FISERV INC
Form 10-Q
May 06, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2010

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 0-14948

FISERV, INC.

(Exact Name of Registrant as Specified in Its Charter)

WISCONSIN	**39-1506125**
(State or Other Jurisdiction of Incorporation or Organization)	**(I. R. S. Employer Identification No.)**
255 FISERV DRIVE, BROOKFIELD, WI	**53045**
(Address of Principal Executive Offices)	**(Zip Code)**

(262) 879-5000

(Registrant s Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer	x	Accelerated filer	¨
Non-accelerated filer	¨	Smaller reporting company	¨

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

As of May 4, 2010, there were 152,610,235 shares of common stock, $.01 par value, of the registrant outstanding.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

FISERV, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In millions, except per share data)

(Unaudited)

	Three Months Ended March 31,	
	2010	**2009**
Revenue:		
Processing and services	**$ 831**	$ 831
Product	**177**	192
Total revenue	**1,008**	1,023
Expenses:		
Cost of processing and services	**462**	458
Cost of product	**136**	142
Selling, general and administrative	**172**	198
Total expenses	**770**	798
Operating income	**238**	225
Interest expense, net	**(45)**	(54)
Income from continuing operations before income taxes and income from investment in unconsolidated affiliate	**193**	171
Income tax provision	**(73)**	(66)
Income from investment in unconsolidated affiliate, net of income taxes	**3**	1
Income from continuing operations	**123**	106
Loss from discontinued operations, net of income taxes	**(2)**	(3)
Net income	**$ 121**	$ 103
Net income (loss) per share - basic:		
Continuing operations	**$ 0.81**	$ 0.68
Discontinued operations	**(0.01)**	(0.02)
Total	**$ 0.79**	$ 0.66
Net income (loss) per share - diluted:		
Continuing operations	**$ 0.80**	$ 0.68
Discontinued operations	**(0.01)**	(0.02)

Total	**$ 0.79**	$ 0.66
Shares used in computing net income (loss) per share:		
Basic	**152.5**	155.5
Diluted	**153.7**	156.0

See notes to condensed consolidated financial statements.

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FISERV, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in millions)

(Unaudited)

	March 31, 2010	December 31, 2009
ASSETS		
Cash and cash equivalents	**$ 416**	$ 363
Trade accounts receivable, net	**514**	554
Deferred income taxes	**44**	46
Prepaid expenses and other current assets	**270**	314
Total current assets	**1,244**	1,277
Property and equipment, net	**281**	293
Intangible assets, net	**1,970**	2,006
Goodwill	**4,369**	4,371
Other long-term assets	**445**	431
Total assets	**$ 8,309**	$ 8,378
LIABILITIES AND SHAREHOLDERS EQUITY		
Accounts payable and accrued expenses	**$ 510**	$ 565
Deferred revenue	**347**	337
Current maturities of long-term debt	**133**	259
Total current liabilities	**990**	1,161
Long-term debt	**3,381**	3,382
Deferred income taxes	**583**	580
Other long-term liabilities	**237**	229
Total liabilities	**5,191**	5,352
Commitments and contingencies		
Shareholders equity:		
Preferred stock, no par value: 25.0 million shares authorized; none issued		
Common stock, $0.01 par value: 450.0 million shares authorized; 197.9 million shares issued	**2**	2
Additional paid-in capital	**729**	727
Accumulated other comprehensive loss	**(70)**	(69)
Accumulated earnings	**4,492**	4,371
Treasury stock, at cost, 45.3 million and 44.7 million shares	**(2,035)**	(2,005)
Total shareholders equity	**3,118**	3,026
Total liabilities and shareholders equity	**$ 8,309**	$ 8,378

See notes to condensed consolidated financial statements.

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FISERV, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In millions)

(Unaudited)

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Cash flows from operating activities:		
Net income	**$ 121**	$ 103
Adjustment for discontinued operations	**2**	3
Adjustments to reconcile net income to net cash provided by operating activities from continuing operations:		
Depreciation and other amortization	**47**	47
Amortization of acquisition-related intangible assets	**37**	34
Share-based compensation	**10**	11
Deferred income taxes	**5**	3
Other non-cash items	**(10)**	(1)
Changes in assets and liabilities:		
Trade accounts receivable	**39**	52
Prepaid expenses and other assets	**(12)**	4
Accounts payable and other liabilities	**11**	(13)
Deferred revenue	**10**	(12)
Net cash provided by operating activities from continuing operations	**260**	231
Cash flows from investing activities:		
Capital expenditures, including capitalization of software costs	**(42)**	(45)
Other investing activities	**7**	3
Net cash used in investing activities from continuing operations	**(35)**	(42)
Cash flows from financing activities:		
Repayments of long-term debt	**(126)**	(101)
Issuance of common stock and treasury stock	**21**	10
Purchases of treasury stock	**(71)**	(25)
Other financing activities	**5**	4
Net cash used in financing activities from continuing operations	**(171)**	(112)
Net change in cash and cash equivalents from continuing operations	**54**	77
Net cash transactions transferred to discontinued operations	**(1)**	
Beginning balance	**363**	230
Ending balance	**$ 416**	$ 307
Discontinued operations cash flow information:		
Net cash (used in) provided by operating activities	**$ (3)**	$ 1
Net cash provided by investing activities	**2**	1
Net cash used in financing activities		(2)

Net change in cash and cash equivalents from discontinued operations	**(1)**	
Net cash transactions transferred from continuing operations	**1**	
Beginning balance - discontinued operations		38
Ending balance - discontinued operations	**$**	$ 38

See notes to condensed consolidated financial statements.

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FISERV, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Principles of Consolidation

The condensed consolidated financial statements for the three-month periods ended March 31, 2010 and 2009 are unaudited. In the opinion of management, all adjustments necessary for a fair presentation of the condensed consolidated financial statements have been included. Such adjustments consisted of normal recurring items. Interim results are not necessarily indicative of results for a full year. The condensed consolidated financial statements and accompanying notes are presented as permitted by Form 10-Q and do not contain certain information included in the annual consolidated financial statements and accompanying notes of Fiserv, Inc. (the Company). These interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and accompanying notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2009.

The condensed consolidated financial statements include the accounts of Fiserv, Inc. and all 100% owned subsidiaries. Investments in less than 50% owned affiliates in which the Company has significant influence are accounted for using the equity method of accounting. All intercompany transactions and balances have been eliminated in consolidation.

2. Fair Value Measurements

Assets and liabilities which are measured at fair value are classified in the following categories:

Level 1 At March 31, 2010 and December 31, 2009, the fair values of available-for-sale investments in asset-backed securities of $10 million and $11 million, respectively, were based on quoted prices in active markets for identical instruments as of the reporting date.

Level 2 At March 31, 2010 and December 31, 2009, the fair values of available-for-sale investments in asset-backed securities of $5 million and $6 million, respectively, and liabilities for interest rate hedge contracts of $93 million and $92 million, respectively, were determined from market based valuation models for which pricing inputs were either directly or indirectly observable as of the reporting date.

Level 3 At March 31, 2010 and December 31, 2009, the fair values of available-for-sale investments of $23 million were based on valuation models with unobservable pricing inputs and management estimates. Unrealized losses of $2 million were recorded in accumulated other comprehensive loss at March 31, 2010 and December 31, 2009.

The fair value of the Company s total debt was estimated using discounted cash flows based on the Company s current incremental borrowing rates or quoted prices in active markets and totaled $3.6 billion and $3.8 billion at March 31, 2010 and December 31, 2009, respectively.

3. Share-Based Compensation

The Company recognized $10 million and $11 million of share-based compensation during the first quarter of 2010 and 2009, respectively. The Company s annual grant of share-based awards generally occurs in the first quarter. During the first quarter of 2010, the Company granted 1.1 million stock options and 0.4 million restricted stock units at weighted-average estimated fair values of $17.48 and $47.73, respectively. During the first quarter of 2009, the Company granted 1.4 million stock options and 0.5 million restricted stock units at weighted-average estimated fair values of $12.40 and $32.78, respectively. During the first quarter of 2010 and 2009, stock options to purchase 0.8 million shares and 0.2 million shares, respectively, were exercised.

