility with a borrowing capacity of \$400.0 million, of which \$48.5 million was borrowed and outstanding and \$92.1 million was committed to standby letters of credit. Of the remaining \$259.4 million, the entire amount was available for future borrowings after consideration of covenant limitations. The facility matures in July 2010. As of September 30, 2007 and December 31, 2006, the Company has unamortized debt issuance costs of \$1.6 million and \$1.9 million, respectively, which are included in Other Assets in the accompanying Consolidated Balance Sheets. The facility bears interest at a rate equal to, at the Company's option, either (a) the greater of the bank's prime rate or the federal funds rate plus 0.5%, or (b) the London Interbank Offered Rate plus a margin equal to 0.475% to 1.20%, depending upon the ratio of total funded debt-to-adjusted earnings before interest, taxes, depreciation and amortization ("Adjusted EBITDA"), as defined in the facility. The Company pays a facility fee, depending upon the ratio of total funded debt to Adjusted EBITDA, equal to 0.15% to 0.30% of the capacity. The facility includes restrictive covenants that limit the Company's ability to incur additional indebtedness, encumber its assets, sell its assets and make certain payments, including amounts for share repurchases and dividends. The facility requires that LII annually and quarterly deliver financial statements, as well as compliance certificates, to the banks within specified time periods.

As of September 30, 2007 and December 31, 2006, the Company had outstanding domestic promissory notes totaling approximately \$107.2 million. The promissory notes mature at various dates through 2010 and have interest rates ranging from 6.73% to 8.00%.

LII's domestic revolving facility and promissory notes contain certain financial covenant restrictions. As of September 30, 2007, LII believes it was in compliance with all covenant requirements. The Company's facility and promissory notes are guaranteed by the Company's material subsidiaries.

The Company has additional borrowing capacity through several foreign facilities governed by agreements between the Company and a syndicate of banks, used primarily to finance seasonal borrowing needs of its foreign subsidiaries. LII had \$4.8 million of obligations outstanding through its foreign subsidiaries as of September 30, 2007.

Under a revolving period asset securitization arrangement, the Company transfers beneficial interests in a portion of its trade accounts receivable to a third party in exchange for cash. The Company's continued involvement in the transferred assets is limited to servicing. These transfers are accounted for as sales rather than secured borrowings. The fair values assigned to the retained and transferred interests are based primarily on the receivables' carrying value given the short term to maturity and low credit risk. As of September 30, 2007 and December 31, 2006, the Company had not sold any beneficial interests in accounts receivable.

LII periodically reviews its capital structure, including its primary bank facility, to ensure that it has adequate liquidity. LII believes that cash flows from operations, as well as available borrowings under its revolving credit facility and other sources of funding will be sufficient to fund its operations for the foreseeable future.

The Company has included \$18.0 million of restricted cash in Cash and Cash Equivalents in the accompanying unaudited Consolidated Balance Sheet as of September 30, 2007. The restricted cash primarily

[Table of Contents](#)

relates to routine lockbox collections and letters of credit issued with respect to the operations of the Captive, which expire on December 31, 2007.

On October 12, 2007, the Company entered into a \$650 million Third Amended and Restated Revolving Credit Facility Agreement which replaces the Company's previous domestic revolving credit facility. For more information see Note 20.

7. Product Warranties:

The changes in the carrying amount of the Company's total product warranty liabilities for the nine months ended September 30, 2007 were as follows (in millions):

Total product warranty liability at December 31, 2006	\$ 104.7
Payments made in 2007, net of recoveries	(23.3)
Changes resulting from issuance of new warranties	23.7
Changes in estimates associated with pre-existing warranties	10.8
Total product warranty liability at September 30, 2007	<u>\$ 115.9</u>

The change in product warranty liability that results from changes in estimates of warranties issued prior to 2007 was primarily due to revaluing warranty reserves based on higher material input costs, adjustments to failure rates for products the Company no longer manufactures, and changes in foreign currency translation rates. In the third quarter, the Company recorded \$1.2 million related to changes in estimates associated with pre-existing warranties which was primarily due to changes in foreign currency translation rates. Product warranty liabilities of \$34.3 million and \$27.2 million are included in Accrued Expenses and \$81.6 million and \$77.5 million are included in Other Liabilities in the accompanying Consolidated Balance Sheets as of September 30, 2007 and December 31, 2006, respectively.

8. Pension and Postretirement Benefit Plans:

The components of net periodic benefit cost for the three months and nine months ended September 30, 2007 and 2006 were as follows (in millions):

	For the			
	Three Months Ended September 30,			
	2007	2006	2007	2006
	Pension Benefits		Other Benefits	
Service cost	\$ 1.7	\$ 1.8	\$ 0.2	\$ 0.4
Interest cost	3.7	3.9	0.2	0.3
Expected return on plan assets	(4.2)	(4.2)	—	—
Amortization of prior service cost	0.2	0.2	(0.4)	(0.1)
Amortization of net loss	1.1	1.5	0.2	0.2
Settlements or curtailments	3.9	—	—	—
Total net periodic pension cost	<u>\$ 6.4</u>	<u>\$ 3.2</u>	<u>\$ 0.2</u>	<u>\$ 0.8</u>

	For the			
	Nine Months Ended September 30,			
	2007	2006	2007	2006
	Pension Benefits		Other Benefits	
Service cost	\$ 5.3	\$ 5.5	\$ 0.5	\$ 1.0
Interest cost	11.2	11.5	0.6	1.1
Expected return on plan assets	(13.0)	(12.4)	—	—
Amortization of prior service cost	0.7	0.8	(1.3)	(0.4)
Amortization of net loss	3.5	4.6	0.8	0.6
Settlements or curtailments	4.6	1.9	—	—
Total net periodic pension cost	<u>\$ 12.3</u>	<u>\$ 11.9</u>	<u>\$ 0.6</u>	<u>\$ 2.3</u>

The Company recorded a one-time pension settlement change of \$3.9 million in the third quarter of 2007 related to the retirement of its former chief executive officer.

9. Stock-Based Compensation:

The Company's Amended and Restated 1998 Incentive Plan provides for various long-term incentive awards, which include stock options, performance shares, restricted stock awards and stock appreciation rights. A detailed description of the awards under these plans is included in the Company's Annual Report on Form 10-K for the year ended December 31, 2006.

Table of Contents

The Company accounts for stock-based awards under the provisions of Statement of Financial Accounting Standards No. 123R, *Share-Based Payment*. Compensation expense of \$3.3 million and \$4.8 million and \$16.6 million and \$17.6 million was recognized for the three months and the nine months ended September 30, 2007 and 2006, respectively, and is included in Selling, General and Administrative Expenses in the accompanying Consolidated Statements of Operations. Cash flows from the tax benefits of tax deductions in excess of the compensation costs recognized for stock-based awards of \$14.5 million and \$8.8 million were included in cash flows from financing activities for the nine months ended September 30, 2007 and 2006, respectively.

The following tables summarize certain information concerning the Company's stock options, stock appreciation rights, performance shares and restricted stock awards as of September 30, 2007 (in millions, except per share data, years, and forfeiture rates):

	<u>Stock Options</u>	<u>Stock Appreciation Rights</u>
Shares outstanding	2.4	1.6
Weighted-average exercise price per share outstanding	\$15.03	\$26.66
Shares exercisable	2.3	0.6
Weighted-average exercise price per exercisable share	\$14.86	\$20.43
Unrecognized expense	\$ 0.1	\$ 4.4
Expected weighted-average period to be recognized (in years)	0.3	1.9
Weighted-average estimated forfeiture rate	7%	14%

	<u>Performance Shares</u>	<u>Restricted Stock Awards</u>
Nonvested shares	1.1	0.9
Weighted-average grant date fair value per share	\$22.32	\$26.15
Unrecognized expense	\$ 13.0	\$ 8.1
Expected weighted-average period to be recognized (in years)	1.9	1.9
Weighted-average estimated forfeiture rate	20%	12%

10. Income Taxes:

As a result of the adoption of FIN No. 48, the Company recognized a \$1.2 million decrease in the liability for unrecognized tax benefits, which was accounted for as an increase to the January 1, 2007 retained earnings balance.

As of January 1, 2007, the Company had approximately \$20.0 million in total gross unrecognized tax benefits. Of this amount, \$14.4 million (net of federal benefit on state issues) will be recognized through the statement of operations, \$3.2 million will be recognized through goodwill and \$1.0 million will be recognized through stockholders' equity. In addition, the Company recognizes interest and penalties accrued related to unrecognized tax benefits in income tax expense in accordance with FIN No. 48. As of January 1, 2007, the Company had recognized \$1.2 million (net of federal tax benefits) in interest and penalties.

The Internal Revenue Service ("IRS") completed its examination of the Company's consolidated tax returns for the years 1999 – 2003 and issued a Revenue Agent's Report ("RAR") on April 6, 2006. The IRS has proposed certain significant adjustments to the Company's insurance deductions and research tax credits. The Company disagrees with the RAR, which is currently under review by the administrative appeals division of the IRS, and anticipates resolution by the end of 2007. It is possible that a reduction in the unrecognized tax benefits may occur but an estimate of the impact on the statement of operations cannot be made at this time.

The Company is subject to examination by numerous taxing authorities in jurisdictions such as Australia, Belgium, Canada, Germany, and the United States. The Company is generally no longer subject to U.S. federal, state and local, or non-US income tax examinations by taxing authorities for years before 1999.

Since January 1, 2007, Michigan, New York, South Carolina, and West Virginia have enacted legislation

[Table of Contents](#)

effective for tax years beginning on or after January 1, 2007. The Company believes any adjustments will be immaterial.

11. Restructuring Charges:

Restructuring charges incurred for the three months and nine months ended September 30, 2007 and 2006 include the following amounts (in millions):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2007	2006	2007	2006
Consolidation of Hearth Products operations	\$ 2.4	\$ —	\$ 2.4	\$ —
Reorganization of corporate administrative function	1.1	—	7.7	—
Facility lease	—	1.2	0.3	1.2
Allied Air Enterprises consolidation	0.3	3.3	3.2	12.7
Pension settlement (1)	—	—	0.7	—
Gain on sale of land	—	—	—	(0.8)
Other	0.5	—	(0.1)	—
Total	<u>\$ 4.3</u>	<u>\$ 4.5</u>	<u>\$ 14.2</u>	<u>\$ 13.1</u>

(1) Amount not reflected in restructuring reserves as this item is related to the Company's pension obligation.

