

WESCO FINANCIAL CORP

Form 10-Q

November 07, 2006

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**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, 2006 or**

☐ **Transition report pursuant to section 13 or 15 (d) of the Securities Exchange Act of 1934
For the transition period from _____ to**

Commission file number 1-4720

WESCO FINANCIAL CORPORATION

(Exact name of Registrant as Specified in its Charter)

DELAWARE

95-2109453

(State or Other Jurisdiction of
incorporation or organization)

(I.R.S. Employer Identification No.)

301 East Colorado Boulevard, Suite 300, Pasadena,
California

91101-1901

(Address of Principal Executives Offices)

(Zip Code)

626/585-6700

(Registrant's Telephone Number, Including Area Code)

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

Yes : ☒ No ☐

Indicate by check mark whether 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 Exchange Act.

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 Exchange Act).

Yes ☐ No : ☒

**APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS
DURING THE PRECEDING FIVE YEARS**

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Section 12, 13 or 15 (d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

Yes ☐ No ☐

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. 7,119,807 as of October 31, 2006

PART I. FINANCIAL INFORMATION

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Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Reference is made to Item 7A, Quantitative and Qualitative Disclosures About Market Risk, appearing on pages 34 and 35 of the Form 10-K Annual Report for the year ended December 31, 2005, filed by Wesco Financial Corporation (Wesco), for information on equity price risk and interest rate risk at Wesco. There have been no material changes through September 30, 2006.

Item 4. Controls and Procedures.

An evaluation was performed under the supervision and with the participation of the management of Wesco, including Charles T. Munger (Chief Executive Officer) and Jeffrey L. Jacobson (Chief Financial Officer), of the effectiveness of the design and operation of Wesco's disclosure controls and procedures as of December 31, 2005. Based on that evaluation, Messrs. Munger and Jacobson concluded that the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in reports it files or submits under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported as specified in the rules and forms of the Securities Exchange Commission, and are effective to ensure that information required to be disclosed by Wesco in the reports it files or submits under the Exchange Act, as amended, is accumulated and communicated to Wesco's management, including Mr. Munger and Mr. Jacobson, as appropriate to allow timely decisions regarding required disclosure. There have been no significant changes in Wesco's internal control over financial reporting during the quarter ended September 30, 2006 that have materially affected or are reasonably likely to materially affect the internal control over financial reporting except that the Company's CORT Business Services subsidiary (CORT) has undertaken the implementation of a revenue, inventory and receivables system for its operating districts. As of September 30, 2006, a material number of its operating districts have migrated to the new system. This ongoing implementation has been, and continues to be, subject to various levels of testing, including a detailed reconciliation and review of data migrated from the previous environment to the new environment. Implementation of this new financial reporting sub-system necessarily involves changes to CORT's financial reporting procedures and controls. Wesco's management believes that appropriate internal controls are in place with CORT's new financial reporting sub-system.

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PART II. OTHER INFORMATION

Item 1A. Risk Factors

Reference is made to Item 1A, Risk Factors, appearing on pages 15 through 18 of the Form 10-K Annual Report for the year ended December 31, 2005, filed by Wesco, for information regarding the most significant factors affecting Wesco's operations. There have been no material changes in these factors through September 30, 2006.

Item 6. Exhibits

- 31 (a) Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Chief Executive Officer)
- 31 (b) Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Chief Financial Officer)
- 32 (a) Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Chief Executive Officer)
- 32 (b) Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Chief Financial Officer)

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WESCO FINANCIAL CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEET

(Dollar amounts in thousands)

(Unaudited)