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4. Shares Used in Computing Net Income Per Share

Basic weighted-average outstanding shares used in calculating net income per share were 152.5 million and 155.5 million for the first quarter of 2010 and 2009, respectively. Diluted weighted-average outstanding shares used in calculating net income per share were 153.7 million and 156.0 million for the first quarter of 2010 and 2009, respectively, and included 1.2 million and 0.5 million common stock equivalents, respectively. For the first quarter of 2010 and 2009, stock options for 2.5 million shares and 6.4 million shares, respectively, were excluded from the calculation of diluted weighted-average outstanding shares because their impact was anti-dilutive.

5. Interest Rate Hedge Contracts

To manage exposure to fluctuations in interest rates, the Company maintains a series of interest rate swap agreements (Swaps) with total notional values of $1.2 billion at March 31, 2010 and December 31, 2009. The Swaps have been designated by the Company as cash flow hedges, effectively fix interest rates on floating rate term loan borrowings at a weighted-average rate of approximately 4.8% prior to financing spreads and related fees, and have expiration dates through September 2012. The fair values of the Swaps, as discussed in Note 2, were recorded in other long-term liabilities and in accumulated other comprehensive loss, net of income taxes, in the condensed consolidated balance sheets. The components of other comprehensive income (loss) pertaining to interest rate hedge contracts are presented in Note 6. In the first quarter of 2010 and 2009, interest expense recognized due to hedge ineffectiveness was not significant, and no amounts were excluded from the assessments of hedge effectiveness. Based on the amounts recorded in accumulated other comprehensive loss at March 31, 2010, the Company estimates that it will recognize approximately $40 million in interest expense related to interest rate hedge contracts during the next twelve months.

6. Comprehensive Income

Comprehensive income was as follows:

	Three Months Ended March 31,	
(In millions)	**2010**	**2009**
Net income	**$ 121**	$ 103
Other comprehensive income (loss), net of income taxes:		
Fair market value adjustments on investments	**1**	10
Fair market value adjustments on cash flow hedges	**(8)**	(3)
Reclassification adjustment for net realized losses on cash flow hedges included in interest expense	**8**	8
Foreign currency translation adjustments	**(2)**	(1)
Other comprehensive income (loss)	**(1)**	14
Comprehensive income	**$ 120**	$ 117

7. Business Segment Information

The Company s operations are comprised of the Payments and Industry Products (Payments) segment, the Financial Institution Services (Financial) segment, and the Corporate and Other segment. The Payments segment primarily provides electronic bill payment and settlement, electronic funds transfer, and debit processing products and services to meet the electronic transaction processing needs of the financial services industry. The businesses in this segment also provide card and print personalization services, Internet banking, investment account processing services for separately managed accounts, and fraud and risk management products and services. The Financial segment provides banks, thrifts and credit unions with account processing services, item processing services, loan origination and servicing products, cash management and consulting services, and other products and services that support numerous types of financial transactions. The Corporate and Other segment primarily consists of unallocated corporate overhead expenses, amortization of acquisition-related intangible assets and intercompany eliminations.

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(In millions)	Payments	Financial	Corporate and Other	Total
Three Months Ended March 31, 2010				
Processing and services revenue	**$ 397**	**$ 432**	**$ 2**	**$ 831**
Product revenue	**143**	**40**	**(6)**	**177**
Total revenue	**$ 540**	**$ 472**	**$ (4)**	**$ 1,008**
Operating income	**$ 148**	**$ 136**	**$ (46)**	**$ 238**
Three Months Ended March 31, 2009				
Processing and services revenue	$ 386	$ 445	$	$ 831
Product revenue	158	43	(9)	192
Total revenue	$ 544	$ 488	$ (9)	$ 1,023
Operating income	$ 155	$ 142	$ (72)	$ 225

8. Subsidiary Guarantors of Long-Term Debt

Certain of the Company s 100% owned domestic subsidiaries (Guarantor Subsidiaries) jointly and severally, and fully and unconditionally guarantee the Company s indebtedness under its revolving credit facility, senior term loan and senior notes. The following condensed consolidating financial information is presented on the equity method and reflects the summarized financial information for: (a) the Company; (b) the Guarantor Subsidiaries on a combined basis; and (c) the Company s non-guarantor subsidiaries on a combined basis.

CONDENSED CONSOLIDATING STATEMENT OF INCOME

THREE MONTHS ENDED MARCH 31, 2010

(In millions)	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Revenue:					
Processing and services	$	$ 589	$ 260	$ (18)	$ 831
Product		156	30	(9)	177
Total revenue		745	290	(27)	1,008
Expenses:					
Cost of processing and services	(1)	322	161	(20)	462
Cost of product		120	22	(6)	136
Selling, general and administrative	18	109	45		172
Total expenses	17	551	228	(26)	770
Operating income (loss)	(17)	194	62	(1)	238
Interest (expense) income, net	14	(57)	(2)		(45)
Income (loss) from continuing operations before income taxes and income from investment in unconsolidated affiliate	(3)	137	60	(1)	193

Income tax (provision) benefit	2	(52)	(23)		(73)
Income from investment in unconsolidated affiliate, net of income taxes			3		3
Income (loss) from continuing operations	(1)	85	40	(1)	123
Equity in earnings of consolidated affiliates	124			(124)	
Loss from discontinued operations, net of income taxes	(2)				(2)
Net income	$ 121	$ 85	$ 40	$ (125)	$ 121

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CONDENSED CONSOLIDATING STATEMENT OF INCOME

THREE MONTHS ENDED MARCH 31, 2009

(In millions)	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Revenue:					
Processing and services	$	$ 584	$ 264	$ (17)	$ 831
Product		171	27	(6)	192
Total revenue		755	291	(23)	1,023
Expenses:					
Cost of processing and services	2	311	158	(13)	458
Cost of product		130	26	(14)	142
Selling, general and administrative	25	115	58		198
Total expenses	27	556	242	(27)	798
Operating income (loss)	(27)	199	49	4	225
Interest (expense) income, net	10	(61)	(3)		(54)
Income (loss) from continuing operations before income taxes and income from investment in unconsolidated affiliate	(17)	138	46	4	171
Income tax (provision) benefit	6	(53)	(17)	(2)	(66)
Income from investment in unconsolidated affiliate, net of income taxes			1		1
Income (loss) from continuing operations	(11)	85	30	2	106
Equity in earnings of consolidated affiliates	114			(114)	
(Loss) income from discontinued operations, net of income taxes		(4)	1		(3)
Net income	$ 103	$ 81	$ 31	$ (112)	$ 103

CONDENSED CONSOLIDATING BALANCE SHEET

MARCH 31, 2010

(In millions)	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
ASSETS					
Cash and cash equivalents	$ 116	$ 152	$ 148	$	$ 416
Trade accounts receivable, net	(2)	341	175		514
Prepaid expenses and other current assets	58	137	119		314
Total current assets	172	630	442		1,244

Investments in consolidated affiliates	5,163			(5,163)	
Goodwill and intangible assets, net	2	5,413	924		6,339
Other long-term assets	113	300	313		726
Total assets	$ 5,450	$ 6,343	$ 1,679	$ (5,163)	$ 8,309
LIABILITIES AND SHAREHOLDERS EQUITY					
Total current liabilities	$ 229	$ 439	$ 322	$	$ 990
Long-term debt	3,373	8			3,381
Due to (from) consolidated affiliates	(2,053)	1,961	92		
Other long-term liabilities	783	36	1		820
Total liabilities	2,332	2,444	415		5,191
Total shareholders equity	3,118	3,899	1,264	(5,163)	3,118
Total liabilities and shareholders equity	$ 5,450	$ 6,343	$ 1,679	$ (5,163)	$ 8,309