The table below provides further analysis of the Company's restructuring reserves for the nine months ended September 30, 2007 (in millions):

Description of Reserves	Balance at December 31, 2006	Charged to Earnings	Reversal of Prior Period Charges	Cash Utilization	Non-cash Utilization	Other	Balance at September 30, 2007
Severance and related expense	\$ 1.8	\$ 10.6	\$ —	\$ (2.8)	\$ —	\$ 1.4	\$ 11.0
Equipment moves	—	1.0	—	(1.0)	—	—	—
Recruiting and relocation	—	0.7	—	(0.7)	—	—	—
Lease termination	1.5	0.3	—	(0.4)	—	—	1.4
Other	0.8	1.5	(0.6)	(1.3)	(0.4)	—	—
Total restructuring reserves	<u>\$ 4.1</u>	<u>\$ 14.1</u>	<u>\$ (0.6)</u>	<u>\$ (6.2)</u>	<u>\$ (0.4)</u>	<u>\$ 1.4</u>	<u>\$ 12.4</u>

In the third quarter of 2007, the Company announced plans to close its hearth products operations in Lynwood, California and consolidate its U.S. factory-built fireplace manufacturing operations in its facility in Union City, Tennessee. The consolidation will be a phased process and is expected to be completed by the end of the second quarter of 2008. In connection with this consolidation project, the Company recorded pre-tax restructuring charges of \$2.4 million in its Residential Heating & Cooling segment for the three months ended September 30, 2007. The restructuring charges primarily related to severance related costs and the disposal of certain long-lived assets. LII currently expects to incur pre-tax restructuring charges of approximately \$2.7 million over the next six months due to this consolidation project.

In the second quarter of 2007, the Company reorganized its corporate administrative function and eliminated the position of chief administrative officer. In connection with this action, the Company entered into negotiations with its former chief administrative officer to settle the terms of his employment agreement. As of June 30, 2007, these negotiations continued and the final settlement was unknown. Therefore, the Company recorded a liability of approximately \$8.0 million as of June 30, 2007, which represented the Company's estimate of the amounts to be paid to settle the employment agreement. Restructuring expense of \$6.6 million was recorded in the second quarter of 2007, which represented the \$8.0 million estimate of the amounts to be paid to settle the employment agreement, net of \$1.4 million of previously recorded stock-based compensation expense. In September 2007, the Company reached an agreement to settle the terms of the former chief administrative officer's employment agreement. As a result, the Company recorded an additional \$1.1 million of restructuring expense related to this matter in the third quarter of 2007.

[Table of Contents](#)

A division of the Company's Residential Heating & Cooling segment commenced plans to close its Burlington, Washington facility in 2005. During the three months ended September 30, 2006, the Company recorded a pre-tax restructuring charge of approximately \$1.2 million related to an operating lease on the idle facility in Burlington. The charge reflected the net present value of the remaining lease payments on the operating lease, net of estimated sublease income on the facility. In the second quarter of 2007, the Company entered into a sub-lease agreement for the idle facility. As a result, the Company recorded a pre-tax restructuring charge of approximately \$0.3 million to reflect the net present value of the remaining lease payments on the operating lease, net of sublease income on the facility. The operating lease and sub-lease both expire in June 2011.

In February 2006, Allied Air Enterprises, a division of the Company's Residential Heating & Cooling segment, announced that it had commenced plans to consolidate its manufacturing, distribution, research & development, and administrative operations of the Company's two-step Residential Heating & Cooling operations in South Carolina, and close its current operations in Bellevue, Ohio. The consolidation was substantially completed during the first quarter of 2007. The amounts recorded related primarily to severance and benefits and other exit costs incurred, including charges of \$1.5 million and \$3.7 million of accelerated depreciation recorded in the three months and nine months ended September 30, 2006, respectively, related to the reduction in useful lives and disposal of certain long-lived assets.

A pension settlement loss of approximately \$0.7 million is included in the Company's Residential Heating & Cooling segment's restructuring expense for the nine months ended September 30, 2007. The pension settlement loss related to the Company's full funding of lump sum pension payments to selected participants in March 2007.

Also included in restructuring expense for the nine months ended September 30, 2006 is a gain of \$0.8 million related to the sale of a parcel of land. The Company had reduced the carrying value of the land to its then net realizable value in connection with a prior restructuring initiative of its Service Experts operations in 2001.

12. Earnings per Share:

Basic earnings per share are computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted earnings per share are computed by dividing net income by the sum of the weighted-average number of shares and the number of equivalent shares assumed outstanding, if dilutive, under the Company's stock-based compensation plans. As of September 30, 2007, the Company had 81,326,014 shares issued of which 16,883,456 were held as treasury shares. Diluted earnings per share are computed as follows (in millions, except per share data):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2007	2006	2007	2006
Net income	\$ 61.2	\$ 35.6	\$ 130.1	\$ 124.9
Weighted-average shares outstanding — basic	66.6	69.5	67.4	70.7
Effect of diluted securities attributable to share-based payments	3.2	3.4	3.3	3.9
Weighted-average shares outstanding — diluted	69.8	72.9	70.7	74.6
Diluted earnings per share	\$ 0.88	\$ 0.49	\$ 1.84	\$ 1.67

Options to purchase 99,278 shares of common stock at prices ranging from \$35.82 to \$49.63 per share and options to purchase 720,597 shares of common stock at prices ranging from \$29.34 to \$49.63 per share were outstanding for the nine months ended September 30, 2007 and 2006, respectively, but were not included in the diluted earnings per share calculation because the assumed exercise of such options would have been anti-dilutive.

13. Comprehensive Income:

Comprehensive income for the three months and nine months ended September 30, 2007 and 2006 was computed as follows (in millions):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2007	2006	2007	2006
Net income	\$ 61.2	\$ 35.6	\$ 130.1	\$ 124.9
Foreign currency translation adjustments	26.4	0.5	57.1	16.3
Effective portion of gains on futures contracts designated as cash flow hedges	1.7	—	9.8	—
Minimum pension liability	—	—	—	(0.5)
Total comprehensive income	\$ 89.3	\$ 36.1	\$ 197.0	\$ 140.7

14. Investments in Affiliates:

Investments in affiliates in which the Company does not exercise control but has significant influence are accounted for using the equity method of accounting. If the fair value of an investment in an affiliate is below its carrying value and the difference is deemed to be other than temporary, the difference between the fair value and the carrying value is charged to earnings.

Investments in affiliated companies accounted for under the equity method consist of the following: a common stock ownership interest in Alliance Compressor LLC, a joint venture engaged in the manufacture and sale of compressors; a common stock ownership interest in Frigus-Bohn S.A. de C.V., a Mexican joint venture that produces unit coolers and condensing units; and a common stock ownership interest in Kulthorn Kirby Public Company Limited, a Thailand company engaged in the manufacture of compressors for refrigeration and air conditioning applications.

The Company recorded \$2.7 million and \$2.5 million of equity in the earnings of its unconsolidated affiliates for the three months ended September 30, 2007 and 2006, respectively, and \$8.9 million and \$7.5 million of equity in the earnings of its unconsolidated affiliates for the nine months ended September 30, 2007 and 2006, respectively, and has included these amounts in Equity in Earnings of Unconsolidated Affiliates in the accompanying Consolidated Statements of Operations. The carrying amount of investments in unconsolidated affiliates as of September 30, 2007 and December 31, 2006 is \$62.8 million and \$52.4 million, respectively, and is included in Long-term Other Assets in the accompanying Consolidated Balance Sheets.

15. Derivatives:

LII utilizes a program to mitigate the exposure to volatility in the prices of certain commodities the Company uses in its production process. The program includes the use of futures contracts and fixed forward contracts. The intent of the program is to protect the Company's operating margins and overall profitability from adverse price changes by entering into derivative instruments.

The Company accounts for instruments that qualify as cash flow hedges utilizing Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended ("SFAS No. 133"). Beginning in the fourth quarter of 2006, futures contracts entered into that met established accounting criteria were formally designated as cash flow hedges. For futures contracts that are designated and qualify as cash flow hedges, the Company assesses hedge effectiveness and measures hedge ineffectiveness at least quarterly throughout the designated period. The effective portion of the gain or loss on the futures contracts are recorded, net of applicable taxes, in AOCI, a component of Stockholders' Equity in the accompanying Consolidated Balance Sheets. When net income is affected by the variability of the underlying cash flow, the applicable offsetting amount of the gain or loss from the futures contracts that is deferred in AOCI is released to net income and is reported as a component of Cost of Goods Sold in the accompanying Consolidated Statements of Operations. During the three months and the nine months ended September 30, 2007, \$3.2 million and \$4.6 million in gains, respectively, were reclassified from AOCI to net income. Changes in the fair value of futures contracts that do not effectively offset changes in the fair value of the underlying hedged item throughout the designated hedge period ("ineffectiveness") are recorded in net income each period and are reported in (Gains), Losses, and Other Expenses, net in the accompanying Consolidated Statements of Operations. Losses recognized in net income representing hedge ineffectiveness were not material for the three months or the nine months ended September 30, 2007.

Table of Contents

The Company may enter into instruments that economically hedge certain of its risks, even though hedge accounting does not apply or the Company elects not to apply hedge accounting under SFAS No. 133 to such instruments. In these cases, there exists a natural hedging relationship in which changes in the fair value of the instruments act as an economic offset to changes in the fair value of the underlying item(s). Changes in the fair value of instruments not designated as cash flow hedges are recorded in net income throughout the term of the derivative instrument and are reported in (Gains), Losses, and Other Expenses, net in the accompanying Consolidated Statements of Operations. For the three months and the nine months ended September 30, 2007 and 2006, net gains of \$0.4 million and \$2.2 million and \$1.6 million and \$47.0 million, respectively, were recognized in earnings related to instruments not accounted for as cash flow hedges.

16. Commitments and Contingencies:

Guarantees

On June 22, 2006, Lennox Procurement Company Inc. ("Procurement"), a wholly-owned subsidiary of the Company, entered into a lease agreement with BTMU Capital Corporation ("BTMUCC"), pursuant to which BTMUCC is leasing certain property located in Richardson, Texas to Procurement for a term of seven years (the "Lake Park Lease"). The leased property consists of an office building of approximately 192,000 square feet, which includes the Company's corporate headquarters, and land and related improvements.

During the term, the Lake Park Lease requires Procurement to pay base rent in quarterly installments, payable in arrears. At the end of the term, if Procurement is not in default, Procurement must elect to do one of the following: (i) purchase the leased property for a net price of approximately \$41.2 million (the "Lease Balance"); (ii) make a final supplemental payment to BTMUCC equal to approximately 82% of the Lease Balance and return the leased property to BTMUCC in good condition; (iii) arrange a sale of the leased property to a third party; or (iv) renew the Lake Park Lease under mutually agreeable terms. If Procurement elects to arrange a sale of the leased property to a third party, then Procurement must pay to BTMUCC the amount (if any) by which the Lease Balance exceeds the net sales proceeds paid by the third party; provided, however, that, absent certain defaults, such amount cannot exceed approximately 82% of the Lease Balance. If the net sales proceeds paid by the third party are greater than the Lease Balance, the excess sales proceeds will be paid to Procurement.

Procurement's obligations under the Lake Park Lease and related documents are secured by a pledge of Procurement's interest in the leased property. Procurement's obligations under such documents are also guaranteed by the Company pursuant to a Guaranty, dated as of June 22, 2006, in favor of BTMUCC.

The Company is accounting for the Lake Park Lease as an operating lease.

