

DIAMOND OFFSHORE DRILLING INC

Form 10-Q

November 03, 2006

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**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, 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 1-13926

DIAMOND OFFSHORE DRILLING, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation
or organization)

76-0321760
(I.R.S. Employer
Identification No.)

15415 Katy Freeway
Houston, Texas
77094

(Address of principal executive offices)
(Zip Code)

(281) 492-5300

(Registrant's telephone number, including area code)

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

Yes 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 Exchange Act. (Check one):

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

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

As of October 30, 2006 Common stock, \$0.01 par value per share 129,182,574 shares

**DIAMOND OFFSHORE DRILLING, INC.
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QUARTER ENDED SEPTEMBER 30, 2006**

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CONSOLIDATED BALANCE SHEETS**

(Unaudited)

(In thousands, except per share data)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 688,179	\$ 842,590
Marketable securities	100,406	2,281
Accounts receivable	448,179	357,104
Rig inventory and supplies	48,654	47,196
Prepaid expenses and other	58,515	32,707
Total current assets	1,343,933	1,281,878
Drilling and other property and equipment, net of accumulated depreciation	2,526,965	2,302,020
Other assets	23,247	23,024
Total assets	\$ 3,894,145	\$ 3,606,922
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 74,355	\$ 60,976
Accrued liabilities	182,371	169,037
Taxes payable	15,939	38,973
Total current liabilities	272,665	268,986
Long-term debt	965,796	977,654
Deferred tax liability	462,141	445,094
Other liabilities	77,807	61,861
Total liabilities	1,778,409	1,753,595
Commitments and contingencies (Note 9)		
Stockholders equity:		
Common stock (par value \$0.01, 500,000,000 shares authorized, 134,099,374 shares issued and 129,182,574 shares outstanding at September 30, 2006; 133,842,429 shares issued and 128,925,629 shares outstanding at December 31, 2005)	1,341	1,338
Additional paid-in capital	1,296,798	1,277,934
Retained earnings	931,945	688,459

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Accumulated other comprehensive gains	65	9
Treasury stock, at cost (4,916,800 shares at September 30, 2006 and December 31, 2005)	(114,413)	(114,413)
Total stockholders' equity	2,115,736	1,853,327
Total liabilities and stockholders' equity	\$ 3,894,145	\$ 3,606,922

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

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Table of Contents**DIAMOND OFFSHORE DRILLING, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS**

(Unaudited)

(In thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Revenues:				
Contract drilling	\$ 498,453	\$ 300,535	\$ 1,431,496	\$ 823,222
Revenues related to reimbursable expenses	16,003	9,987	42,878	29,457
Total revenues	514,456	310,522	1,474,374	852,679
Operating expenses:				
Contract drilling	224,883	160,537	599,271	471,240
Reimbursable expenses	13,982	8,350	37,083	24,784
Depreciation	49,757	46,494	148,858	137,944
General and administrative	9,959	8,928	29,786	27,587
(Gain) loss on sale of assets	(272)	(761)	2,191	(8,753)
Casualty gain on <i>Ocean Warwick</i>		(33,605)		(33,605)
Total operating expenses	298,309	189,943	817,189	619,197
Operating income	216,147	120,579	657,185	233,482
Other income (expense):				
Interest income	10,037	6,078	26,843	17,974
Interest expense	(6,128)	(8,341)	(18,678)	(33,664)
Gain (loss) on sale of marketable securities	149	(12)	(53)	(1,209)
Other, net	2,842	1,115	6,608	1,985
Income before income tax expense	223,047	119,419	671,905	218,568
Income tax expense	(58,597)	(37,380)	(186,413)	(65,129)
Net income	\$ 164,450	\$ 82,039	\$ 485,492	\$ 153,439
Income per share:				
Basic	\$ 1.27	\$ 0.64	\$ 3.76	\$ 1.19
Diluted	\$ 1.19	\$ 0.60	\$ 3.52	\$ 1.14

Weighted average shares outstanding:

Shares of common stock	129,172	128,748	129,110	128,638
Dilutive potential shares of common stock	9,617	9,819	9,664	9,551
Total weighted average shares outstanding	138,789	138,567	138,774	138,189