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CONDENSED CONSOLIDATING BALANCE SHEET

DECEMBER 31, 2009

(In millions)	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
ASSETS					
Cash and cash equivalents	$ 55	$ 169	$ 139	$	$ 363
Trade accounts receivable, net	(2)	361	195		554
Prepaid expenses and other current assets	91	135	134		360
Total current assets	144	665	468		1,277
Investments in consolidated affiliates	3,154			(3,154)	
Goodwill and intangible assets, net	2	5,447	928		6,377
Other long-term assets	114	305	305		724
Total assets	$ 3,414	$ 6,417	$ 1,701	$ (3,154)	$ 8,378
LIABILITIES AND SHAREHOLDERS EQUITY					
Total current liabilities	$ 337	$ 488	$ 336	$	$ 1,161
Long-term debt	3,373	9			3,382
Due to (from) consolidated affiliates	(4,094)	3,973	121		
Other long-term liabilities	772	34	3		809
Total liabilities	388	4,504	460		5,352
Total shareholders equity	3,026	1,913	1,241	(3,154)	3,026
Total liabilities and shareholders equity	$ 3,414	$ 6,417	$ 1,701	$ (3,154)	$ 8,378

CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

THREE MONTHS ENDED MARCH 31, 2010

(In millions)	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Cash flows from operating activities:					
Net cash provided by operating activities from continuing operations	$ 76	$ 120	$ 63	$ 1	$ 260
Cash flows from investing activities:					
Capital expenditures, including capitalization of software costs		(34)	(8)		(42)
Other investing activities	150		7	(150)	7
Net cash (used in) provided by investing activities from continuing operations	150	(34)	(1)	(150)	(35)

Cash flows from financing activities:					
Repayments of long-term debt	(126)				(126)
Purchases of treasury stock	(71)				(71)
Other financing activities	33	(103)	(53)	149	26
Net cash used in financing activities from continuing operations	(164)	(103)	(53)	149	(171)
Net change in cash and cash equivalents from continuing operations	62	(17)	9		54
Net cash transactions transferred to discontinued operations	(1)				(1)
Beginning balance	55	169	139		363
Ending balance	$ 116	$ 152	$ 148	$	$ 416

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CONDENSED CONSOLIDATING STATEMENT OF CASH FLOWS

THREE MONTHS ENDED MARCH 31, 2009

(In millions)	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Cash flows from operating activities:					
Net cash provided by operating activities from continuing operations	$ 56	$ 97	$ 83	$ (5)	$ 231
Cash flows from investing activities:					
Capital expenditures, including capitalization of software costs	(1)	(38)	(6)		(45)
Other investing activities		(42)	(51)	96	3
Net cash used in investing activities from continuing operations	(1)	(80)	(57)	96	(42)
Cash flows from financing activities:					
Repayments of long-term debt	(100)		(1)		(101)
Purchases of treasury stock	(25)				(25)
Other financing activities	102	(1)	4	(91)	14
Net cash (used in) provided by financing activities from continuing operations	(23)	(1)	3	(91)	(112)
Net change in cash and cash equivalents from continuing operations	32	16	29		77
Net cash transactions transferred from (to) discontinued operations	10	(10)			
Beginning balance	32	104	94		230
Ending balance	$ 74	$ 110	$ 123	$	$ 307

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-Looking Statements

This quarterly report contains forward-looking statements intended to qualify for the safe harbor from liability established by the Private Securities Litigation Reform Act of 1995. Forward-looking statements include those that express a plan, belief, expectation, estimation, anticipation, intent, contingency, future development or similar expression, and can generally be identified as forward-looking because they include words such as believes, anticipates, expects, could, should or words of similar meaning. Statements that describe our objectives or g are also forward-looking statements. The forward-looking statements in this report involve significant risks and uncertainties, and a number of factors, both foreseen and unforeseen, that could cause actual results to differ materially from our current expectations. The factors that may affect our results include, among others: the impact on our business of the current state of the economy, including the risk of reduction in revenue resulting from decreased spending on the products and services we offer or from the elimination of existing or potential clients due to consolidation or financial failures in the financial services industry; changes in client demand for our products or services; pricing or other actions by competitors; the impact of our Fiserv 2.0 initiatives; our ability to comply with government regulations, including privacy regulations; and other factors identified in our Annual Report on Form 10-K for the year ended December 31, 2009 and in other documents that we file with the Securities and Exchange Commission. We urge you to consider these factors carefully in evaluating forward-looking statements and caution you not to place undue reliance on forward-looking statements, which speak only as of the date of this report. We undertake no obligation to update forward-looking statements to reflect events or circumstances occurring after the date of this report.

Overview

We provide integrated information management and electronic commerce systems and services, including transaction processing, electronic bill payment and presentment, business process outsourcing, document distribution services, and software and systems solutions. Our operations are primarily in the United States and are comprised of our Payments and Industry Products (Payments) segment, Financial Institution Services (Financial) segment, and Corporate and Other segment. The Payments segment primarily provides electronic bill payment and settlement, electronic funds transfer, and debit processing products and services to meet the electronic transaction processing needs of the financial services industry. Our businesses in this segment also provide card and print personalization services, Internet banking, investment account processing services for separately managed accounts, and fraud and risk management products and services. The Financial segment provides banks, thrifts and credit unions with account processing services, item processing services, loan origination and servicing products, cash management and consulting services, and other products and services that support numerous types of financial transactions. The Corporate and Other segment primarily consists of unallocated corporate overhead expenses, amortization of acquisition-related intangible assets and intercompany eliminations.

Management s discussion and analysis of financial condition and results of operations is provided as a supplement to our unaudited condensed consolidated financial statements and accompanying footnotes to help provide an understanding of our financial condition, the changes in our financial condition and our results of operations. Our discussion is organized as follows:

Results of operations. This section contains an analysis of our results of operations presented in the accompanying unaudited condensed consolidated statements of income by comparing the results for the quarter ended March 31, 2010 to the comparable period in 2009.

Liquidity and capital resources. This section provides an analysis of our cash flows and a discussion of our outstanding debt as of March 31, 2010.

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Results of Operations

The following table presents, for the periods indicated, certain amounts included in our condensed consolidated statements of income, the relative percentage that those amounts represent to revenue, and the change in those amounts from year to year. This information should be read together with the condensed consolidated financial statements and accompanying notes.

(In millions)	Three Months Ended March 31,		Percentage of Revenue [1]		Increase (Decrease)	
	2010	2009	2010	2009	$	%
Revenue:						
Processing and services	$ 831	$ 831	82.4%	81.2%	$	
Product	177	192	17.6%	18.8%	(15)	(8)%
Total revenue	1,008	1,023	100.0%	100.0%	(15)	(1)%
Expenses:						
Cost of processing and services	462	458	55.6%	55.1%	4	1%
Cost of product	136	142	76.8%	74.0%	(6)	(4)%
Sub-total	598	600	59.3%	58.7%	(2)	
Selling, general and administrative	172	198	17.1%	19.4%	(26)	(13)%
Total expenses	770	798	76.4%	78.0%	(28)	(4)%
Operating income	238	225	23.7%	22.0%	13	6%
Interest expense, net	(45)	(54)	(4.5)%	(5.3)%	(9)	(17)%
Income from continuing operations before income taxes and income from investment in unconsolidated affiliate	$ 193	$ 171	19.1%	16.7%	$ 22	13%

[1] Each percentage of revenue is calculated as the relevant revenue, expense or income amount divided by total revenue, except for cost of processing and services and cost of product amounts which are divided by the related component of revenue.