The majority of the Service Experts segment's motor vehicle fleet is leased through operating leases. The lease terms are generally non-cancelable for the first 12-month term and then are month-to-month, cancelable at the Company's option. While there are residual value guarantees on these vehicles, the Company has not historically made significant payments to the lessors as the leases are maintained until the fair value of the assets fully mitigates the Company's obligations under the lease agreements. As of September 30, 2007, the Company estimates that it will incur an additional \$7.9 million above the contractual obligations on these leases until the fair value of the leased vehicles fully mitigates the Company's residual value guarantee obligation under the lease agreements.

Environmental

Applicable environmental laws can potentially impose obligations on the Company to remediate hazardous substances at the Company's properties, at properties formerly owned or operated by the Company and at facilities to which the Company has sent or sends waste for treatment or disposal. The Company is aware of contamination at some facilities; however, the Company does not presently believe that any future remediation costs at such facilities will be material to the Company's results of operations. No amounts have been recorded for non-asset retirement obligation environmental liabilities that are not probable or estimable.

At one site located in Brazil, the Company is currently evaluating the remediation efforts that may be required under applicable environmental laws related to the release of certain hazardous materials. The Company currently believes that the release of the hazardous materials occurred over an extended period of time, including a time when the Company did not own the site. The Company continues to conduct additional assessments of the site to help determine the possible remediation activities that may be conducted at this site. Once the site assessments are completed and the possible remediation activities have been evaluated, the Company plans to

Table of Contents

commence remediation efforts, pending any required approvals by local governmental authorities. The Company believes that containment is one of several viable options to comply with local regulatory standards. As a result, the Company recorded a charge of approximately \$1.7 million in 2006 for estimated containment costs at the site. During the nine months ended September 30, 2007, the Company recorded a charge of \$0.4 million primarily related to additional site assessments. As of September 30, 2007 and December 31, 2006, the Company had discounted liabilities recorded of approximately \$2.1 million and \$1.7 million related to this matter which are included in Other Long Term Liabilities in the accompanying Consolidated Balance Sheets. These liabilities are discounted at approximately 6% as the aggregate amount of the obligation and the amount and timing of cash payments are reliably determinable. If, after the site assessments are completed, it is determined that containment is more costly or the local governmental authorities require more costly remediation activities, the costs to contain or remediate the site could be as high as \$5.1 million (undiscounted). The Company is exploring options for recoveries.

The Company has additional reserves of approximately \$4.2 million related to various other environmental matters recorded as of September 30, 2007. Balances of approximately \$1.7 million and \$2.5 million are recorded in Accrued Expenses and Other Liabilities, respectively, in the Consolidated Balance Sheet as of September 30, 2007.

Estimates of future costs are subject to change due to prorated cleanup periods and changing environmental remediation regulations.

Litigation

The Company is involved in various claims and lawsuits incidental to its business. As previously reported, in January 2003, the Company, along with one of its subsidiaries, Heatcraft Inc., was named in the following lawsuits in connection with the Company's former heat transfer operations:

- Lynette Brown, et al., vs. Koppers Industries, Inc., Heatcraft Inc., Lennox International Inc., et al., Circuit Court of Washington County, Civil Action No. CI 2002-479;
- Likisha Booker, et al., vs. Koppers Industries, Inc., Heatcraft Inc., Lennox International Inc., et al., Circuit Court of Holmes County; Civil Action No. 2002-549;
- Walter Crowder, et al., vs. Koppers Industries, Inc., Heatcraft Inc. and Lennox International Inc., et al., Circuit Court of Leflore County, Civil Action No. 2002-0225; and
- Benobe Beck, et al., vs. Koppers Industries, Inc., Heatcraft Inc. and Lennox International Inc., et al., Circuit Court of the First Judicial District of Hinds County, No. 03-000030.

On behalf of approximately 100 plaintiffs, the lawsuits allege personal injury resulting from alleged emissions of trichloroethylene, dichloroethylene, and vinyl chloride and other unspecified emissions from the South Plant in Grenada, Mississippi, previously owned by Heatcraft Inc. Each plaintiff seeks to recover actual and punitive damages. On Heatcraft Inc.'s motion to transfer venue, two of the four lawsuits (Booker and Crowder) were ordered severed and transferred to Grenada County by the Mississippi Supreme Court, requiring plaintiffs' counsel to maintain a separate lawsuit for each of the individual plaintiffs named in these suits. To the Company's knowledge, as of October 19, 2007, plaintiffs' counsel has requested the transfer of files regarding five individual plaintiffs from the Booker case and five individual plaintiffs from the Crowder case. Additionally, LII has joined in motions to dismiss filed by co-defendants in the four original lawsuits. These motions, which are still pending, seek dismissal (rather than transfer), without prejudice to refile in Grenada County, of all cases not yet transferred to Grenada County. It is not possible to predict with certainty the outcome of these matters or an estimate of any potential loss. Based on current negotiations, management believes that it is unlikely that any final resolution of these matters will have a material impact on the Company's financial statements.

17. Share Repurchase Plan:

On July 25, 2007, the Company announced that its Board of Directors approved a new \$500 million share repurchase plan, pursuant to which LII plans to repurchase shares of its common stock through open market purchases (the "2007 Share Repurchase Plan"). Based on the closing price of LII's common stock on July 24, 2007, a \$500 million repurchase would represent over 20% of the Company's market capitalization. The 2007

[Table of Contents](#)

Share Repurchase Plan terminates and replaces the 2005 Share Repurchase Plan. The Company currently intends to fully execute the repurchase by the end of the third quarter of 2008. During the third quarter of 2007, the Company purchased 3,026,100 shares of its common stock for \$104.2 million, representing approximately 21% of the \$500 million repurchase authorization.

18. Reportable Business Segments:

The Company operates in four reportable business segments of the heating, ventilation, air conditioning and refrigeration (“HVACR”) markets. The first reportable segment is Residential Heating & Cooling, in which LII manufactures and markets a full line of heating, air conditioning and hearth products for the residential replacement and new construction markets in the United States and Canada. The second reportable segment is Commercial Heating & Cooling, in which LII manufactures and sells rooftop products and related equipment for light commercial applications in the United States and Canada and primarily rooftop products, chillers and air handlers in Europe. The third reportable segment is Service Experts, which includes sales, installation, maintenance and repair services for heating, ventilation and air conditioning (“HVAC”) equipment by LII-owned service centers in the United States and Canada. The fourth reportable segment is Refrigeration, which manufactures and sells unit coolers, condensing units and other commercial refrigeration products in the United States and international markets.

Transactions between segments, such as products sold to Service Experts by the Residential Heating & Cooling segment, are recorded on an arms-length basis using the market price for these products. The eliminations of these intercompany sales and any associated profit are noted in the reconciliation of segment results to the income from continuing operations before income taxes below.

The Company uses segment profit (loss) as the primary measure of profitability to evaluate operating performance and to allocate capital resources. The Company defines segment profit (loss) as a segment’s income (loss) from continuing operations before income taxes included in the accompanying Consolidated Statements of Operations excluding (gains), losses and other expenses, net; restructuring charges; goodwill impairment; interest expense, net; and other expense (income), net; less (plus) realized gains (losses) on settled futures contracts not designated as cash flow hedges and the ineffective portion of settled cash flow hedges; and less (plus) foreign currency exchange gains (losses).

The Company’s corporate costs include those costs related to corporate functions such as legal, internal audit, treasury, human resources, tax compliance and senior executive staff. Corporate costs also include the long-term share-based incentive awards provided to employees throughout LII. The Company recorded these share-based awards as Corporate costs as they are determined at the discretion of the Board of Directors and based on the historical practice of doing so for internal reporting purposes.

Net sales and segment profit (loss) by business segment, along with a reconciliation of segment profit (loss) to net earnings (loss) for the three months and the nine months ended September 30, 2007 and 2006, are shown below (in millions):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2007	2006	2007	2006
Net Sales				
Residential Heating & Cooling	\$ 456.5	\$ 502.4	\$ 1,315.5	\$ 1,464.2
Commercial Heating & Cooling	255.1	228.0	650.6	554.1
Service Experts	183.9	174.0	512.0	492.8
Refrigeration	157.5	137.3	450.1	394.6
Eliminations (1)	(23.2)	(21.4)	(65.1)	(64.0)
	<u>\$ 1,029.8</u>	<u>\$ 1,020.3</u>	<u>\$ 2,863.1</u>	<u>\$ 2,841.7</u>
Segment Profit (Loss)				
Residential Heating & Cooling	\$ 63.7	\$ 53.4	\$ 143.2	\$ 168.7
Commercial Heating & Cooling	37.8	25.8	76.6	53.2
Service Experts	9.2	7.4	18.4	10.2
Refrigeration	17.8	13.8	46.6	40.2
Corporate and other	(23.4)	(21.2)	(64.2)	(66.5)
Eliminations (1)	—	0.5	(0.2)	0.3
Subtotal that includes segment profit and eliminations	105.1	79.7	220.4	206.1
Reconciliation to income before income taxes:				
(Gains), losses and other expenses, net	(1.2)	(3.0)	(5.2)	(47.3)
Restructuring charges	4.3	4.5	14.2	13.1
Interest expense, net	1.9	1.2	4.8	3.6
Other expense (income), net	0.2	0.1	0.3	0.1
Less: Realized gains on settled futures contracts not designated as cash flow hedges and the ineffective portion of settled cash flow hedges (2)	1.5	20.2	3.2	52.3
Less: Foreign currency exchange gains (losses) (2)	1.6	1.0	3.7	—
	<u>\$ 96.8</u>	<u>\$ 55.7</u>	<u>\$ 199.4</u>	<u>\$ 184.3</u>

(1) Eliminations consist of intercompany sales between business segments, such as products sold to Service Experts by the Residential Heating & Cooling segment.

(2) Realized gains (losses) on settled futures contracts not designated as cash flow hedges, the ineffective portion of settled cash flow hedges and foreign currency exchange gains (losses) are components of (Gains), Losses and Other Expenses, net in the accompanying Consolidated Statements of Operations.

Table of Contents

Total assets by business segment as of September 30, 2007 and December 31, 2006 are shown below (in millions). The assets in the Corporate segment are primarily comprised of cash, deferred tax assets, and investments in consolidated subsidiaries. Assets recorded in the operating segments represent those assets directly associated with those segments.

	<u>As of September 30, 2007</u>	<u>As of December 31, 2006</u>
Total Assets		
Residential Heating & Cooling	\$ 648.0	\$ 587.0
Commercial Heating & Cooling	383.8	285.7
Service Experts	212.6	183.4
Refrigeration	391.6	344.3
Corporate and other	311.2	328.7
Eliminations (1)	(12.4)	(9.3)
Segment assets	<u>\$ 1,934.8</u>	<u>\$ 1,719.8</u>

- (1) Eliminations consist of net intercompany receivables and intercompany profit included in inventory from products sold between business segments, such as products sold to Service Experts by the Residential Heating & Cooling segment.