	Sept. 30, 2006	Dec. 31, 2005
ASSETS		
Cash and cash equivalents	\$ 1,241,263	\$ 1,194,113
Investments:		
Securities with fixed maturities	67,124	74,441
Marketable equity securities	988,208	884,673
Rental furniture	196,732	187,572
Goodwill of acquired businesses	266,607	266,607
Other assets	145,359	121,105
	\$ 2,905,293	\$ 2,728,511
LIABILITIES AND SHAREHOLDERS' EQUITY		
Insurance losses and loss adjustment expenses		
Affiliated business	\$ 23,922	\$ 19,697
Unaffiliated business	50,400	42,283
Unearned insurance premiums		
Affiliated business	13,670	12,301
Unaffiliated business	14,285	16,092
Deferred furniture rental income and security deposits	23,252	22,204
Notes payable	50,200	42,300
Income taxes payable, principally deferred	329,293	290,615
Other liabilities	52,570	52,587
	557,592	498,079
Shareholders' equity:		
Capital stock and additional paid-in capital	33,324	33,324
Unrealized appreciation of investments, net of taxes	311,101	256,710
Retained earnings	2,003,276	1,940,398
Total shareholders' equity	2,347,701	2,230,432
	\$ 2,905,293	\$ 2,728,511

See notes beginning on page 7.

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WESCO FINANCIAL CORPORATION
CONDENSED CONSOLIDATED STATEMENT OF
INCOME AND RETAINED EARNINGS

(Dollar amounts in thousands except for amounts per share)
(Unaudited)

	Three Months Ended		Nine Months Ended	
	Sept. 30, 2006	Sept. 30, 2005	Sept. 30, 2006	Sept. 30, 2005
Revenues:				
Furniture rentals	\$ 83,323	\$ 77,748	\$ 246,019	\$ 227,152
Sales and service revenues	35,745	37,315	107,972	107,654
Insurance premiums earned				
Affiliated business	7,069	7,171	20,565	21,600
Unaffiliated business	8,804	6,024	23,839	16,350
Dividend and interest income	22,071	14,547	61,582	40,103
Realized investment gains				774
Other	941	895	2,774	2,643
	157,953	143,700	462,751	416,276
Costs and expenses:				
Cost of products and services sold	39,519	40,108	117,180	115,064
Insurance losses and loss adjustment expenses				
Affiliated business	3,708	2,638	8,443	7,534
Unaffiliated business	6,540	4,942	14,982	8,401
Insurance underwriting expenses				
Affiliated business	1,976	1,800	4,941	4,386
Unaffiliated business	3,280	3,117	7,123	5,759
Selling, general and administrative expenses	67,073	67,218	201,067	197,968
Interest expense	775	375	2,033	894
	122,871	120,198	355,769	340,006
Income before income taxes	35,082	23,502	106,982	76,270
Income taxes	11,569	5,636	36,307	20,797
Net income	23,513	17,866	70,675	55,473
Retained earnings beginning of period	1,982,362	1,688,481	1,940,398	1,655,929
Cash dividends declared and paid	(2,599)	(2,528)	(7,797)	(7,583)
Retained earnings end of period	\$ 2,003,276	\$ 1,703,819	\$ 2,003,276	\$ 1,703,819

Amounts per capital share based on 7,119,807
shares outstanding throughout each period:

Net income	\$	3.31	\$	2.51	\$	9.93	\$	7.79
Cash dividends	\$.365	\$.355	\$	1.095	\$	1.065

See notes beginning on page 7.

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WESCO FINANCIAL CORPORATION
CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

(Dollar amounts in thousands)

(Unaudited)

	Nine Months Ended	
	Sept. 30, 2006	Sept. 30, 2005
Cash flows from operating activities, net	\$ 89,541	\$ 70,864
Cash flows from investing activities:		
Sales, maturities and redemptions of securities with fixed maturities	28,390	36,558
Purchases of equity securities	(18,855)	
Purchases of securities with fixed maturities	(21,691)	(16,178)
Purchases of rental furniture	(72,501)	(79,658)
Sales of rental furniture	53,569	54,643
Other, net	(11,406)	(5,250)
Net cash flows from investing activities	(42,494)	(9,885)
Cash flows from financing activities:		
Net increase in notes payable, principally line of credit	7,900	8,975
Payment of cash dividends	(7,797)	(7,583)
Net cash flows from financing activities	103	1,392
Increase in cash and cash equivalents	47,150	62,371
Cash and cash equivalents beginning of period	1,194,113	1,161,163
Cash and cash equivalents end of period	\$ 1,241,263	\$ 1,223,534
Supplementary information:		
Interest paid during period	\$ 1,642	\$ 1,216
Income taxes paid, net, during period	27,020	29,032

See notes beginning on page 7.