Total Revenue

(In millions)	Three Months Ended March 31, Payments	Financial	Corporate and Other	Total
Total revenue:				
2010	$ 540	$ 472	$ (4)	$ 1,008
2009	544	488	(9)	1,023
Revenue growth (decline)	$ (4)	$ (16)	$ 5	$ (15)
Revenue growth (decline) percentage	(1)%	(3)%		(1)%

Total revenue decreased $15 million, or 1%, in the first quarter of 2010 compared to 2009. Revenue in our Payments segment decreased $4 million, or 1%, and revenue in our Financial segment decreased $16 million, or 3%. The decrease in Payments segment revenue was primarily due to lower product revenue in our output solutions business, including pass-through postage revenue, partially offset by revenue increases driven by new clients and increased transaction volumes from existing clients in our electronic payments businesses. The decrease in Financial segment revenue was primarily due to volume declines in our check processing business and lower specialty consulting and software license revenue, partially offset by increased revenue in our bank and credit union account processing businesses.

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Total Expenses

Total expenses decreased $28 million, or 4%, to $770 million in the first quarter of 2010 compared to 2009. Total expenses as a percentage of total revenue were 76.4% and 78.0% in the first quarter of 2010 and 2009, respectively. Cost of processing and services as a percentage of processing and services revenue in the first quarter of 2010 was 55.6%, which was relatively consistent compared to the first quarter of 2009. Cost of product as a percentage of product revenue increased from 74.0% in the first quarter of 2009 to 76.8% in 2010, due primarily to a decline in higher margin software license revenue which negatively impacted our operating margin. Selling, general and administrative expenses decreased $26 million, or 13%, in the first quarter of 2010 compared to 2009, due primarily to $15 million of employee severance expenses recognized in the first quarter of 2009 and a decline in merger and integration costs associated with our acquisition of CheckFree Corporation (CheckFree).

Operating Income and Operating Margin

	Three Months Ended March 31,			
(In millions)	**Payments**	**Financial**	**Corporate and Other**	**Total**
Operating income:				
2010	$ 148	$ 136	$ (46)	$ 238
2009	155	142	(72)	225
Operating income growth (decline)	$ (7)	$ (6)	$ 26	$ 13
Operating income growth (decline) percentage	(5)%	(4)%		6%
Operating margin:				
2010	27.5%	28.8%		23.7%
2009	28.5%	29.3%		22.0%
Operating margin growth (decline) [1]	(1.0%)	(0.5%)		1.7%

[1] Represents the percentage point improvement or decline in operating margin.

Total operating income increased $13 million, or 6%, in the first quarter of 2010 compared to 2009. Our operating margin was 23.7% and 22.0% in the first quarter of 2010 and 2009, respectively.

Operating income in our Payments segment decreased $7 million, or 5%, and operating margin decreased 100 basis points to 27.5% in the first quarter of 2010 compared to 2009. The decreases in operating income and operating margin resulted primarily from a decline in higher margin project revenue in our output solutions business and increased expenditures associated with the development of new products, partially offset by improved operating leverage in our electronic funds transfer businesses.

Operating income in our Financial segment decreased $6 million, or 4%, and operating margin decreased 50 basis points to 28.8% in the first quarter of 2010 compared to 2009. Operating income and operating margin were negatively impacted by decreases in higher margin software license and specialty consulting revenue and volume declines in our check processing business. These negative factors were partially offset by revenue growth and scale efficiencies in our bank and credit union account processing businesses.

The operating loss in our Corporate and Other segment decreased $26 million in the first quarter of 2010 compared to 2009, due primarily to $15 million of employee severance expenses recognized in the first quarter of 2009 and lower merger and integration costs associated with our acquisition of CheckFree.

Interest Expense, Net

Interest expense decreased $9 million, or 17%, in the first quarter of 2010 compared to 2009 primarily due to decreases in total outstanding borrowings and interest rates.

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Income Tax Provision

The income tax provision increased $7 million from $66 million in the first quarter of 2009 to $73 million in the first quarter of 2010. Our effective income tax rate was 37.9% and 38.3% in the first quarter of 2010 and 2009, respectively.

Net Income Per Share Diluted from Continuing Operations

Net income per share-diluted from continuing operations was $0.80 and $0.68 in the first quarter of 2010 and 2009, respectively. Net income per share-diluted from continuing operations in 2009 was negatively impacted by approximately $0.09 per share due to employee severance expenses and merger costs. The amortization of acquisition-related intangible assets reduced net income per share-diluted from continuing operations by $0.15 per share and $0.14 per share in the first quarter of 2010 and 2009, respectively.

Liquidity and Capital Resources

General

Our primary liquidity needs are: (i) to fund normal operating expenses; (ii) to meet the principal and interest requirements of our outstanding indebtedness; and (iii) to fund capital expenditures and operating lease payments. We believe these needs will be satisfied using cash flows generated by operations, our cash and cash equivalents at March 31, 2010 of $416 million and available borrowings under our revolving credit facility of $870 million at March 31, 2010.

(In millions)	Three Months Ended March 31, 2010	2009	Increase (Decrease) $	%
Income from continuing operations	$ 123	$ 106	$ 17	
Depreciation and amortization	84	81	3	
Share-based compensation	10	11	(1)	
Net changes in working capital and other	43	33	10	
Operating cash flow	$ 260	$ 231	$ 29	13%
Capital expenditures	$ 42	$ 45	$ (3)	(7)%

Our net cash provided by operating activities from continuing operations, or operating cash flow, was $260 million in the first quarter of 2010, an increase of 13% compared with $231 million in 2009. Our current policy is to use our operating cash flow primarily to repay debt and fund capital expenditures, acquisitions and share repurchases, rather than to pay dividends. Our capital expenditures decreased $3 million to $42 million in the first quarter of 2010 compared to 2009. Capital expenditures were 4% of our total revenue in the first quarter of 2010 and 2009.

Share Repurchases

In the first quarter of 2010, we purchased approximately 1.4 million shares of our common stock for $67 million and, as of March 31, 2010, we had approximately 5.8 million shares remaining under our existing authorizations. Shares repurchased are generally held for issuance in connection with our equity plans.

Indebtedness

(In millions)	March 31, 2010	December 31, 2009
Long-term debt (including current maturities)	$ 3,514	$ 3,641

In the first quarter of 2010, we used a portion of our operating cash flow to repay approximately $125 million of long-term debt, which reduced our outstanding debt, including current maturities, to approximately $3.5 billion at March 31, 2010. Our long-term debt currently consists primarily of $1.75 billion under our unsecured senior term loan facility and $1.75 billion of senior notes. The

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unsecured senior term loan bears interest at a variable rate based on LIBOR plus a specified margin or the bank s base rate and matures in November 2012. To manage exposure to fluctuations in interest rates, we maintain a series of interest rate swap agreements (Swaps) with total notional values of $1.2 billion. The Swaps effectively fix interest rates on floating rate term loan borrowings at a weighted-average rate of approximately 4.8%, prior to financing spreads and related fees, and have expiration dates through September 2012. The next scheduled principal payment of $130 million on our senior term loan is due in December 2010. The term loan facility contains various restrictions and covenants substantially similar to those contained in the revolving credit facility described below. In addition, we have $1.25 billion of 6.125% senior notes due in November 2012 and $500 million of 6.8% senior notes due in November 2017, which pay interest at the stated rate on May 20 and November 20 of each year.

We maintain a $900 million revolving credit facility with a syndicate of banks. Borrowings under this facility bear interest at a variable rate based on LIBOR plus a specified margin or the bank s base rate. The facility, as amended, contains various restrictions and covenants that require us, among other things, to limit our consolidated indebtedness to no more than three and one-half times consolidated net earnings before interest, taxes, depreciation and amortization and certain other adjustments and to maintain consolidated net earnings before interest, taxes, depreciation and amortization and certain other adjustments of at least three times consolidated interest expense. There are no significant commitment fees or compensating balance requirements. The facility expires on March 24, 2011. As of March 31, 2010, we had issued letters of credit totaling $30 million under this facility and our available borrowings were $870 million. During the first quarter of 2010, we were in compliance with all financial debt covenants in this and our other credit facilities, including those contained in our senior term loan and our senior notes.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The quantitative and qualitative disclosures about market risk required by this item are incorporated by reference to Item 7A of our Annual Report on Form 10-K for the year ended December 31, 2009 and have not materially changed since December 31, 2009.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures

As required by Rule 13a-15(b) under the Securities Exchange Act of 1934 (the Exchange Act), our management, with the participation of our chief executive officer and chief financial officer, evaluated the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act). Based on this evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective as of March 31, 2010.