19. Related Party Transactions:

Thomas W. Booth, Stephen R. Booth and John W. Norris, III, each a member of the Company's Board of Directors, John W. Norris, Jr., LII's former Chairman of the Board, other former directors of the Company, and Lynn B. Storey, the mother of Jeffrey D. Storey, M.D., a director of the Company, as well as other stockholders of the Company who may be immediate family members of the foregoing persons, are, individually or through trust arrangements, members of A.O.C. Corporation ("AOC"). As previously announced, on March 16, 2007, LII entered into an agreement with AOC to issue up to 2,239,589 shares of LII common stock in exchange for 2,695,770 shares of LII common stock owned by AOC. This transaction was completed on September 6, 2007. LII acquired 2,695,770 shares of LII common stock owned by AOC in exchange for 2,239,563 newly issued LII common shares. The transaction reduced the number of outstanding shares of LII common stock by 456,207 shares, at minimal cost to LII. Following the issuance and exchange of LII common stock, AOC distributed the newly acquired shares of LII common stock pro rata to its shareholders. The issuance, exchange and liquidating distribution are referred to herein as the "AOC Transaction."

There were no special benefits provided for any of the related persons described above under the AOC Transaction. Each related person's participation in the AOC Transaction arose out of his or her ownership of common stock of AOC and was on the same basis as all other shareholders of AOC.

[Table of Contents](#)

Thomas W. Booth, Stephen R. Booth and John W. Norris, III, each a member of the Company's Board of Directors, John W. Norris, Jr., LII's former Chairman of the Board, other former directors of the Company, and Lynn B. Storey, the mother of Jeffrey D. Storey, M.D., a director of the Company, as well as other stockholders of the Company who may be immediate family members of the foregoing persons, are also, individually or through trust arrangements, members of AOC Land Investment, L.L.C. ("AOC Land"). AOC Land owned 70% of AOC Development II, L.L.C. ("AOC Development"), which owned substantially all of One Lake Park, L.L.C. ("One Lake Park") prior to the dissolution of AOC Development and One Lake Park in the second half of 2006. Beginning in 1998, the Company leased part of an office building in Richardson, Texas owned by One Lake Park for use as its corporate headquarters. LII terminated these leases in June 2006. Lease payments for the six months ended June 30, 2006 totaled approximately \$1.4 million. LII believes that the terms of its leases with One Lake Park were, at the time entered into, comparable to terms that could have been obtained from unaffiliated third parties.

20. Subsequent Events:

On October 10, 2007 the Company announced plans to close its refrigeration operations in Danville, Illinois and consolidate its Danville manufacturing, support, and warehouse functions in its Tifton, Georgia and Stone Mountain, Georgia operations. The facility in Danville manufactures evaporators and other heat transfer products for the commercial refrigeration industry. The consolidation will be a phased process and is expected to be completed over the next 18 months with pre-tax restructuring-related charges of approximately \$17 million over that time.

The Company entered into a \$650 million Third Amended and Restated Revolving Credit Facility Agreement (the "Credit Agreement") with Bank of America, N.A., as administrative agent, swingline lender and issuing bank (the "Administrative Agent"), JPMorgan Chase Bank, N.A. and Wachovia Bank, National Association, as co-syndication agents, and the lenders party thereto on October 12, 2007. The Credit Agreement replaces the Company's previous domestic revolving credit facility, the Second Amended and Restated Credit Facility Agreement, dated as of July 8, 2005, among the Company, Bank of America, N.A., as administrative agent, JPMorgan Chase Bank, N.A., as syndication agent, and the lenders named therein.

The Credit Agreement provides for an unsecured \$650 million revolving credit facility that matures on October 12, 2012. The revolving credit facility includes a subfacility for swingline loans of up to \$50 million and provides for the issuance of letters of credit for the full amount of the credit facility. The revolving loans bear interest at either (i) the Eurodollar rate plus a margin of between 0.5% and 1% that is based on the Company's Debt to Adjusted EBITDA Ratio (as defined in the Credit Agreement) or (ii) the higher of (a) the Federal Funds Rate plus 0.5% and (b) the prime rate set by Bank of America, N.A. The Company may prepay the revolving loans at any time without premium or penalty, other than customary breakage costs in the case of Eurodollar loans.

The Company will pay a facility fee in the range of 0.125% to 0.25% based on the Company's Debt to Adjusted EBITDA Ratio. The Company will also pay a letter of credit fee in the range of 0.5% to 1% based on the Company's Debt to Adjusted EBITDA Ratio, as well as an additional issuance fee of 0.125% for letters of credit issued.

The Credit Agreement contains financial covenants relating to leverage and interest coverage. Other covenants contained in the Credit Agreement restrict, among other things, mergers, asset dispositions, guarantees, debt, liens, acquisitions, investments, affiliate transactions and the Company's ability to make restricted payments.

The Credit Agreement contains customary events of default. If any event of default occurs and is continuing, lenders with a majority of the aggregate commitments may require the Administrative Agent to terminate the Company's right to borrow under the Credit Agreement and accelerate amounts due under the Credit Agreement (except for a bankruptcy event of default, in which case such amounts will automatically become due and payable and the lenders' commitments will automatically terminate).

The Company's obligations under the Credit Agreement are guaranteed by certain of its material domestic subsidiaries, including Lennox Industries Inc., Allied Air Enterprises Inc., Service Experts Inc. and Lennox Global Ltd.

The Company made a \$25 million prepayment on a domestic promissory note to facilitate the amendment of the Credit Agreement, resulting in a make-whole payment of \$0.2 million which will be recognized as interest expense in the fourth quarter of 2007.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

Forward-Looking Information

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, that are based on information currently available to management as well as management’s assumptions and beliefs. All statements, other than statements of historical fact, included in this Quarterly Report on Form 10-Q constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including but not limited to statements identified by the words “may,” “will,” “should,” “plan,” “predict,” “anticipate,” “believe,” “intend,” “estimate” and “expect” and similar expressions. Such statements reflect our current views with respect to future events, based on what we believe are reasonable assumptions; however, such statements are subject to certain risks and uncertainties. In addition to the specific uncertainties discussed elsewhere in this Quarterly Report on Form 10-Q, the risk factors set forth in Part I, “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2006, and those set forth in Part II, “Item 1A. Risk Factors” of this report, if any, may affect our performance and results of operations. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may differ materially from those in the forward-looking statements. We disclaim any intention or obligation to update or review any forward-looking statements or information, whether as a result of new information, future events or otherwise.

Overview

We operate in four reportable business segments of the heating, ventilation, air conditioning and refrigeration (“HVACR”) markets. The first reportable segment is Residential Heating & Cooling, in which we manufacture and market a full line of heating, air conditioning and hearth products for the residential replacement and new construction markets in the United States and Canada. The second reportable segment is Commercial Heating & Cooling, in which we manufacture and sell rooftop products and related equipment for light commercial applications in the United States and Canada and primarily rooftop products, chillers and air handlers in Europe. The third reportable segment is Service Experts, which includes sales, installation, maintenance and repair services for heating, ventilation and air conditioning (“HVAC”) equipment by Company-owned service centers in the United States and Canada. The fourth reportable segment is Refrigeration, in which we manufacture and sell unit coolers, condensing units and other commercial refrigeration products in the United States and international markets.

Our products and services are sold through a combination of distributors, independent and Company-owned dealer service centers, other installing contractors, wholesalers, manufacturers’ representatives, original equipment manufacturers and to national accounts. The demand for our products and services is seasonal and dependent on the weather. Hotter than normal summers generate strong demand for replacement air conditioning and refrigeration products and services and colder than normal winters have the same effect on heating products and services. Conversely, cooler than normal summers and warmer than normal winters depress HVACR sales and services. In addition to weather, demand for our products and services is influenced by national and regional economic and demographic factors, such as interest rates, the availability of financing, regional population and employment trends, new construction, general economic conditions and consumer confidence.

The principal elements of cost of goods sold in our manufacturing operations are components, raw materials, factory overhead, labor and estimated costs of warranty expense. In our Service Experts segment, the principal components of cost of goods sold are equipment, parts and supplies and labor. The principal raw materials used in our manufacturing processes are steel, copper and aluminum. Higher prices for these commodities and related components continue to present a challenge to us and the HVACR industry in general. We partially mitigate the impact of higher commodity prices through a combination of price increases, commodity contracts, improved production efficiency and cost reduction initiatives.

Our fiscal year ends on December 31 and our interim fiscal quarters are each comprised of 13 weeks. For convenience, throughout this Management’s Discussion and Analysis of Financial Condition and Results of Operations, the 13-week periods comprising each fiscal quarter are denoted by the last day of the calendar quarter.

Company Highlights

- Our Commercial Heating & Cooling, Service Experts, and Refrigeration segments experienced increases in net sales in the third quarter of 2007 compared to the prior year quarter due to favorable product price and mix changes, increased volumes and the favorable impact of changes in foreign currency exchange rates. Our Residential Heating & Cooling segment's sales decreased for the third quarter of 2007 compared to the prior year quarter largely due to weak residential new construction sales.
- Operational income for the third quarter of 2007 increased \$41.9 million, or 73.5%, from the prior year quarter. As a percentage of sales, operational income increased to 9.6% in the third quarter of 2007 as compared to 5.6% in the third quarter of 2006. The increase in operational income was due to price increases implemented since the third quarter of 2006 offsetting increases in commodity and other manufacturing costs. Additionally, we reduced selling, general and administrative expenses through cost management and cost reduction initiatives.
- Net income for the third quarter of 2007 increased \$25.6 million, or 71.9%, as compared to the prior year quarter due to higher gross profit and lower operating expenses.
- On July 25, 2007, we announced that our Board of Directors approved a new \$500 million share repurchase plan, pursuant to which we plan to repurchase shares of our common stock through open market purchases (the "2007 Share Repurchase Plan"). Based on the closing price of our common stock on July 24, 2007, a \$500 million repurchase would represent over 20% of our market capitalization. We currently intend to fully execute the repurchase by the end of the third quarter of 2008. The 2007 Share Repurchase Plan terminates and replaces the 2005 Share Repurchase Plan. During the third quarter, we purchased 3,026,100 shares of our common stock for \$104.2 million, representing approximately 21% of the \$500 million repurchase authorization.
- On October 12, 2007, we entered into a \$650 million Third Amended and Restated Revolving Credit Facility Agreement which replaces our previous \$400 million domestic revolving credit facility.