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WESCO FINANCIAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollar amounts in thousands except for amounts per share)

(Unaudited)

Note 1.

The unaudited condensed consolidated financial statements of which these notes are an integral part include the accounts of Wesco Financial Corporation ("Wesco") and its subsidiaries. In management's opinion, such statements reflect all adjustments (all of them of a normal recurring nature) necessary to a fair statement of interim results in accordance with accounting principles generally accepted in the United States.

Reference is made to the notes to Wesco's consolidated financial statements appearing on pages 46 through 57 of its 2005 Form 10-K Annual Report for other information deemed generally applicable to the condensed consolidated financial statements. In particular, Wesco's significant accounting policies and practices are set forth in Note 1 on pages 46 through 48.

In July 2006, the Financial Accounting Standards Board (the "FASB") issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109* ("FIN 48"), which requires expanded disclosure and clarifies the accounting for uncertainty of income tax positions taken or expected to be taken in income tax returns when it is likely that an examination of the tax returns will result in the assessment of additional taxes. FIN 48 requires the recognition in the financial statements of the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN 48 will be effective as of the beginning of 2007, with the cumulative effect, if any, of the change in accounting principle recorded as an adjustment to opening retained earnings. Wesco is currently evaluating the impact on its consolidated financial statements of adopting FIN 48. Wesco does not believe that the adoption of FIN 48 or any other accounting pronouncements issued by the FASB that are required to be adopted after September 30, 2006 will likely have a material effect on its consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106 and 132(R)* ("SFAS 158"), which requires recognition of the overfunded or underfunded status of a company's defined benefit pension and other postretirement plan as an asset or liability in the consolidated balance sheet, and the recognition of changes in the funded status of a company's postretirement plans, whose changes are not recognized through periodic earnings, to be reported as a component of other comprehensive income. Wesco does not believe that the adoption of SFAS 158 will have a material effect on its consolidated financial statements when adopted as of yearend 2006.

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The following table sets forth Wesco's consolidated comprehensive income for the three- and nine-month periods ended September 30, 2006 and 2005:

	Three Months Ended		Nine Months Ended	
	Sept. 30, 2006	Sept. 30, 2005	Sept. 30, 2006	Sept.. 30, 2005
Net income	\$ 23,513	\$ 17,866	\$ 70,675	\$ 55,473
Increase in unrealized appreciation of investments, net of income tax effect of \$24,977, \$22,045, \$29,567 and \$32,189	46,097	41,106	54,391	59,975
Comprehensive income	\$ 69,610	\$ 58,972	\$ 125,066	\$ 115,448

Note 3.

Following is a summary of securities with fixed maturities:

	Sept. 30, 2006	Dec. 31, 2005
Amortized cost	\$ 66,246	\$ 72,841
Gross unrealized gains	897	1,606
Gross unrealized losses	(19)	(6)
Fair value	\$ 67,124	\$ 74,441

Following is a summary of marketable equity securities (all common stocks):

	Sept. 30, 2006	Dec. 31, 2005
Total cost	\$ 511,004	\$ 492,148
Gross unrealized gains	477,204	402,789
Gross unrealized losses		(10,264)
Fair value	\$ 988,208	\$ 884,673
Fair value:		
The Procter & Gamble Company	\$ 443,436	\$ 414,103
The Coca-Cola Company	321,946	290,458
Other	222,826	180,112
Fair value	\$ 988,208	\$ 884,673

Dollar amounts in thousands except for amounts per share

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Effective as of yearend 2005, proceeds from the sales of rental furniture are classified on the consolidated statement of cash flows in the category of investing activities, consistent with the classification of cash used for the purchases of rental furniture. In prior periods, proceeds from sales of rental furniture had been included in operating cash flows in Wesco's consolidated statements of cash flows. Reference is made to Note 9 to Wesco's consolidated financial statements appearing on page 54 of its 2005 Form 10-K Annual Report for a more complete explanation of the reclassification.