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

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CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited)

(In thousands)

	Nine Months Ended September 30,	
	2006	2005
Operating activities:		
Net income	\$ 485,492	\$ 153,439
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	148,858	137,944
Casualty gain on <i>Ocean Warwick</i>		(33,605)
Loss (gain) on sale and disposition of assets	2,191	(8,753)
Loss on sale of marketable securities, net	53	1,209
Deferred tax provision	17,017	54,085
Accretion of discounts on marketable securities	(8,999)	(5,884)
Amortization of debt issuance costs	648	7,557
Accretion of discounts on long-term debt	309	7,339
Stock-based compensation expense	2,281	
Excess tax benefits from stock-based payment arrangements	(1,156)	
Changes in operating assets and liabilities:		
Accounts receivable	(91,135)	(110,995)
Rig inventory and supplies and other current assets	(5,417)	(7,973)
Accounts payable and accrued liabilities	29,481	16,354
Taxes payable	(43,348)	575
Other items, net	(137)	3,234
Net cash provided by operating activities	536,138	214,526
Investing activities:		
Capital expenditures	(367,718)	(187,066)
Proceeds from sale of assets, net of disposal costs	(349)	19,551
Proceeds from casualty loss of <i>Ocean Warwick</i>		44,088
Proceeds from sale and maturities of marketable securities	1,638,092	4,863,752
Purchases of marketable securities	(1,727,185)	(4,511,361)
Proceeds from maturities of Australian dollar time deposits		11,761
Proceeds from settlement of forward contracts	4,517	939
Net cash (used by) provided by investing activities	(452,643)	241,664
Financing activities:		
Issuance of 4.875% senior unsecured notes		249,462
Debt issue costs		(1,866)
Excess tax benefits from share-based payment arrangements	1,156	
Redemption of zero coupon debentures		(460,015)

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Payment of quarterly and special dividends	(242,006)	(32,159)
Proceeds from stock options exercised	2,944	9,565
Net cash used by financing activities	(237,906)	(235,013)
Effect of exchange rate changes on cash		(474)
Net change in cash and cash equivalents	(154,411)	220,703
Cash and cash equivalents, beginning of period	842,590	266,007
Cash and cash equivalents, end of period	\$ 688,179	\$ 486,710

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

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**DIAMOND OFFSHORE DRILLING, INC. AND SUBSIDIARIES
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

1. General Information

The unaudited consolidated financial statements of Diamond Offshore Drilling, Inc. and subsidiaries, which we refer to as Diamond Offshore, we, us or our, should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2005 (File No. 1-13926).

As of October 30, 2006 Loews Corporation, or Loews, owned 54.3% of our outstanding shares of common stock.

Interim Financial Information

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission, or SEC. Accordingly, pursuant to such rules and regulations, they do not include all disclosures required by generally accepted accounting principles, or GAAP, for complete financial statements. The consolidated financial information has not been audited but, in the opinion of management, includes all adjustments (consisting only of normal recurring accruals) necessary for a fair presentation of the consolidated balance sheets, statements of operations, and statements of cash flows at the dates and for the periods indicated. Results of operations for interim periods are not necessarily indicative of results of operations for the respective full years.

Cash and Cash Equivalents, Marketable Securities

We consider short-term, highly liquid investments that have an original maturity of three months or less and deposits in money market mutual funds that are readily convertible into cash to be cash equivalents.

We classify our investments in marketable securities as available for sale and they are stated at fair value in our Consolidated Balance Sheets. Accordingly, any unrealized gains and losses, net of taxes, are reported in our Consolidated Balance Sheets in Accumulated other comprehensive gains (losses) until realized. The cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity and such adjustments are included in our Consolidated Statements of Operations in Interest income. The sale and purchase of securities are recorded on the date of the trade. The cost of debt securities sold is based on the specific identification method. Realized gains or losses, as well as any declines in value that are judged to be other than temporary, are reported in our Consolidated Statements of Operations in Other income (expense).

Derivative Financial Instruments

Our derivative financial instruments include foreign currency forward exchange contracts and a contingent interest provision that is embedded in our 1.5% Convertible Senior Debentures Due 2031, or 1.5% Debentures, issued on April 11, 2001. See Note 5.