Results of Operations

The following table presents certain information concerning our financial results, including information presented as a percentage of net sales, for the third quarter ended and year-to-date through September 30, 2007 and 2006 (dollars in millions):

	Third Quarter				Year-to-Date September 30,			
	2007		2006		2007		2006	
	Dollars	Percent	Dollars	Percent	Dollars	Percent	Dollars	Percent
Net sales	\$ 1,029.8	100.0%	\$ 1,020.3	100.0%	\$ 2,863.1	100.0%	\$ 2,841.7	100.0%
Cost of goods sold	736.2	71.5	763.5	74.8	2,075.8	72.5	2,105.5	74.1
Gross profit	293.6	28.5	256.8	25.2	787.3	27.5	736.2	25.9
Selling, general and administrative expenses	194.3	18.9	200.8	19.7	582.7	20.4	589.9	20.8
(Gains), losses and other expenses, net	(1.2)	(0.1)	(3.0)	(0.3)	(5.2)	(0.2)	(47.3)	(1.7)
Restructuring charges	4.3	0.4	4.5	0.4	14.2	0.5	13.1	0.5
Equity in earnings of unconsolidated affiliates	(2.7)	(0.3)	(2.5)	(0.2)	(8.9)	(0.3)	(7.5)	(0.3)
Operational income	<u>\$ 98.9</u>	<u>9.6%</u>	<u>\$ 57.0</u>	<u>5.6%</u>	<u>\$ 204.5</u>	<u>7.1%</u>	<u>\$ 188.0</u>	<u>6.6%</u>
Net income	<u>\$ 61.2</u>	<u>5.9%</u>	<u>\$ 35.6</u>	<u>3.5%</u>	<u>\$ 130.1</u>	<u>4.5%</u>	<u>\$ 124.9</u>	<u>4.4%</u>

The following table sets forth net sales by geographic market for the third quarter ended and year-to-date through September 30, 2007 and 2006 (dollars in millions):

	Third Quarter				Year-to-Date September 30,			
	2007		2006		2007		2006	
	Dollars	Percent	Dollars	Percent	Dollars	Percent	Dollars	Percent
Geographic Market:								
U.S.	\$ 758.0	73.6%	\$ 789.1	77.4%	\$ 2,130.8	74.4%	\$ 2,234.0	78.6%
Canada	108.4	10.5	95.1	9.3	270.7	9.5	237.6	8.4
International	163.4	15.9	136.1	13.3	461.6	16.1	370.1	13.0
Total net sales	<u>\$ 1,029.8</u>	<u>100.0%</u>	<u>\$ 1,020.3</u>	<u>100.0%</u>	<u>\$ 2863.1</u>	<u>100.0%</u>	<u>\$ 2,841.7</u>	<u>100.0%</u>

Third Quarter 2007 Compared to Third Quarter 2006 – Consolidated Results

Net Sales

Net sales increased \$9.5 million, or 0.9%, to \$1,029.8 million for the third quarter of 2007 from \$1,020.3 million for the third quarter of 2006. The favorable impact of changes in foreign currency exchange rates increased net sales by \$21.0 million. Our Commercial Heating & Cooling, Service Experts, and Refrigeration segments experienced increases in net sales due to favorable product price and mix changes and increased volumes. Our Residential Heating & Cooling segment's sales decreased for the third quarter of 2007 compared to the prior year quarter largely due to weak residential new construction sales.

Gross Profit

Gross profit was \$293.6 million for the third quarter of 2007 compared to \$256.8 million for the prior year quarter, an increase of \$36.8 million. Gross profit margin increased to 28.5% for the third quarter of 2007 compared to 25.2% in 2006 primarily due to favorable price increases implemented since the third quarter of 2006 combined with lower manufacturing costs.

Selling, General and Administrative Expenses

Selling, general and administrative ("SG&A") expenses decreased \$6.5 million, or 3.2%, for the third quarter of 2007 compared to the prior year quarter. As a percentage of total net sales, SG&A expenses decreased to 18.9% for the third quarter of 2007 from 19.7% for the third quarter of 2006. A decrease in volume related selling expenses had a favorable impact on SG&A expenses. Additionally, cost reduction initiatives resulted in lower SG&A expenses in the third quarter of 2007 as compared to the prior year quarter. These savings were partially offset by a one-time pension settlement charge of \$3.9 million related to the retirement of our former chief executive officer and changes in foreign currency exchange rates.

(Gains), Losses and Other Expenses, Net

(Gains), losses and other expenses, net were \$(1.2) million for the third quarter of 2007 compared to \$(3.0) million for the third quarter of 2006 and included the following (in millions):

	Third Quarter	
	2007	2006
Realized gains on settled futures contracts not designated as cash flow hedges	\$ (1.4)	\$ (20.2)
Unrealized losses on unsettled futures contracts not designated as cash flow hedges	1.0	18.6
Ineffective portion of losses on cash flow hedges	0.3	—
Foreign currency exchange gains	(1.6)	(1.0)
Other items, net	0.5	(0.4)
(Gains), losses and other expenses, net	<u>\$ (1.2)</u>	<u>\$ (3.0)</u>

Realized and unrealized gains on settled futures contracts not designated as cash flow hedges decreased as we had fewer futures contracts not designated as cash flow hedges in the third quarter of 2007 compared to the same period in 2006. Beginning in the fourth quarter of 2006, futures contracts entered into that met established accounting criteria were formally designated as cash flow hedges. For more information see Note 15 in the Notes to our Consolidated Financial Statements.

Restructuring Charges

We recognized \$4.3 million and \$4.5 million in restructuring charges for the third quarter of 2007 and 2006, respectively. Restructuring charges incurred during the third quarter of 2007 primarily related to the consolidation of our Hearth Products operations and the reorganization of our corporate administrative function. Charges recognized in the third quarter of 2006 primarily related to the consolidation of our manufacturing,

[Table of Contents](#)

distribution, research and development and administrative operations of our two-step operations into South Carolina and closing of our operations in Bellevue, Ohio (the “Allied Air Enterprises Consolidation”). The restructuring of these operations was substantially completed during the first quarter of 2007. Charges recorded in the third quarter of 2006 reflected the net present value of remaining lease payments on an operating lease at an idle facility in Burlington, Washington, net of estimated sublease income on the facility.

In the third quarter of 2007, we announced plans to close our Hearth Products operations in Lynwood, California and consolidate our U.S. factory-built fireplace manufacturing operations in our facility in Union City, Tennessee. In connection with this consolidation project, we recorded pre-tax restructuring charges of \$2.4 million in our Residential Heating & Cooling segment for the three months ended September 30, 2007. The restructuring charges primarily related to severance related costs and the disposal of certain long-lived assets. The consolidation will be a phased process and is expected to be completed by the end of the second quarter of 2008. We currently expect to incur pre-tax restructuring charges of approximately \$2.7 million over the next six months due to this consolidation project and anticipate the consolidation leading to annual cost reductions of over \$2.0 million beginning in April of 2008.

In the second quarter of 2007, we reorganized our corporate administrative function and eliminated the position of chief administrative officer. In connection with this action, we entered into negotiations with our former chief administrative officer to settle the terms of his employment agreement. Restructuring expense of \$6.6 million was recorded in the second quarter of 2007, which represented the \$8.0 million estimate of the amounts to be paid to settle the employment agreement, net of \$1.4 million of previously recorded stock-based compensation expense. In September 2007, we reached an agreement to settle the terms of the former chief administrative officer’s employment agreement. As a result, we recorded an additional \$1.1 million of restructuring expense related to this matter in the third quarter of 2007. We do not expect to incur any material costs related to this reorganization in the future.

On October 10, 2007, we announced plans to close our refrigeration operations in Danville, Illinois and consolidate our Danville manufacturing, support, and warehouse functions in our Tifton, Georgia and Stone Mountain, Georgia operations. The consolidation will be a phased process and is expected to be completed over the next 18 months with pre-tax restructuring-related charges of approximately \$17 million over that time. We expect the consolidation to lead to annual pre-tax cost reductions of over \$6 million beginning in 2009.

Equity in Earnings of Unconsolidated Affiliates

Investments in affiliates in which we do not exercise control but have significant influence are accounted for using the equity method of accounting. Equity in earnings of unconsolidated affiliates increased by \$0.2 million to \$2.7 million for the third quarter of 2007 compared to \$2.5 million for the same period in 2006. The increase was due to the performance of our unconsolidated affiliates.

Interest Expense, Net

Interest expense, net, increased by \$0.7 million to \$1.9 million for the third quarter of 2007 from \$1.2 million for the third quarter of 2006. The higher net interest expense was primarily due to higher interest expense and a decrease in interest income earned during the quarter ended September 30, 2007. Interest expense increased due to higher debt balances as the result of our share repurchases. Interest income decreased due to lower rates in the third quarter of 2007 as compared to the prior year quarter.

Provision for Income Taxes

The provision for income taxes was \$35.6 million for the third quarter of 2007 compared to \$20.1 million for the prior year quarter. The effective tax rate was 36.8% and 36.1% for the third quarter of 2007 and 2006, respectively. Our effective rates differ from the statutory federal rate of 35% for certain items, such as state and local taxes, non-deductible expenses, foreign operating losses for which no tax benefits have been recognized and foreign taxes at rates other than 35%.

Third Quarter 2007 Compared to Third Quarter 2006 – Results by Segment

The key performance indicators of our segments’ profitability are net sales and operational profit. We define segment profit (loss) as a segment’s income (loss) from continuing operations before income taxes included in the accompanying Consolidated Statements of Operations excluding (gains), losses and other expenses, net;

[Table of Contents](#)

restructuring charges; goodwill impairment; interest expense, net; and other expense (income), net; less (plus) realized gains (losses) on settled futures contracts not designated as cash flow hedges and the ineffective portion of settled cash flow hedges; and less (plus) foreign currency exchange gains (losses).

Residential Heating & Cooling

The following table details our Residential Heating & Cooling segment's net sales and profit for the third quarter of 2007 and 2006 (dollars in millions):

	Third Quarter		Difference	% Change
	2007	2006		
Net sales	\$456.5	\$502.4	\$(45.9)	(9.1)%
Profit	63.7	53.4	10.3	19.3
% of net sales	14.0%	10.6%		

Net sales in our Residential Heating & Cooling business segment decreased \$45.9 million, or 9.1%, to \$456.5 million for the third quarter of 2007 from \$502.4 million for the third quarter of 2006. Due to continuing weakness in the U.S. residential new construction market, unit volumes were down in the third quarter of 2007 as compared to the third quarter of 2006. Price increases implemented in response to higher commodity and component costs partially offset the decrease in sales due to reduced unit volumes.

Segment profit in Residential Heating & Cooling increased 19.3% to \$63.7 million for the third quarter of 2007 from \$53.4 million in the prior year. Segment profit margins improved from 10.6% for the third quarter of 2006 to 14.0% for the third quarter of 2007. The unfavorable impact of lower unit volumes was more than offset by a reduction in operating and administrative expenses. Operating and administrative expenses were lower in the third quarter of 2007 compared to the prior year primarily due to cost reduction activities and costs savings related to the consolidation of our Allied Air Enterprises manufacturing operations. Our operating margins were also higher in the third quarter of 2007 as compared to the prior year quarter as price increases were effective in offsetting higher commodity and component costs. In addition, freight and commission costs were lower as a percentage of sales.

In the third quarter of 2007 we revised our warranty policy for fulfilling the terms of our warranty obligation on certain products that we no longer manufacture. We believe that the revised policy may have a favorable and material impact to our financial results in future periods while still meeting the terms of our warranty obligation to our customers.