The following table shows the effects of the reclassification on data presented in the condensed consolidated statement of cash flows for the nine-month period ended September 30, 2005.

Net cash flows from operating activities as previously reported	\$ 125,507
Reclassification	(54,643)
Revised net cash flows from operating activities	\$ 70,864
Net cash flows from investing activities as previously reported	\$ (64,528)
Reclassification	54,643
Revised net cash flows from investing activities	\$ (9,885)

Note 5.

Federal and state environmental agencies have made claims relating to alleged contamination of soil and groundwater with trichloroethylene and perchloroethylene against Precision Brand Products (PBP), whose results, like those of its parent, Precision Steel, are included in Wesco's industrial segment, and various other businesses situated in an industrial park in Downers Grove, Illinois. PBP, along with the other businesses, has been negotiating remedial actions with various governmental entities.

To date, PBP has recorded provisions aggregating \$1,293 (\$778, after taxes), representing the estimated share of its costs of remediation agreed to with governmental entities and other parties, and related expenses. Several of PBP's and Precision Steel's insurers have undertaken the cost of their defense and have agreed to indemnify them within the policy limits in connection with the matters, but have reserved their rights retroactively to decline coverage and receive reimbursement of amounts paid. To date, PBP has recovered \$522 (\$313, after taxes) from its insurers.

PBP, Precision Steel, and other parties have been named in several civil lawsuits brought by and on behalf of area residents relating to this alleged contamination. Muniz v. Precision Brand Products, Inc., et al., filed in April 2004 in the U.S. District Court for the Northern District of Illinois (the Court), is a class action alleging that PBP and the other defendants caused diminution in property values of nearby homes and put the residents at an increased risk of contracting cancer. The Court has granted the plaintiffs' motion to certify the class on liability issues, but not on damages. The plaintiffs have recently agreed, in arbitration, to a group settlement aggregating \$15,750, following which each of the thirteen plaintiffs, including PBP, deposited \$1,211 into an escrow account. The agreement has been approved by the Court on a preliminary basis, with

Dollar amounts in thousands except for amounts per share

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finalization expected to occur early in the fourth quarter of 2006, after which the funds are expected to be released to the plaintiffs. Each defendant's \$1,211 payment is subject to reallocation among the group based on each defendant's relative responsibility for the contamination, to be determined by arbitration, if possible, or otherwise, by sampling and analysis of the soils and groundwater. Although PBP's and Precision Steel's insurers had undertaken their defense of this matter, PBP and Precision are involved in negotiations with the insurers as to amounts ultimately to be collected from them. Inasmuch as the ultimate financial responsibility of each defendant has not yet been determined, and negotiations with the insurance companies have not yet been concluded, it is difficult to estimate the ultimate cost, including the impact of insurance proceeds, that will be borne by PBP and Precision Steel, and thus reflected in Wesco's consolidated financial statements. Nevertheless, in the second quarter of 2006, a provision of \$750 (\$450, after income tax benefit) was recorded, reflecting an estimate of the cost expected ultimately to be borne by PBP, Precision Steel, and, thus Wesco, in settling this matter.

In Bendik v. Precision Brand Products, Inc. and Precision Steel Warehouse, Inc., filed in May 2003 in the Circuit Court of Cook County, Illinois, the plaintiff claims that her exposure to contaminants allegedly released by PBP and Precision caused her to contract cancer. The plaintiff seeks unspecified compensatory and punitive damages. PBP and Precision have filed third party actions against a number of other companies who were or are located in the industrial park. Because settlement mediation and independent discussions have been unsuccessful thus far, PBP is planning soon to undertake the sampling and analysis of soils and groundwater in an effort to assess the extent to which contamination from the industrial park may have migrated to the pumping wells that served the plaintiff's home. The matter has been assigned to a pre-trial judge for potential settlement discussions. PBP is negotiating coverage matters with its insurers. Pote vs. Precision Brand Products, Inc. and Precision Steel Warehouse, Inc., filed in December 2004 in the same court as the Bendik matter, is a wrongful death action brought by the Estate of Ralph Pote pending against PBP and Precision Steel and other companies who were or are located in the industrial park, alleging that the defendants released contaminants into the soil and groundwater and that exposure to such contaminants was ultimately responsible for the death of Mr. Pote. This matter has been consolidated with the Bendik matter for purposes of discovery. The plaintiff seeks unspecified compensatory damages, but has preserved the ability to request punitive damages in the future. A third party defendant who recently named Wesco as a cross-defendant in the Bendik and Muniz lawsuits, has dropped Wesco as a defendant in these matters.