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We paid interest totaling \$29.1 million on long-term debt for the nine months ended September 30, 2006. During the nine months ended September 30, 2005, we paid interest totaling \$89.7 million on long-term debt, which included \$73.3 million in accreted interest paid in connection with the June 2005 partial redemption of our Zero Coupon Convertible Debentures due 2020, or Zero Coupon Debentures.

We paid \$5.2 million and \$5.4 million in foreign income taxes, net of foreign tax refunds, during the nine months ended September 30, 2006 and 2005, respectively. We paid \$199.4 million in U.S. income taxes during the nine months ended September 30, 2006. We received refunds of \$11.4 million and \$7.7 million in U.S. income taxes during the nine months ended September 30, 2006 and 2005, respectively.

During the nine months ended September 30, 2006, the holders of \$12.1 million accreted value, or \$19.9 million in principal amount at maturity, of our Zero Coupon Debentures and \$20,000 in principal amount of our 1.5% Debentures elected to convert their outstanding debentures into shares of our common stock. During the nine months ended September 30, 2005, the holders of \$13,000 in principal amount of our 1.5% Debentures elected to convert their outstanding debentures into shares of our common stock. See Note 8.

Capitalized Interest

We capitalize interest cost for the construction and upgrade of qualifying assets. In April 2005 and July 2006 we began capitalizing interest on expenditures related to the upgrades of the *Ocean Endeavor* and the *Ocean Monarch*, respectively, for ultra-deepwater service. In December 2005 and January 2006 we began capitalizing interest on expenditures related to the construction of our two jack-up rigs, the *Ocean Scepter* and *Ocean Shield*, respectively.

A reconciliation of our total interest cost to Interest expense as reported in our Consolidated Statements of Operations is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(In thousands)			
Total interest cost including amortization of debt issuance costs	\$ 8,895	\$8,590	\$25,577	\$34,000
Capitalized interest	(2,767)	(249)	(6,899)	(336)
Total interest expense as reported	\$ 6,128	\$8,341	\$18,678	\$33,664

Debt Issuance Costs

Debt issuance costs are included in our Consolidated Balance Sheets in Other assets and are amortized over the respective terms of the related debt. Interest expense for the nine months ended September 30, 2005 includes \$6.9 million in debt issuance costs that we wrote-off in connection with the June 2005 redemption of approximately 96% of our then outstanding Zero Coupon Debentures.

Treasury Stock

Depending on market conditions, we may, from time to time, purchase shares of our common stock in the open market or otherwise. We account for the purchase of treasury stock using the cost method, which reports the cost of the shares acquired in Treasury stock as a deduction from stockholders' equity in our Consolidated Balance Sheets. We did not repurchase any shares of our outstanding common stock during the nine months ended September 30, 2006 or 2005.

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A reconciliation of net income to comprehensive income is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
	(In thousands)			
Net income	\$ 164,450	\$ 82,039	\$ 485,492	\$ 153,439
Other comprehensive gains (losses), net of tax:				
Foreign currency translation gain (loss)		308		(102)
Unrealized holding gain (loss) on investments	80	(11)	118	14
Reclassification adjustment for gain included in net income		(5)	(62)	(90)
Comprehensive income	\$ 164,530	\$ 82,331	\$ 485,548	\$ 153,261

The tax effect related to the change in foreign currency translation gain (loss) was \$(29,000) and \$193,000 for the quarter and nine months ended September 30, 2005. The tax effect related to the change in unrealized holding gain (loss) on investments was \$(43,000) and \$6,000 for the quarters ended September 30, 2006 and 2005, respectively and \$(64,000) and \$(8,000) for the nine months ended September 30, 2006 and 2005, respectively. The tax effect on the reclassification adjustment for net gains included in net income was \$3,000 for the quarter ended September 30, 2005 and \$33,000 and \$48,000 for the nine months ended September 30, 2006 and 2005, respectively.