Commercial Heating & Cooling

The following table details our Commercial Heating & Cooling segment's net sales and profit for the third quarter of 2007 and 2006 (dollars in millions):

	Third Quarter		Difference	% Change
	2007	2006		
Net sales	\$255.1	\$228.0	\$27.1	11.9%
Profit	37.8	25.8	12.0	46.5
% of net sales	14.8%	11.3%		

Net sales in our Commercial Heating & Cooling segment increased \$27.1 million, or 11.9%, to \$255.1 million for the third quarter of 2007 from \$228.0 million for the third quarter of 2006. The increase in net sales was driven by price increases throughout the segment combined with a favorable product mix shift in our domestic operations as demand for our high-efficiency units increased in the third quarter of 2007. Unit volumes remained relatively flat across the segment. The favorable impact of changes in foreign currency exchange rates increased net sales by \$6.5 million.

Segment profit in Commercial Heating & Cooling increased 46.5% to \$37.8 million for the third quarter of 2007 from \$25.8 million in the prior year. As a percentage of net sales, segment profit increased from 11.3% in 2006 to 14.8% in 2007. The improvement in segment profit was driven by price increases that offset increases in materials and other manufacturing costs. A favorable product mix shift to high-efficiency units in our domestic operations also contributed to the increase in segment profit in the third quarter of 2007 as compared to the prior

[Table of Contents](#)

year. We continued to realize the benefits of our Commercial Regional Distribution Network in North America, a strategic initiative in freight and logistics designed to optimize transportation load capacity and reduce transportation costs for our products. Additionally, SG&A expenses decreased due to cost reduction initiatives.

Service Experts

The following table details our Service Experts segment's net sales and profit for the third quarter of 2007 and 2006 (dollars in millions):

	Third Quarter		Difference	% Change
	2007	2006		
Net sales	\$183.9	\$174.0	\$9.9	5.7%
Profit	9.2	7.4	1.8	24.3
% of net sales	5.0%	4.3%		

Net sales in our Service Experts segment increased \$9.9 million, or 5.7%, to \$183.9 million for the third quarter of 2007 from \$174.0 million for the third quarter of 2006. The increase in net sales was primarily due to favorable changes in the mix of our sales and services in both the U.S. and Canadian markets. Strong residential service and replacement sales offset a sales decline related to the residential new construction market in the U.S. Residential new construction sales in our Canadian operations remained strong due to favorable market conditions. Commercial sales decreased slightly in the third quarter of 2007 as compared to the same period in 2006 due to a decrease in commercial new construction sales. The favorable impact of changes in foreign currency exchange rates increased net sales by \$2.6 million.

Segment profit in Service Experts increased \$1.8 million to \$9.2 million for the third quarter of 2007 from \$7.4 million in the prior year. As a percentage of net sales, segment profit increased from 4.3% for the third quarter of 2006 to 5.0% for the third quarter of 2007. Our margins primarily improved as we increased the percentage of higher margin service and replacement business in 2007 as compared to 2006.

Refrigeration

The following table details our Refrigeration segment's net sales and profit for the third quarter of 2007 and 2006 (dollars in millions):

	Third Quarter		Difference	% Change
	2007	2006		
Net sales	\$157.5	\$137.3	\$20.2	14.7%
Profit	17.8	13.8	4.0	29.0
% of net sales	11.3%	10.1%		

Net sales in our Refrigeration segment increased \$20.2 million, or 14.7%, to \$157.5 million for the third quarter of 2007 from \$137.3 million in the prior year. Increases in unit volumes in our European, Australian, and South American operations offset a slight decrease in our domestic unit volumes. Our international operations' unit volumes increased due to favorable economic conditions and export growth. Increased prices contributed to the increase in sales, particularly in our domestic operations. Price increases were implemented as the result of rising commodity and component costs. The favorable impact of changes in foreign currency exchange rates increased net sales by \$9.4 million.

Segment profit in Refrigeration increased \$4.0 million to \$17.8 million for the third quarter of 2007 from \$13.8 million for the prior year quarter. Segment profit margins increased to 11.3% in 2007 compared to 10.1% in 2006. The increase in segment profit is primarily due to the increase in unit volumes in international markets and price increases effectively offsetting higher commodity and component costs.

Corporate and Other

Corporate and other costs were slightly higher at \$23.4 million for the third quarter of 2007 compared to \$21.2 million for the third quarter of 2006. 2007 expenses increased primarily due to a one-time executive retirement pension settlement charge that was partially offset by lower professional fees.

[Table of Contents](#)

Year-to-Date Through September 30, 2007 Compared to Year-to-Date Through September 30, 2006 – Consolidated Results

Net Sales

Year-to-date net sales increased \$21.4 million, or 0.8%, to \$2,863.1 million in 2007 from \$2,841.7 million in 2006. The increase in net sales was due to increased volumes and favorable price and product mix changes in our Commercial Heating & Cooling, Service Experts, and Refrigeration segments, as well as a favorable impact of changes in foreign currency exchange rates of \$44.4 million. Net sales decreased in our Residential Heating & Cooling segment largely due to decreased demand in the residential new construction market.

Gross Profit

Year-to-date gross profit was \$787.3 million in 2007 compared to \$736.2 million in 2006, an increase of \$51.1 million. Gross profit margin increased to 27.5% for 2007 compared to 25.9% for 2006 due to favorable sales mix changes and volume increases. Price increases partially offset increases in commodity and component costs.

Selling, General and Administrative Expenses

Year-to-date SG&A expenses decreased to \$582.7 million in 2007 compared to \$589.9 million in 2006. As a percentage of total net sales, SG&A expenses were 20.4% for 2007 and 20.8% for 2006. Year-over-year reductions in unit volumes decreased volume related selling expenses included in SG&A expenses. Additionally, cost management and cost reduction initiatives had a favorable impact on SG&A expenses in the first nine months of 2007 as compared to the prior year. These savings in SG&A expenses were partially offset by a one-time pension settlement charge of \$3.9 million recorded in the third quarter of 2007 related to the retirement of our former chief executive officer.

(Gains), Losses and Other Expenses, Net

Year-to-date (gains), losses and other expenses, net were \$(5.2) million in 2007 and \$(47.3) million in 2006 and included the following (in millions):

	<u>Year-to-Date September 30,</u>	
	<u>2007</u>	<u>2006</u>
Realized gains on settled futures contracts not designated as cash flow hedges	\$ (3.1)	\$ (52.3)
Unrealized losses on unsettled futures contracts not designated as cash flow hedges	0.9	5.3
Ineffective portion of losses on cash flow hedges	0.1	—
Foreign currency exchange gains	(3.7)	—
Other items, net	0.6	(0.3)
(Gains), losses and other expenses, net	<u>\$ (5.2)</u>	<u>\$ (47.3)</u>

Realized and unrealized gains on settled futures contracts not designated as cash flow hedges decreased as we had fewer futures contracts not designated as cash flow hedges in the first nine months of 2007 compared to the same period in 2006. Beginning in the fourth quarter of 2006, futures contracts entered into that met established accounting criteria were formally designated as cash flow hedges. For more information see Note 15 in the Notes to our Consolidated Financial Statements.

Restructuring Charges

We recognized \$14.2 million and \$13.1 million in year-to-date restructuring charges in 2007 and 2006, respectively. In 2007 we incurred restructuring charges of \$2.4 million related to the consolidation of our Hearth Products operations, \$7.7 million related to the reorganization of our corporate administrative function and \$3.2 million related to the Allied Air Enterprises Consolidation. Charges recognized in 2006 primarily related to the Allied Air Enterprises Consolidation, which was substantially completed during the first quarter of 2007.

Equity in Earnings of Unconsolidated Affiliates

Investments in affiliates in which we do not exercise control but have significant influence are accounted for

[Table of Contents](#)

using the equity method of accounting. Year-to-date equity in earnings of unconsolidated affiliates increased by \$1.4 million to \$8.9 million in 2007 as compared to \$7.5 million in 2006. The increase was due to the performance of our unconsolidated affiliates.

Interest Expense, Net

Year-to-date interest expense, net, increased by \$1.2 million to \$4.8 million in 2007 from \$3.6 million in 2006. The higher net interest expense was due primarily to an increase in interest expense and a decrease in interest income earned. Interest expense increased due to higher debt balances as the result of our share repurchases. Interest income decreased due to lower average investment balances and lower rates in 2007 as compared to 2006.

Provision for Income Taxes

The year-to-date provision for income taxes was \$69.3 million in 2007 compared to \$59.4 million in 2006. The year-to-date effective tax rate was 34.8% and 32.2% for 2007 and 2006, respectively. Our effective rates differ from the statutory federal rate of 35% for certain items, such as a \$3.2 million benefit in 2007 from a change in estimated gain from the prior year, state and local taxes, non-deductible expenses, foreign operating losses for which no tax benefits have been recognized and foreign taxes at rates other than 35%.

Year-to-Date Through September 30, 2007 Compared to Year-to-Date Through September 30, 2006 – Results by Segment

The key performance indicators of our segments' profitability are net sales and operational profit. We define segment profit (loss) as a segment's income (loss) from continuing operations before income taxes included in the accompanying Consolidated Statements of Operations excluding (gains), losses and other expenses, net; restructuring charges; goodwill impairment; interest expense, net; and other expense (income), net; less (plus) realized gains (losses) on settled futures contracts not designated as cash flow hedges and the ineffective portion of settled cash flow hedges; and less (plus) foreign currency exchange gains (losses).

Residential Heating & Cooling

The following table details our Residential Heating & Cooling segment's year-to-date net sales and profit for 2007 and 2006 (dollars in millions):

	Year-to-Date September 30,		Difference	% Change
	2007	2006		
Net sales	\$1,315.5	\$1,464.2	\$(148.7)	(10.2)%
Profit	143.2	168.7	(25.5)	(15.1)
% of net sales	10.9%	11.5%		

Year-to-date net sales in our Residential Heating & Cooling segment decreased \$148.7 million, or 10.2%, to \$1,315.5 million in 2007 from \$1,464.2 million in 2006. Net sales decreased primarily due to reduced unit volumes attributable to the U.S. residential new construction market. Unit volumes have generally been lower across the residential HVAC industry in 2007 as compared to 2006 due to softness in the U.S. residential new construction market. We believe the decrease in our unit volumes is consistent with industry trends. The decrease in net sales attributable to lower unit volumes was partially offset by an increase in sales prices implemented as a result of higher commodity and component costs.

Year-to-date segment profit in Residential Heating & Cooling decreased 15.1% to \$143.2 million in 2007 from \$168.7 million in 2006. Segment profit margins declined from 11.5% for 2006 to 10.9% for 2007. The decrease in segment profit was primarily driven by a decrease in unit volumes. Adjustments to failure rates for products we no longer manufacture and the higher cost of claims increased our warranty costs. Favorable price changes partially offset the decrease in segment profit. Lower sales volumes resulted in a reduction of our freight and commission expenses. Additionally, our cost saving initiatives helped to reduce SG&A expenses.