Management anticipates that additional provisions with respect to such remediation and related legal matters may be required in the future, and expects that the insurers will continue to provide defenses and reimbursement of some of the costs previously recorded. However, as of September 30, 2006, it was not possible to reasonably estimate the amount, if any, of additional loss or a range of losses that may be required in connection with these matters, or any related benefit from insurance indemnification. Although it is not expected that the ultimate impact of such future costs will be material in relation to Wesco's shareholders' equity, the effect on industrial segment and consolidated net income in any given period could be material.

Dollar amounts in thousands except for amounts per share

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Following is condensed consolidated financial information for Wesco, by business segment:

	Three Months Ended		Nine Months Ended	
	Sept. 30, 2006	Sept. 30, 2005	Sept. 30, 2006	Sept. 30, 2005
Insurance segment:				
Revenues	\$ 37,686	\$ 27,505	\$ 105,233	\$ 77,390
Net income	15,529	10,458	48,058	37,460
Assets at end of period	2,295,562	2,146,293	2,295,562	2,146,293
Furniture rental segment:				
Revenues	\$ 103,307	\$ 99,624	\$ 304,945	\$ 288,415
Net income	7,645	6,986	21,281	16,317
Assets at end of period	265,551	257,215	265,551	257,215
Industrial segment:				
Revenues	\$ 15,771	\$ 15,439	\$ 49,056	\$ 46,391
Net income	270	185	1,209	823
Assets at end of period	19,452	18,520	19,452	18,520
Goodwill of acquired businesses, included in assets at end of period	\$ 266,607	\$ 266,607	\$ 266,607	\$ 266,607
Realized investment gains:				
Before taxes (included in revenues)	\$	\$	\$	\$ 774
After taxes (included in net income)				503
Other items unrelated to business segments:				
Revenues	\$ 1,189	\$ 1,132	\$ 3,517	\$ 3,306
Net income	69	237	127	370
Assets at end of period	58,121	39,659	58,121	39,659
Consolidated totals:				
Revenues	\$ 157,953	\$ 143,700	\$ 462,751	\$ 416,276
Net income	23,513	17,866	70,675	55,473
Assets at end of period	2,905,293	2,728,294	2,905,293	2,728,294

Dollar amounts in thousands except for amounts per share

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WESCO FINANCIAL CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Reference is made to Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations appearing on pages 22 through 36 of the Form 10-K Annual Report filed by Wesco Financial Corporation (Wesco) for the year 2005 for information deemed generally appropriate to an understanding of the accompanying condensed consolidated financial statements. The information set forth in the following paragraphs updates such discussion. Further, in reviewing the following paragraphs, attention is directed to the accompanying unaudited condensed consolidated financial statements.

OVERVIEW

Financial Condition

Wesco continues to have a strong balance sheet at September 30, 2006, with relatively little debt. Liquidity, which has traditionally been high, has been even higher than usual for the past several years due principally to sales, maturities and redemptions of fixed-maturity investments, and reinvestment of the proceeds in cash equivalents pending redeployment.

Results of Operations

After-tax earnings improved in 2006 from the corresponding 2005 amounts principally due to increased investment income earned by the insurance segment resulting mainly from increased interest rates on short-term investments, and improved results of the furniture rental segment, partially offset by decreased underwriting income of the insurance businesses.