Changes in internal control over financial reporting

There was no change in our internal control over financial reporting that occurred during the quarter ended March 31, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In the normal course of business, we and our subsidiaries are named as defendants in lawsuits in which claims are asserted against us. In the opinion of management, the liabilities, if any, which may ultimately result from such lawsuits are not expected to have a material adverse effect on our financial statements.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The table below sets forth information with respect to purchases made by or on behalf of the company or any affiliated purchaser (as defined in Rule 10b-18(a)(3) under the Exchange Act) of shares of our common stock during the quarter ended March 31, 2010:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (1)
January 1-31, 2010	472,960	$ 47.74	472,960	1,693,352
February 1-28, 2010	675,000	46.57	675,000	6,018,352
March 1-31, 2010	260,800	49.25	260,800	5,757,552
Total	1,408,760		1,408,760	

(1) The purchases shown in the table above were made pursuant to a May 20, 2009 authorization of our board of directors to purchase up to 5 million shares of our common stock. On February 24, 2010, our board of directors authorized the repurchase of up to 5 million additional shares of our common stock. These repurchase authorizations do not expire.

ITEM 6. EXHIBITS

The exhibits listed in the accompanying exhibit index are filed as part of this Quarterly Report on Form 10-Q.

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SIGNATURES

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.

FISERV, INC.

Date: May 6, 2010

By: /s/ Thomas J. Hirsch

Thomas J. Hirsch

Executive Vice President,

Chief Financial Officer,

Treasurer and Assistant Secretary

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Exhibit Index

Exhibit Number	Exhibit Description
10.1	Agreement with Peter J. Kight, dated March 31, 2010
31.1	Certification of the Chief Executive Officer, dated May 6, 2010
31.2	Certification of the Chief Financial Officer, dated May 6, 2010
32	Certification of the Chief Executive Officer and Chief Financial Officer, dated May 6, 2010
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema Document
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document

* Furnished with this quarterly report on Form 10-Q are the following documents formatted in XBRL (Extensible Business Reporting Language): (i) the Condensed Consolidated Statements of Income for the three months ended March 31, 2010 and 2009, (ii) the Condensed Consolidated Balance Sheets at March 31, 2010 and December 31, 2009, (iii) the Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2010 and 2009, and (iv) Notes to Condensed Consolidated Financial Statements.

For the Year	2008	2007	2006
	(In thousands)		
Fiber	$ 10,987	$ 13,722	$ 14,313
Recreational leases and other	2,205	717	3,116
Total revenues	$ 13,192	$ 14,439	$ 17,429

Fiber sold consists of:

	For the Year		
	2008	2007	2006
Tons sold	1,079,873	1,215,471	1,114,820
Revenue per ton sold	$ 10.17	$ 11.29	$ 12.84

In 2008, revenue per ton decreased because we harvested and sold higher levels of pulpwood. The majority of our sales were to Temple-Inland at market prices.

In 2007, Temple-Inland retained a greater portion of recreational lease revenues.

Items Not Allocated to Segments

Unallocated items represent income and expenses managed on a company-wide basis and include general and administrative expenses, share-based compensation, other non-operating income and expense and interest expense.

In 2008 and 2007, the increase in interest expense was due to higher average debt balances and higher borrowing costs.

In 2008, the increase in share-based compensation expense was a result of recognizing accelerated expense for retirement eligible employees and fully vested awards to members of our board of directors, and from an increase in the number of participants in our plan. In 2007 and 2006, share-based compensation was allocated from Temple-Inland and represents the expense of Temple-Inland share-based awards granted to our employees.

In 2008 and 2007, the increase in general and administrative expenses was due to increased costs associated with implementing corporate functions as a stand-alone public company.

Income Taxes

Our effective tax rate, which is income tax as a percentage of income before taxes, was 30 percent in 2008, 36 percent in 2007 and 37 percent in 2006. The 2008 rate reflects a benefit from increased percentage depletion deduction related to our mineral activities and a federal income tax rate change for qualified timber gains due to the Food, Conservation and Energy Act of 2008. We anticipate that our effective tax rate in 2009 will be about 37 percent due to our announced 2009 strategic initiatives and the expiration in June 2009 of special tax rates for qualified timber gains under the Food, Conservation and Energy Act of 2008. We have not provided a valuation allowance for our deferred tax asset because we believe it is likely it will be recoverable in future periods.

Capital Resources and Liquidity

Sources and Uses of Cash

We operate in cyclical industries and our cash flows fluctuate accordingly. Our principal operating cash requirements are for the acquisition and development of real estate, either directly or indirectly through ventures, taxes, interest, and compensation. Our principal sources of cash are proceeds from the sale of real estate and timber, the cash flow from minerals and commercial operating properties, and borrowings. Operating cash flows are affected by the timing of the payment of real estate development expenditures and the collection of proceeds from the eventual sale of the real estate, the timing of which can vary substantially depending on many factors including the size of the project, state and local permitting requirements, and availability of utilities. Working capital is subject to operating needs, the timing of sales of real estate and timber, the timing of collection of mineral royalties or mineral lease payments, collection of receivables, reimbursement from utility or improvement districts, and the payment of payables and expenses.

Cash Flows from Operating Activities

Cash flows from real estate development activities, undeveloped land sales, timber sales, and mineral and recreational leases are classified as operating cash flows.

Net cash (used for) operations was $(51,889,000) in 2008, $(63,981,000) in 2007 and $(27,705,000) in 2006. In 2008, expenditures for real estate development and acquisition exceeded non-cash real estate cost of sales principally due to contractual commitments to our Cibolo Canyons project. We invested $34,863,000 in this project in 2008. In 2007, expenditures for real estate development and acquisition significantly exceeded non-cash real estate cost of sales principally due to the investment of $47,000,000 in new real estate projects, an increase in the deferred tax asset of $19,544,000 due primarily to a tax gain resulting from our contractual right to receive certain hotel occupancy and sales revenues through 2034 at our Cibolo Canyons project, and distributions to minority interests of $11,042,000. In 2006, expenditures for real estate development and acquisition significantly exceeded non-cash real estate cost of sales principally due to the investment of $74,000,000 in ten new real estate projects.

Cash Flows from Investing Activities

Capital contributions to and capital distributions from unconsolidated ventures are classified as investing activities. In addition, expenditures related to reforestation activities in our fiber resources segment are classified as investing activities.

In 2008, net cash (used for) investing activities was $(16,667,000) as capital contributed to unconsolidated ventures exceeded distributions received principally due to our contractual commitment to Palisades West LLC. In 2008, we contributed $9,118,000 to this venture which consists of two office buildings totaling approximately 375,000 square

feet located in Austin, Texas. In 2007, net cash (used for) investing activities was $(10,828,000) as capital contributed to unconsolidated ventures exceeded distributions received. Net cash provided by investing activities was $7,410,000 in 2006 as capital distributions we received from unconsolidated ventures exceeded contributions.

Cash Flows from Financing Activities

Net cash provided by financing activities was $69,163,000 in 2008, $71,979,000 in 2007 and $17,703,000 in 2006. In 2008, our debt increased by $71,387,000 to fund our real estate development expenditures, net investment in our unconsolidated ventures and net working capital to operate our business. In 2007, the increase in debt funded expenditures for real estate development and acquisitions. In 2006, the increase in debt, including borrowings under our credit facility with Temple-Inland, funded expenditures for real estate development and acquisitions in excess of the net distributions we received from ventures.