Commercial Heating & Cooling

The following table details our Commercial Heating & Cooling segment's year-to-date net sales and profit for 2007 and 2006 (dollars in millions):

[Table of Contents](#)

	Year-to-Date September 30,		Difference	% Change
	2007	2006		
Net sales	\$650.6	\$554.1	\$96.5	17.4%
Profit	76.6	53.2	23.4	44.0
% of net sales	11.8%	9.6%		

Year-to-date net sales in our Commercial Heating & Cooling segment increased \$96.5 million, or 17.4%, to \$650.6 million in 2007 from \$554.1 million in 2006. The increase in net sales was primarily due to favorable price and product mix changes in our domestic operations as customer demand increased for our high-efficiency rooftop units. The favorable impact of the change in foreign currency exchange rates increased net sales by \$15.3 million.

Year-to-date segment profit in Commercial Heating & Cooling increased 44.0% to \$76.6 million in 2007 from \$53.2 million in 2006. As a percentage of net sales, segment profit increased from 9.6% for 2006 to 11.8% for 2007. An increase in demand in our international markets combined with price increases and a favorable product mix shift in our domestic operations has improved segment profit. Additionally, the strategic initiatives related to our Commercial Regional Distribution Network in North America helped to lower freight costs and further contributed to the Commercial Heating & Cooling segment's year over year increase in profits.

Service Experts

The following table details our Service Experts segment's year-to-date net sales and profit for 2007 and 2006 (dollars in millions):

	Year-to-Date September 30,		Difference	% Change
	2007	2006		
Net sales	\$512.0	\$492.8	\$19.2	3.9%
Profit	18.4	10.2	8.2	80.4
% of net sales	3.6%	2.1%		

Year-to-date net sales in our Service Experts segment increased \$19.2 million, or 3.9%, to \$512.0 million in 2007 from \$492.8 million in 2006. The increase in net sales primarily relates to favorable changes in the mix of our sales and services. Residential sales in our Canadian operations increased in 2007 as compared to 2006 in both residential service and replacement and residential new construction due to favorable market conditions. Additionally, 2007 year-to-date net sales increased in our U.S. operations. As a percentage of total sales, U.S. residential service and replacement sales increased year over year, offsetting a decrease in sales caused by the decline in residential new construction sales.

Year-to-date segment profit in Service Experts increased \$8.2 million to \$18.4 million in 2007 from \$10.2 million in 2006. As a percentage of net sales, segment profit increased from 2.1% for 2006 to 3.6% for 2007. The improvement in our margins was primarily caused by a favorable change in sales and service mix as a larger percentage of our sales came from higher margin service and replacement business in 2007 as compared to 2006 coupled with an increase in sales volumes. We incurred higher commissions expense in 2007 related to the increase in residential service and replacement sales.

Refrigeration

The following table details our Refrigeration segment's year-to-date net sales and profit for 2007 and 2006 (dollars in millions):

	Year-to-Date September 30,		Difference	% Change
	2007	2006		
Net sales	\$450.1	\$394.6	\$55.5	14.1%
Profit	46.6	40.2	6.4	15.9
% of net sales	10.4%	10.2%		

[Table of Contents](#)

Year-to-date net sales in our Refrigeration segment increased \$55.5 million, or 14.1%, to \$450.1 million in 2007 from \$394.6 million in 2006. The Refrigeration segment's sales increase was primarily due to an increase in volumes in Europe, Australia, and Brazil. Favorable market conditions in Europe and Australia and an increase in exports in South America improved our foreign operations' unit volumes. Additionally, increased prices resulting from an increase in commodity and component costs contributed to higher sales. The favorable impact of the change in foreign currency exchange rates increased net sales by \$23.3 million.

Year-to-date segment profit in our Refrigeration segment increased \$6.4 million to \$46.6 million in 2007 from \$40.2 million in 2006. Segment profit margins increased to 10.4% for 2007 from 10.2% for 2006. Increases in sales volumes increased segment profit. However, a change in the product mix and geographic mix of our sales generated more sales of products with lower margins during the first half of the year. Additionally, higher commodity and component costs that were not fully offset by price increases lowered profit margins. Lower expenses from cost reduction initiatives were offset by costs associated with expanding our international operations, including our strategic growth initiatives in Asia.

Corporate and Other

Corporate and other's year-to-date costs decreased from \$66.5 million in 2006 to \$64.2 million in 2007. The decrease primarily resulted from a reduction in professional fees partially offset by a one-time executive retirement pension settlement charge.

Liquidity and Capital Resources

Our working capital and capital expenditure requirements are generally met through internally generated funds, bank lines of credit and a revolving period asset securitization arrangement. Working capital needs are generally greater in the first and second quarter due to the seasonal nature of our business cycle.

As of September 30, 2007, our debt-to-total-capital ratio was 15.6%, up from 12.7% as of September 30, 2006, primarily due to an incremental \$40.6 million of debt in 2007. Higher debt was primarily due to the repurchase of approximately 5.4 million shares of our common stock for \$179.8 million since September 30, 2006 under the 2005 Share Repurchase Plan and the 2007 Share Repurchase Plan.

The following table summarizes our year-to-date cash activity for 2007 and 2006 (in millions):

	Year-to-Date September 30,	
	2007	2006
Net cash provided by operating activities	\$ 110.5	\$ 84.8
Net cash used in investing activities	(69.0)	(54.4)
Net cash used in financing activities	(101.4)	(137.1)

Net Cash Provided by Operating Activities

Year-to-date cash provided by operating activities in 2007 was \$110.5 million compared to \$84.8 million in 2006. The primary reason for the increase in cash provided by operating activities was a change in inventory from an increase of \$45.1 million in 2007 compared to an increase of \$96.9 million in 2006. Inventory increased in the first nine months of 2007 due to a normal seasonal increase. However, inventory increased more in the first nine months of 2006 primarily due to (i) a planned increase in finished goods to manage through the Allied Air Enterprises Consolidation, (ii) increased costs of 13 SEER units during the 2006 transition, and (iii) increasing commodity costs impacting raw material inventory costs during the first nine months of 2006. The impact of the inventory improvement was partially offset by an increase in accounts receivable of \$111.3 million in 2007 compared to \$93.3 million in 2006. The increase in accounts receivable was primarily due to increased sales in the third quarter as well as geographic and customer mix. Our third quarter sales were modestly higher in 2007 as compared to 2006.

Net Cash Used in Investing Activities

Year-to-date net cash used in investing activities was \$69.0 million in 2007 compared to \$54.4 million in

[Table of Contents](#)

2006. Capital expenditures of \$44.5 million and \$49.8 million in 2007 and 2006, respectively, were primarily for purchases of production equipment in our Residential Heating & Cooling and Commercial Heating & Cooling segments. We made net short-term investments in debt securities of \$25.0 million in 2007.

Net Cash Used in Financing Activities

Year-to-date net cash used in financing activities was \$101.4 million in 2007 compared to \$137.1 million in 2006. We paid a total of \$35.0 million in dividends on our common stock in the first nine months of 2007 compared to \$31.2 million during the same period in 2006. The increase in cash dividends paid was attributable to an increase in the quarterly cash dividend from \$0.11 to \$0.13 per share of common stock, effective as of the dividend paid on January 12, 2007. Year-to-date net short-term and revolving long-term borrowings totaled approximately \$51.3 million in 2007 as compared to \$(0.7) million in 2006. During the first nine months of 2007, we used approximately \$150.5 million to repurchase 4,284,100 shares of our common stock. Such repurchases were made primarily under the 2005 Stock Repurchase Plan and the 2007 Stock Repurchase Plan.

The following table summarizes our outstanding debt obligations as of September 30, 2007 and the classification in the accompanying Consolidated Balance Sheet (in millions):

Description of Obligation	Short-Term Debt	Current Maturities	Long-Term Maturities	Total
Domestic promissory notes	\$ —	\$ 61.1	\$ 46.1	\$ 107.2
Domestic revolving credit facility	—	—	48.5	48.5
Other foreign obligations	3.8	0.2	0.8	4.8
Total Debt	<u>\$ 3.8</u>	<u>\$ 61.3</u>	<u>\$ 95.4</u>	<u>\$ 160.5</u>

As of September 30, 2007, we had outstanding long-term debt obligations totaling \$156.7 million, including \$61.3 million of current maturities. The amount outstanding consisted primarily of outstanding domestic promissory notes with an aggregate principal outstanding of \$107.2 million. The promissory notes mature at various dates through 2010 and have interest rates ranging from 6.73% to 8.00%.

As of September 30, 2007, we had a domestic revolving credit facility with a borrowing capacity of \$400.0 million, of which \$48.5 million was borrowed and outstanding and \$92.1 million was committed to standby letters of credit. Of the remaining \$259.4 million, the entire amount was available for future borrowings after consideration of covenant limitations. The facility matures in July 2010. The facility contains certain financial covenants and bears interest at a rate equal to, at our option, either (a) the greater of the bank's prime rate or the federal funds rate plus 0.5% or (b) the London Interbank Offered Rate plus a margin equal to 0.475% to 1.20% depending upon the ratio of total funded debt-to-adjusted earnings before interest, taxes, depreciation and amortization ("Adjusted EBITDA"), as defined in the facility. We pay a facility fee, depending upon the ratio of total funded debt to Adjusted EBITDA, equal to 0.15% to 0.30% of the capacity. The facility includes restrictive covenants that limit our ability to incur additional indebtedness, encumber our assets, sell our assets and make certain payments, including amounts for share repurchases and dividends.

Our domestic revolving and term loans contain certain financial covenant restrictions. As of September 30, 2007, we believe we were in compliance with all covenant requirements. Our facility and promissory notes are guaranteed by our material subsidiaries.

We have additional borrowing capacity through several foreign facilities governed by agreements between us and a syndicate of banks, used primarily to finance seasonal borrowing needs of our foreign subsidiaries. We had \$4.8 million of obligations outstanding through our foreign subsidiaries as of September 30, 2007.

As of September 30, 2007, \$18.0 million of cash and cash equivalents was restricted primarily due to routine lockbox collections and letters of credit issued with respect to the operations of our captive insurance subsidiary, which expire on December 31, 2007. These letter of credit restrictions can be transferred to our revolving lines of credit as needed.

On October 12, 2007, we entered into a \$650 million Third Amended and Restated Revolving Credit Facility Agreement (the "Credit Agreement") with Bank of America, N.A., as administrative agent, swingline lender and issuing bank (the "Administrative Agent"), JPMorgan Chase Bank, N.A. and Wachovia Bank, National Association, as co-syndication agents, and the lenders party thereto. The Credit Agreement replaces our previous domestic revolving credit facility, the Second Amended and Restated Credit Facility Agreement, dated as of July

Table of Contents

8, 2005, among us, Bank of America, N.A., as administrative agent, JPMorgan Chase Bank, N.A., as syndication agent, and the lenders named therein.