Currency Translation

Our functional currency is the U.S. dollar. Effective October 1, 2005, we changed the functional currency of certain of our subsidiaries operating outside the United States to the U.S. dollar to more appropriately reflect the primary economic environment in which our subsidiaries operate. Prior to this date, these subsidiaries utilized the local currency of the country in which they conducted business as their functional currency. As a result of this change, currency translation adjustments and transaction gains and losses, including gains and losses from the settlement of foreign currency forward exchange contracts, are reported as Other income (expense) in our Consolidated Statements of Operations. For the three and nine months ended September 30, 2006, we recognized net foreign currency exchange gains of \$3.1 million and \$7.2 million, respectively. We recognized net foreign currency exchange gains of \$1.0 million and \$1.9 million during the three and nine months ended September 30, 2005, respectively. See Note 5.

Revenue Recognition

Revenue from our dayrate drilling contracts is recognized as services are performed. In connection with such drilling contracts, we may receive lump-sum fees for the mobilization of equipment. These fees are earned as services are performed over the initial term of the related drilling contracts. We defer mobilization fees received, as well as direct and incremental mobilization costs incurred, and amortize each, on a straight-line basis, over the term of the related drilling contracts (which is the period estimated to be benefited from the mobilization activity). Straight-line amortization of mobilization revenues and related costs over the initial term of the related drilling contracts (which generally range from two to 60 months) is consistent with the timing of net cash flows generated from the actual drilling services performed. Absent a contract, mobilization costs are recognized currently.

From time to time, we may receive fees from our customers for capital improvements to our rigs. We defer such fees received in Other liabilities on our Consolidated Balance Sheets and recognize these fees into income on a straight-line basis over the period of the related drilling contract. We capitalize the costs of such capital improvements and depreciate them over the estimated useful life of the asset.

We record reimbursements received for the purchase of supplies, equipment, personnel services and other services provided at the request of our customers in accordance with a contract or agreement, for the gross amount billed to the customer, as Revenues related to reimbursable expenses in our Consolidated Statements of Operations.

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Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. Actual results could differ from those estimated.

Reclassifications

Certain amounts applicable to the prior periods have been reclassified to conform to the classifications currently followed. Such reclassifications do not affect earnings.

Recent Accounting Pronouncements

In September 2006, the SEC issued Staff Accounting Bulletin, or SAB, No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, or SAB 108. SAB 108 requires a registrant to quantify the impact of correcting all misstatements on its current year financial statements using two approaches, the rollover and iron curtain approaches. A registrant is required to adjust their current year financial statements if either approach to accumulate and identify misstatements results in quantifying a misstatement that is material, after considering all relevant quantitative and qualitative factors. SAB 108 is required to be considered for financial statements for fiscal years ending after November 15, 2006; however, earlier application of the guidance in SAB 108 to interim financial statements issued for fiscal years ending after November 15, 2006 is encouraged. We are in the process of evaluating the impact, if any, of applying the guidance in SAB 108 on our financial statements; however, we do not expect the adoption of SAB 108 to have a material impact on our consolidated results of operations, financial position or cash flows.

In September 2006, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards, or SFAS, No. 158, *Accounting for Defined Benefit Pension or Other Postretirement Plans*, or SFAS 158. SFAS 158 amends existing guidance to require (1) balance sheet recognition of the funded status of defined benefit plans, (2) recognition in other comprehensive income of various items before they are recognized in periodic benefit cost, (3) the measurement date for plan assets and the benefit obligation to be the balance sheet date, and (4) additional disclosures regarding the effects on periodic benefit cost for the following fiscal year arising from delayed recognition in the current period. SFAS 158 also includes guidance regarding selection of assumed discount rates for use in measuring the benefit obligation. SFAS 158 provides different effective dates for various aspects of the new rules. For public companies, requirements to recognize the funded status of the plan and to comply with the disclosure provisions of SFAS 158 are effective as of the end of the fiscal year ending after December 15, 2006, and the requirement to measure plan assets and benefit obligations as of the balance sheet date is effective for fiscal years ending after December 15, 2008. Early adoption of SFAS 158 is encouraged and must be applied to all of an entity's benefit plans. We are in the process of evaluating the impact, if any, of applying SFAS 158 on our financial statements; however, we do not expect the adoption of SFAS 158 to have a material impact on our consolidated results of operations, financial position or cash flows.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, or SFAS 157, which establishes a separate framework for measuring fair value in GAAP and expands disclosures about fair value measurements. SFAS 157 was issued to eliminate the diversity in practice that exists due to the different definitions of fair value and the limited guidance for applying those definitions in GAAP that are dispersed among the many accounting pronouncements that require fair value measurements. SFAS 157 does not require any new fair value measurements; however, its adoption may result in changes to current practice. Changes resulting from the application of SFAS 157 relate to the definition of fair value, the methods used to measure fair value and the expanded disclosures about fair value measurements. SFAS 157 emphasizes that fair value is a market-based measurement, rather than an entity-specific measurement. It also establishes a fair value hierarchy that distinguishes between (i) market participant assumptions developed based on market data obtained from independent sources and (ii) the reporting entity's own assumptions about market participant assumptions developed based on the best information available under the circumstances. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, including interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including interim periods. We are in the process of