Liquidity and Contractual Obligations

Liquidity

At year-end 2008, we had $187,933,000 in net unused borrowing capacity under our senior credit facility.

	Senior Credit Facility (In thousands)
Committed	$ 465,000
Plus: unrestricted cash equivalents	5,968
Less: borrowings	(234,900)
Less: letters of credit	(13,135)
Less: minimum liquidity covenant	(35,000)
Unused borrowing capacity at year-end 2008	$ 187,933

Our senior credit facility provides for a $175,000,000 term loan and a $290,000,000 revolving line of credit. We may, upon notice to the lenders, request an increase in the credit facility to provide for a total of $500,000,000. The revolving line of credit may be prepaid at any time without penalty. The term loan may be prepaid at any time; however, repayment prior to June 1, 2009 requires a fee of 1.00% of the principal amount. There is no prepayment fee for the term loan on or after June 1, 2009. The senior credit facility matures December 1, 2010. The revolving line of credit includes a $100,000,000 sublimit for letters of credit, of which $13,135,000 was outstanding at year-end 2008. Total borrowings under our senior credit facility (including the face amount of letters of credit) may not exceed a borrowing base formula, and include a $35,000,000 minimum liquidity requirement at each quarter-end.

At our option, we can borrow at LIBOR plus 4 percent or Prime plus 2 percent. All borrowings under the senior credit facility are secured by (a) an initial pledge of approximately 250,000 acres of undeveloped land, (b) assignments of current and future leases, rents and contracts, including our mineral leases, (c) a security interest in our primary operating account, (d) pledge of the equity interests in current and future material operating subsidiaries or joint venture interests, or if such pledge is not permitted, a pledge of the right to distributions from such entities, and (e) negative pledge (without a mortgage) on most other wholly-owned assets. The senior credit facility provides for releases of real estate provided that borrowing base compliance is maintained.

As a result of current financial market conditions, we closely monitor the banks in our senior credit facility. We have not experienced any difficulty borrowing under our credit facility to date, and we currently have no reason to believe

that the participants will not be able to honor their commitments under these facilities.

In 2008, we entered into an interest rate swap agreement. This instrument expires in 2010 and is for a total notional amount of $100,000,000. It is non-exchange traded and is valued using third-party resources and models. Under the agreement, we mitigate interest rate fluctuations by fixing the interest rate on the first $100,000,000 of our variable rate borrowings at 6.57 percent compared with a floating interest rate of one month LIBOR plus 4 percent (4.77% at year-end 2008). At year-end 2008, the fair value of our interest rate instrument was a $1,938,000 liability that is included in other liabilities.

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Our senior credit facility and other debt agreements contain terms, conditions and financial covenants customary for such agreements including minimum levels of interest coverage and limitations on leverage. At year-end 2008, we had complied with the terms, conditions and financial covenants of these agreements. The following table details our compliance with the financial covenants of these agreements:

Financial Covenant	Requirement	Year-End 2008
Interest Coverage Ratio(a)	³1.50:1.0	2.68:1.0
Revenues/Capital Expenditures Ratio(b)	³0.80:1.0	1.47:1.0
Total Leverage Ratio(c)	40%	23.7%
Minimum Liquidity(d)	>$35 million	$223 million
Net Worth(e)	>$355 million(e)	$447 million

(a) Calculated as EBITDA (earnings before interest, taxes, depreciation and amortization) plus all non-cash compensation expenses plus other non-cash expenses, divided by interest expense. This covenant is applied at the end of each quarter on a rolling four quarter basis, and the requirement increases to 2.00 in second quarter 2009.

(b) Calculated as total gross revenues plus our pro rata share of the operating revenues from unconsolidated ventures, divided by capital expenditures. Capital expenditures are defined as consolidated development and acquisition expenditures plus our pro rata share of unconsolidated ventures development and acquisition expenditures. This covenant is applied at the end of each quarter on a rolling four quarter basis, and the requirement increases to 1.0:1.0 after third quarter 2009.

(c) Calculated as total funded debt divided by adjusted asset value. Total funded debt includes all indebtedness for borrowed funds, all secured liabilities, and all reimbursement obligations with respect to letters of credit or similar instruments. Adjusted asset value is defined as the sum of unrestricted cash and cash equivalents, timberlands, high value timberlands, raw entitled lands, entitled land under development, minerals business, and all other real estate owned at book value without regard to any indebtedness, and our pro rata share of joint ventures book value without regard to any indebtedness. This covenant is applied at the end of each quarter.

(d) Calculated as the amount available for drawing under the revolving commitment, plus unrestricted cash, plus cash equivalents which are not pledged or encumbered and the use of which is not restricted by the terms of any agreement. This covenant is applied at the end of each quarter.

(e) Calculated as the amount by which consolidated total assets exceeds consolidated total liabilities. At year-end 2008, the requirement is $355 million, computed as: $350 million, plus eighty five percent of the aggregate net proceeds received by us from any equity offering, plus fifty percent of all positive net income, on a cumulative basis. This covenant is applied at the end of each quarter.

Based on our current operating projections, we believe that we will remain in compliance with our senior credit facility covenants in the future. However, if market conditions continue to deteriorate or continue for an extended period, we may be unable to comply with our financial covenants and may need to seek amendments, waivers or forbearance of our senior credit facility, or may need to refinance. There can be no assurance that we will be able to obtain any amendments, waivers or forbearance when, as and if needed, or if the lenders would be willing to refinance on terms acceptable to us, or at all. Any amended facilities could be on terms that are both more expensive and more restrictive than our current senior credit facility.

There can be no assurance that these covenants will not adversely affect our ability to finance our future operations or capital needs or to pursue available business opportunities. A breach of any of these covenants or our inability to maintain the required financial ratios could result in a default of the senior credit facility. If a default occurs, the affected lenders could elect to declare the indebtedness, together with accrued interest and other fees, to be immediately due and payable.

Contractual Obligations

At year-end 2008, contractual obligations consist of:

	Payments Due or Expiring by Year (In thousands)				
	Total	2009	2010-11	2012-13	Thereafter
Debt[a]	$ 337,402	$ 35,207	$ 302,195	$	$
Interest payments on debt	20,065	11,574	8,491		
Purchase obligations	20,699	18,417	2,282		
Operating leases	23,746	2,226	4,196	3,719	13,605
Venture contributions	2,792	2,792			
Total	$ 404,704	$ 70,216	$ 317,164	$ 3,719	$ 13,605

[a] Denotes items included in our balance sheet.

Interest payments on debt include interest payments related to our fixed rate debt and estimated interest payments related to our variable rate debt. Estimated interest payments on variable rate debt were calculated assuming that the outstanding balances and interest rates that existed at year-end 2008 remain constant through maturity.

Purchase obligations are defined as legally binding and enforceable agreements to purchase goods and services. Our purchase obligations include commitments for land acquisition and land development, engineering and construction contracts for land development and service contracts. Our commitment to support third-party construction and ownership of a resort hotel, spa and golf facilities at our Cibolo Canyons mixed-use development near San Antonio, Texas represents our most significant purchase obligation. At year-end 2008, our unfunded commitment related to the Cibolo Canyons resort was $13,083,000, which is expected to be funded in 2009.

Our operating leases are for timberland, facilities and equipment. In second quarter 2008, we entered into a 10-year agreement with Palisades West LLC, in which we have a 25 percent ownership interest, to lease approximately 32,000 square feet in Austin, Texas. We occupy this facility as our corporate headquarters effective in fourth quarter 2008. At year-end 2008, the remaining contractual obligation is $12,133,000. Also included in operating leases is a long-term timber lease of over 16,000 acres that has a remaining lease term of 16 years and a remaining contractual obligation of $9,106,000.

Venture contributions represent commitments to contribute a stated amount to a venture as and when needed by the venture. We have excluded from the table contributions that may be made in the ordinary course of business for which there is no commitment to contribute an amount that is quantifiable or identifiable to specific dates.