The Credit Agreement provides for an unsecured \$650 million revolving credit facility that matures on October 12, 2012. The revolving credit facility includes a subfacility for swingline loans of up to \$50 million and provides for the issuance of letters of credit for the full amount of the credit facility. The revolving loans bear interest at either (i) the Eurodollar rate plus a margin of between 0.5% and 1% that is based on the Company's Debt to Adjusted EBITDA Ratio (as defined in the Credit Agreement) or (ii) the higher of (a) the Federal Funds Rate plus 0.5% and (b) the prime rate set by Bank of America, N.A. We may prepay the revolving loans at any time without premium or penalty, other than customary breakage costs in the case of Eurodollar loans.

We will pay a facility fee in the range of 0.125% to 0.25% based on our Debt to Adjusted EBITDA Ratio. We will also pay a letter of credit fee in the range of 0.5% to 1% based on our Debt to Adjusted EBITDA Ratio.

The Credit Agreement contains financial covenants relating to leverage and interest coverage. Other covenants contained in the Credit Agreement restrict, among other things, mergers, asset dispositions, guarantees, debt, liens, acquisitions, investments, affiliate transactions and our ability to make restricted payments.

The Credit Agreement contains customary events of default. If any event of default occurs and is continuing, lenders with a majority of the aggregate commitments may require the Administrative Agent to terminate our right to borrow under the Credit Agreement and accelerate amounts due under the Credit Agreement (except for a bankruptcy event of default, in which case such amounts will automatically become due and payable and the lenders' commitments will automatically terminate).

Our obligations under the Credit Agreement are guaranteed by certain of our material domestic subsidiaries, including Lennox Industries Inc., Allied Air Enterprises Inc., Service Experts Inc. and Lennox Global Ltd.

On July 25, 2007, we announced that our Board of Directors approved a new share repurchase plan for \$500 million, pursuant to which we plan to repurchase shares of our common stock through open market purchases. Based on the closing price of our common stock on July 24, 2007, a \$500 million repurchase would represent over 20% of our market capitalization. We currently intend to fund the stock repurchases through a combination of cash from operations and third party borrowings and to fully execute the repurchase by the end of the third quarter of 2008. The 2007 Share Repurchase Plan terminates and replaces the 2005 Share Repurchase Plan.

We periodically review our capital structure, including our primary bank facility, to ensure that it has adequate liquidity. We believe that cash flows from operations, as well as available borrowings under our amended revolving credit facility and other existing sources of funding, will be sufficient to fund our operations and the share repurchases during the term of the new share repurchase plan.

Off-Balance Sheet Arrangements

In addition to the revolving and term loans described above, we utilize the following financing arrangements in the course of funding our operations:

- Trade accounts receivable are sold on a non-recourse basis to third parties. The sales are reported as a reduction of Accounts and Notes Receivable, Net in the Consolidated Balance Sheets. As of September 30, 2007 and December 31, 2006, respectively, we had not sold any of such accounts receivable. If receivables are sold, the related discount from face value is included in Selling, General and Administrative Expense in the Consolidated Statements of Operations.
- We also lease real estate and machinery and equipment pursuant to leases that, in accordance with Generally Accepted Accounting Principles, are not capitalized on the balance sheet, including high-turnover equipment such as automobiles and service vehicles and short-lived equipment such as personal computers.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Our results of operations can be affected by changes in exchange rates. Net sales and expenses in foreign currencies are translated into United States dollars for financial reporting purposes based on the average

[Table of Contents](#)

exchange rate for the period. Net sales from outside the United States represented 26.4% and 22.6% and 25.6% and 21.4% of total net sales for the third quarter ended and year-to-date through September 30, 2007 and 2006, respectively. Historically, foreign currency transaction gains (losses) have not had a material effect on our overall operations. The impact of a 10% change in exchange rates on income from operations is estimated to be approximately \$6.4 million on an annual basis.

We enter into commodity futures contracts to stabilize prices expected to be paid for raw materials and parts containing high copper and aluminum content. These contracts are for quantities equal to or less than quantities expected to be consumed in future production. As of September 30, 2007, we had metal futures contracts maturing at various dates through February 2009 with a fair value as an asset of \$11.3 million. The impact of a 10% change in commodity prices would have a significant impact on our results from operations on an annual basis, absent any other contravening actions.

Our results of operations can be affected by changes in interest rates due to variable rates of interest on our revolving credit facilities. A 10% change in interest rates would not be material to our results of operations.

Item 4. Controls and Procedures.

Disclosure Controls and Procedures

We carried out an evaluation, under the supervision and with the participation of our current management, including our Chief Executive Officer and Chief Financial Officer (our principal executive officer and principal financial officer, respectively) of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of September 30, 2007 in alerting them in a timely manner to material information required to be disclosed by us in the reports we filed or submitted to the Securities and Exchange Commission under the Securities Exchange Act of 1934.

Changes in Internal Control Over Financial Reporting

During the quarter ended September 30, 2007, there were no changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II — OTHER INFORMATION**Item 1. Legal Proceedings**

There have been no significant changes concerning our legal proceedings since June 30, 2007.

See Note 16 in the Notes to the Consolidated Financial Statements set forth in Part I, Item 1, of this Quarterly Report on Form 10-Q for additional discussion regarding our legal proceedings.

Item 1A. Risk Factors.

In addition to the other information set forth in this Quarterly Report on Form 10-Q, you should carefully consider the risk factors discussed in Part I, “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2006, which could materially affect our business, financial condition or results of operations. There have been no material changes in our risk factors from those disclosed in our 2006 Annual Report on Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**ISSUER PURCHASES OF EQUITY SECURITIES (1)**

<u>Period</u>	<u>Total Number of Shares Purchased (2)</u>	<u>Average Price Paid per Share (including fees) (2)</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)</u>	<u>Approximate Dollar Value of Shares that may yet be Purchased Under the Plans or Programs (1)</u>
July 1 through July 31	12,385	\$ 34.49	—	\$ 500,000,000
August 1 through August 31	2,254,753	\$ 34.46	2,252,400	\$ 422,396,682
September 1 through September 30	<u>777,901</u>	\$ 34.41	<u>773,700</u>	\$ 395,780,523
	3,045,039	\$ 34.44	<u>3,026,100</u>	
AOC Restructuring (3)	<u>2,695,770</u>			
Total	<u>5,740,809</u>			

- (1) On July 25, 2007, we announced that our Board of Directors approved a new share repurchase plan for \$500 million, pursuant to which we plan to repurchase shares of our common stock, par value \$.01 per share, through open market-purchases (the “2007 Share Repurchase Plan”). The 2007 Share Repurchase Plan terminates and replaces the share repurchase plan approved by our Board of Directors in September 2005 (the “2005 Share Repurchase Plan”). In addition, on August 3, 2007, we entered into a written trading plan under Rule 10b5-1 of the Securities Exchange Act of 1934, as amended (the “10b5-1 Plan”), to facilitate share repurchases under the 2007 Share Repurchase Plan. The 10b5-1 Plan became effective on September 4, 2007 and will terminate on February 8, 2008. Prior to July 25, 2007, we had repurchased 7,615,041 shares of common stock under the 2005 Share Repurchase Plan.
- (2) In addition to purchases under the 2005 Share Repurchase Plan and 2007 Share Repurchase Plan, this column reflects the surrender to us of 18,939 shares of common stock to satisfy tax withholding obligations in connection with the exercise of stock appreciation rights.
- (3) We acquired 2,695,770 shares of our common stock owned by members of A.O.C. Corporation in exchange for 2,239,563 newly issued common shares. The transaction reduced the number of outstanding shares of

[Table of Contents](#)

our common stock by 456,207 shares at minimal cost to us. For more information see Note 19 in the Notes to our Consolidated Financial Statements.

Item 5. Other Information.

To streamline our management structure, we have made the decision to eliminate the position of Executive Vice President, IT and Business Development, currently held by Linda A. Goodspeed. Accordingly, on October 26, 2007, we informed Ms. Goodspeed that we will not renew her existing employment agreement which presently expires on December 31, 2007. We do not expect any charges related to her existing employment agreement to be material to our financial statements.

Item 6. Exhibits

- 3.1 — Restated Certificate of Incorporation of the Lennox International Inc. (“LII”) (filed as Exhibit 3.1 to LII’s Registration Statement on Form S-1 (Registration Statement No. 333-75725) filed on April 6, 1999 and incorporated herein by reference).
- 3.2 — Amended and Restated Bylaws of LII (filed as Exhibit 3.1 to LII’s Current Report on Form 8-K filed on July 25, 2007 and incorporated herein by reference).
- 4.1 — Specimen Stock Certificate for the Common Stock, par value \$.01 per share, of LII (filed as Exhibit 4.1 to LII’s Amendment to Registration Statement on Form S-1/A (Registration No. 333-75725) filed on June 16, 1999 and incorporated herein by reference).
- 4.2 — Rights Agreement, dated as of July 27, 2000, between LII and ChaseMellon Shareholder Services, L.L.C., as Rights Agent, which includes as Exhibit A the form of Certificate of Designations of Series A Junior Participating Preferred Stock setting forth the terms of the Preferred Stock, as Exhibit B the form of Rights Certificate and as Exhibit C the Summary of Rights to Purchase Preferred Stock (filed as Exhibit 4.1 to LII’s Current Report on Form 8-K filed on July 28, 2000 and incorporated herein by reference).

LII is a party to several debt instruments under which the total amount of securities authorized under any such instrument does not exceed 10% of the total assets of LII and its subsidiaries on a consolidated basis. Pursuant to paragraph 4(iii)(A) of Item 601(b) of Regulation S-K, LII agrees to furnish a copy of such instruments to the Securities and Exchange Commission upon request.

- 31.1 — Certification of the principal executive officer (filed herewith).
- 31.2 — Certification of the principal financial officer (filed herewith).
- 32.1 — Certification of the principal executive officer and the principal financial officer of the Company pursuant to 18 U.S.C. Section 1350 (filed herewith).

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

LENNOX INTERNATIONAL INC.

Date: October 31, 2007

/s/ Susan K. Carter

Susan K. Carter
Chief Financial Officer
(on behalf of registrant and as principal financial officer)

CERTIFICATION

I, Todd M. Bluedorn, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Lennox International Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 31, 2007

/s/ Todd M. Bluedorn

Todd M. Bluedorn
Chief Executive Officer

CERTIFICATION

I, Susan K. Carter, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Lennox International Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 31, 2007

/s/ Susan K. Carter

Susan K. Carter
Chief Financial Officer

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Lennox International Inc. (the "Company") on Form 10-Q for the quarter ended September 30, 2007 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), each of the undersigned, Todd M. Bluedorn, Chief Executive Officer of the Company, and Susan K. Carter, Chief Financial Officer of the Company, certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002, that to his or her knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Todd M. Bluedorn

Todd M. Bluedorn
Chief Executive Officer

October 31, 2007

/s/ Susan K. Carter

Susan K. Carter
Chief Financial Officer

October 31, 2007

A signed original of this written statement has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request. The foregoing certification is being furnished to the Securities and Exchange Commission as an exhibit to the report.