evaluating the impact, if any, of applying SFAS 157 on our financial statements; however, we do not expect the adoption of SFAS 157 to have a material impact on our consolidated results of operations, financial position or cash flows.

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In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, or FIN 48, which clarifies the accounting for uncertainty in income taxes recognized in financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006; however, earlier application of the provisions of the interpretation is encouraged. We are currently evaluating the guidance provided in FIN 48 and have not yet determined the impact, if any, of adopting FIN 48 on our consolidated results of operations, financial position or cash flows.

2. Stock-Based Compensation

Our Second Amended and Restated 2000 Stock Option Plan, or Stock Plan, provides for the issuance of either incentive stock options or non-qualified stock options to our employees, consultants and non-employee directors. Our Stock Plan also authorizes the award of stock appreciation rights, or SARs, in tandem with stock options or separately. The aggregate number of shares of our common stock for which stock options or SARs may be granted is 1,500,000 shares. The exercise price per share may not be less than the fair market value of the common stock on the date of grant. Generally, stock options and SARs vest ratably over a four year period and expire in ten years.

Effective January 1, 2006, we adopted the FASB's revised SFAS No. 123, Accounting for Stock-Based Compensation, or SFAS 123(R), using the modified prospective application transition method. SFAS 123(R) requires that compensation cost related to share-based payment transactions be recognized in financial statements. The effect of adopting SFAS 123(R) as of January 1, 2006 is as follows:

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
	(In thousands, except per share data)	
Income from continuing operations	\$ (845)	\$ (2,285)
Income before income taxes	(845)	(2,285)
Net income	(607)	(1,642)
Cash flow from operations	\$ (181)	\$ (1,156)
Cash flow from financing activities	181	1,156
Basic earnings per share	\$ (0.01)	\$ (0.01)
Diluted earnings per share	(0.01)	(0.01)

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Prior to the adoption of SFAS 123(R) on January 1, 2006, we accounted for our Stock Plan in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees. Accordingly, no compensation expense was recognized for the options granted to our employees in periods prior to January 1, 2006. If compensation expense had been recognized for stock options granted to our employees based on the fair value of the options at the grant dates our net income and earnings per share, or EPS, would have been as follows:

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
	(In thousands, except per share data)	
Net income as reported	\$ 82,039	\$ 153,439
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects		
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(355)	(995)
Pro forma net income	\$ 81,684	\$ 152,444
Earnings per share of common stock:		
As reported	\$ 0.64	\$ 1.19
Pro forma	\$ 0.63	\$ 1.19
Earnings per share of common stock-assuming dilution:		
As reported	\$ 0.60	\$ 1.14
Pro forma	\$ 0.60	\$ 1.13

The fair value of options and SARs granted under the Stock Plan was estimated using the Binomial Option pricing model with the following weighted average assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Expected life of stock options/SARs (in years)	6	7	6	7
Expected volatility	31.00%	30.00%	30.45%	30.97%
Dividend yield	0.60%	0.51%	0.57%	0.49%
Risk free interest rate	5.12%	3.88%	5.04%	3.96%

Expected life of stock options and SARs is based on historical data as is the expected volatility. The dividend yield is based on the current approved regular dividend rate in effect and the current market price at the time of grant. Risk free interest rates are determined using the U.S. Treasury yield curve at time of grant with a term equal to the expected life of the options and SARs.