Estimated payments related to our interest rate swap agreement are excluded from the table because we cannot reasonably estimate the amount or timing of payment obligations. Additionally, we have other long-term liabilities that are not included in the table because they do not have scheduled maturities.

Our sources of funding are our operating cash flows and borrowings under our senior credit facility. Our contractual obligations due in 2009 will likely be paid from operating cash flows and from borrowings under our senior credit facility.

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Off-Balance Sheet Arrangements

From time to time, we enter into off-balance sheet arrangements to facilitate our operating activities. At year-end 2008, our off-balance sheet unfunded arrangements, excluding contractual interest payments, purchase obligations, and operating lease obligations, included in the table of contractual obligations, consist of:

			Expiring by Year		
	Total	2009	2010-11	2012-13	Thereafter
			(In thousands)		
Standby letters of credit	$ 13,135	$ 10,635	$ 2,500	$	$
Performance bonds	14,099	14,009	70	20	
Recourse obligations	8,991	2,860	4,656	100	1,375
Total	$ 36,225	$ 27,504	$ 7,226	$ 120	$ 1,375

Performance bonds, letters of credit, and recourse obligations are primarily for our real estate development activities and include $3,151,000 of performance bonds and letters of credit we provided on behalf of certain ventures. Our venture partners also provide performance bonds and letters of credit. Generally these performance bonds or letters of credit would be drawn on due to lack of specific performance by us or the ventures, such as failure to deliver streets and utilities in accordance with local codes and ordinances.

Cibolo Canyons San Antonio, Texas

Mixed-Use Development

The Cibolo Canyons mixed-use development consists of 2,100 acres planned to include 1,749 residential lots and 145 commercial acres designated for multifamily and retail uses, of which 537 lots and 64 commercial acres have been sold at year-end 2008. We have $65,894,000 invested in the development at year-end 2008.

The construction and opening of the resort hotel (discussed below) will satisfy a condition to our right to obtain reimbursement of certain infrastructure costs related to our mixed-use development under an Ad Valorem Tax and Non Resort Sales and Use Tax Public Improvement Financing Agreement between us and a Special Purpose Improvement District (SPID).

Until the SPID achieves an adequate tax base to support issuance of bonds, the proceeds of which will be used by the SPID to reimburse us for qualified infrastructure costs, we will not include the estimated reimbursements as a reduction of our real estate cost of sales. At year-end 2008, we have billed the SPID $49,529,000 for qualified infrastructure costs. These costs have been audited by the SPID and approved for payment, and are included in our investment in the mixed-use development.

If the resort hotel is not open and operating on July 1, 2011, the City of San Antonio could terminate the SPID and we would have no payor for reimbursement of qualified infrastructure costs. The resort hotel is under construction and is currently scheduled to open well before July 1, 2011.

Resort Hotel, Spa and Golf

In 2007, we entered into agreements to facilitate third-party construction and ownership of the JW Marriott®
San Antonio Hill Country Resort & Spa, planned to include a 1,002 room destination resort and two PGA Tour®
Tournament Players Club® golf courses. Under these agreements, we transferred to the third-party owners about
700 acres of undeveloped land and we agreed to provide about $38,500,000. In exchange, the third-party owners
assigned to us certain rights under an Economic Development Agreement, including the right to receive 9% of hotel
occupancy revenues and 1.5% of sales generated within the resort through 2034. At year-end 2008, we have provided
$25,417,000 and expect to fund our remaining commitment of $13,083,000 by year-end 2009.

If the resort hotel is not open and operating on July 1, 2011, the City of San Antonio could terminate the SPID and
there would be no source of revenue to fund payments under the Economic Development Agreement. The resort hotel
is under construction and is currently scheduled to open well before July 1, 2011.

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Accounting Policies

Critical Accounting Estimates

In preparing our financial statements, we follow generally accepted accounting principles, which in many cases require us to make assumptions, estimates, and judgments that affect the amounts reported. Our significant accounting policies are included in Note 1 to the Consolidated Financial Statements. Many of these principles are relatively straightforward. There are, however, a few accounting policies that are critical because they are important in determining our financial condition and results and involve significant assumptions, estimates, and judgments that are difficult to determine. We must make these assumptions, estimates, and judgments currently about matters that are inherently uncertain, such as future economic conditions, operating results, and valuations, as well as our intentions. As the difficulty increases, the level of precision decreases, meaning actual results can, and probably will, differ from those currently estimated. We base our assumptions, estimates, and judgments on a combination of historical experiences and other factors that we believe are reasonable. We have reviewed the selection and disclosure of these critical accounting estimates with our Audit Committee.

Investment in Real Estate and Cost of Real Estate Sales In allocating costs to real estate owned and real estate sold, we must estimate current and future real estate values. Our estimates of future real estate values sometimes must extend over periods 15 to 20 years from today and are dependent on numerous assumptions including our intentions and future market and economic conditions. In addition, when we sell real estate from projects that are not finished, we must estimate future development costs through completion. Differences between our estimates and actual results will affect future carrying values and operating results.

Impairment of Long-Lived Assets Measuring assets for impairment requires estimating future fair values based on our intentions as to holding periods, future operating cash flows and the residual value of assets under review, primarily undeveloped land. Depending on the asset under review, we use varying methods to determine fair value, such as discounting expected future cash flows, determining resale values by market, or applying a capitalization rate to net operating income using prevailing rates in a given market. Changes in economic conditions, demand for real estate, and the projected net operating income for a specific property will inevitably change our estimates.

Share-Based Compensation We currently use the Black-Scholes option pricing model to determine the fair value of stock options. The determination of the fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the stock price as well as assumptions regarding a number of other variables. These variables include expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors (term of option), risk-free interest rate and expected dividends. We have limited historical experience as a stand-alone company so we utilized alternative methods in determining our valuation assumptions. The expected life was based on the simplified method utilizing the midpoint between the vesting period and the contractual life of the awards. The expected stock price volatility was based on historical prices of our peers common stock for a period corresponding to the expected life of the options. Pre-vesting forfeitures are estimated based upon the pool of participants and their expected activity.

Income Taxes In preparing our consolidated financial statements, significant management judgment is required to estimate our income taxes. Our estimates are based on our interpretation of federal and state tax laws. We estimate our actual current tax due and assess temporary differences resulting from differing treatment of items for tax and accounting purposes. The temporary differences result in deferred tax assets and liabilities, which are included in our consolidated balance sheet. If needed, we record a valuation allowance against our deferred tax assets based upon our analysis of the timing and reversal of future taxable amounts and our history and future expectations of taxable income. Adjustments may be required by a change in assessment of our deferred

tax assets and liabilities, changes due to audit adjustments by federal and state tax authorities, and changes in tax laws. To the extent adjustments are required in any given period; we will include the adjustments in the tax

provision in our financial statements. These adjustments could materially impact our financial position, cash flow and results of operation.

Pending Accounting Pronouncements

There are three new accounting pronouncements that we will adopt in 2009 or will be required to adopt in 2010. Please read Note 1 to the Consolidated Financial Statements.

Effects of Inflation

Inflation has had minimal effects on operating results the past three years. Our real estate, timber, and property and equipment are carried at historical costs. If carried at current replacement costs, the cost of real estate sold, timber cut, and depreciation expense would have been significantly higher than what we reported.

Legal Proceedings

We are involved in various legal proceedings that arise from time to time in the ordinary course of doing business. We believe we have established adequate reserves for any probable losses, and we do not believe that the outcome of any of these proceedings should have a material adverse effect on our financial position, long-term results of operations, or cash flow. It is possible, however, that charges related to these matters could be significant to results of operations or cash flows in any one accounting period.

Item 7A. ***Quantitative and Qualitative Disclosures About Market Risk.***

Interest Rate Risk

Our interest rate risk is principally related to our variable-rate debt. Interest rate changes impact earnings due to the resulting increase or decrease in the cost of our variable-rate debt, which was $229,030,000 at year-end 2008 and $238,716,000 at year-end 2007.

The following table illustrates the estimated effect on our pre-tax income of immediate, parallel, and sustained shifts in interest rates for the next 12 months at year-end 2008 on our variable-rate debt, with comparative year-end 2007 information. This estimate assumes that debt reductions from contractual payments will be replaced with short-term, variable-rate debt; however, that may not be the financing alternative we choose.

Change in Interest Rates	At Year-End 2008 (In thousands)	At Year-End 2007 (In thousands)
+2%	$ (4,581)	$ (4,774)
+1%	(2,290)	(2,387)
−1%	2,290	2,387
−2%	4,581	4,774

Changes in interest rates affect the value of our interest rate swap agreement ($100,000,000 notional value at year-end 2008). We believe any change in the value of this agreement would not be significant.

Foreign Currency Risk

We have no exposure to foreign currency fluctuations.

Commodity Price Risk

We have no significant exposure to commodity price fluctuations.

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Item 8. ***Financial Statements and Supplementary Data.***

The Consolidated Financial Statements and related notes and schedules are indexed on page F-1, and are attached as pages F-1 through F-31, to this Annual Report on Form 10-K.

Item 9. ***Changes in and Disagreements With Accountants on Accounting and Financial Disclosure.***

None.

Item 9A. ***Controls and Procedures.***

(a) Disclosure controls and procedures

Our management, with the participation of the Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (or the Exchange Act)) as of the end of the period covered by this report. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, our disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by us in the reports that we file or submit under the Exchange Act and are effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

(b) Internal control over financial reporting

Management s report on internal control over financial reporting is included in this Annual Report on Form 10-K on page F-2.

(c) Changes in Internal Control over Financial Reporting

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) in fourth quarter 2008 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. ***Other Information.***

None.

PART III

Item 10. ***Directors, Executive Officers and Corporate Governance.***

Set forth below is certain information about the members of our Board of Directors:

Name	Age	Year First Elected to the Board	Principal Occupation
Kenneth M. Jastrow, II	61	2007	Former Chairman and Chief Executive Officer of Temple-Inland Inc.
Louis R. Brill	67	2007	Former Chief Accounting Officer of Temple-Inland Inc.
Kathleen Brown	63	2007	Senior Advisor, Goldman, Sachs & Co.
William G. Currie	61	2007	Executive Chairman of Universal Forest Products, Inc.
James M. DeCosmo	50	2007	President and Chief Executive Officer of Forestar Group Inc.
Michael E. Dougherty	68	2008	Chairman of Dougherty Financial Group LLC
James A. Johnson	65	2007	Vice Chairman of Perseus LLC
Thomas H. McAuley	63	2007	President of Inland Capital Markets Groups, Inc.
William C. Powers, Jr.	62	2007	President of The University of Texas at Austin
James A. Rubright	62	2007	Chairman and Chief Executive Officer of Rock-Tenn Company
Richard M. Smith	63	2007	Chairman of Newsweek

The remaining information required by this item is incorporated herein by reference from our definitive proxy statement, involving the election of directors, to be filed pursuant to Regulation 14A with the SEC not later than 120 days after the end of the fiscal year covered by this Form 10-K (or Definitive Proxy Statement). Certain information required by this item concerning executive officers is included in Part I of this report.

Item 11. ***Executive Compensation.***

The information required by this item will be contained in our Definitive Proxy Statement to be filed in connection with our 2009 annual meeting of stockholders and is incorporated herein by reference.

Item 12. ***Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.***

The information required by this item will be contained in our Definitive Proxy Statement to be filed in connection with our 2009 annual meeting of stockholders and is incorporated herein by reference.

Item 13. ***Certain Relationships and Related Transactions, and Director Independence.***

The information required by this item will be contained in our Definitive Proxy Statement to be filed in connection with our 2009 annual meeting of stockholders and is incorporated herein by reference.

Item 14. ***Principal Accountant Fees and Services.***

The information required by this item will be contained in our Definitive Proxy Statement to be filed in connection with our 2009 annual meeting of stockholders and is incorporated herein by reference.

PART IV

Item 15. ***Exhibits and Financial Statement Schedules.***

(a) Documents filed as part of this report.

(1) *Financial Statements*

Our Consolidated Financial Statements are attached as pages F-1 through F-31 to this Annual Report on Form 10-K.

(2) *Financial Statement Schedules*

Schedule III Consolidated Real Estate and Accumulated Depreciation is attached as pages S-1 through S-6 to this Annual Report on Form 10-K.

Schedules other than those listed above are omitted as the required information is either inapplicable or the information is presented in our Consolidated Financial Statements and notes thereto.

(3) *Exhibits*

The exhibits listed in the Exhibit Index in (b) below are filed or incorporated by reference as part of this Annual Report on Form 10-K.

(b) Exhibits

Exhibit Number	Exhibit
2.1	Separation and Distribution Agreement, dated December 11, 2007, among Forestar Real Estate Group Inc. (the Company), Guaranty Financial Group Inc., and Temple Inland Inc. (incorporated by reference to Exhibit 2.1 of the Company s Current Report on Form 8-K filed with the Commission on December 11, 2007).
3.1	Amended and Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.1 of the Company s Current Report on Form 8-K filed with the Commission on December 11, 2007).
3.2	Amended and Restated Bylaws (incorporated by reference to Exhibit 3.2 of the Company s Current Report on Form 8-K filed with the Commission on December 11, 2007).
3.3	First Amendment to Amended and Restated Bylaws of Forestar Real Estate Group Inc. (incorporated by reference to Exhibit 3.1 of the Company s Current Report on Form 8-K filed with the Commission on February 19, 2008).
3.4	Certificate of Designation of Series A Junior Participating Preferred Stock (incorporated by reference to Exhibit 3.3 of the Company s Current Report on Form 8-K filed with the Commission on December 11, 2007).
3.5	Second Amendment to Amended and Restated Bylaws of Forestar Real Estate Group Inc.(1)
3.6	Certificate of Ownership and Merger, dated November 21, 2008 (incorporated by reference to Exhibit 3.1 of the Company s Current Report on Form 8-K filed with the Commission on November 24, 2008).
3.7	

	Third Amendment to Amended and Restated Bylaws of Forestar Group Inc. (incorporated by reference to Exhibit 3.2 of the Company s Current Report on Form 8-K filed with the Commission on November 24, 2008).
4.1	Specimen Certificate for shares of common stock, par value $1.00 per share, of Forestar Real Estate Group Inc. (incorporated by reference to Exhibit 4.1 of Amendment No. 5 to the Company s Form 10 filed with the Commission on December 10, 2007).
4.2	Rights Agreement, dated December 11, 2007, between Forestar Real Estate Group Inc. and Computershare Trust Company, N.A., as Rights Agent (including Form of Rights Certificate) (incorporated by reference to Exhibit 4.1 of the Company s Current Report on Form 8-K filed with the Commission on December 11, 2007).
10.1	Tax Matters Agreement, dated December 11, 2007, among Forestar Real Estate Group Inc., Guaranty Financial Group Inc., and Temple Inland Inc. (incorporated by reference to Exhibit 10.1 of the Company s Current Report on Form 8-K filed with the Commission on December 11, 2007).

Exhibit Number	Exhibit
10.2	Transition Services Agreement, dated December 11, 2007, among Forestar Real Estate Group Inc., Guaranty Financial Group Inc., and Temple Inland Inc. (incorporated by reference to Exhibit 10.2 of the Company s Current Report on Form 8-K filed with the Commission on December 11, 2007).
10.3	Employee Matters Agreement, dated December 11, 2007, among Forestar Real Estate Group Inc., Guaranty Financial Group Inc., and Temple Inland Inc. (incorporated by reference to Exhibit 10.3 of the Company s Current Report on Form 8-K filed with the Commission on December 11, 2007).
10.4	Form of Forestar Real Estate Group Retirement Savings Plan (incorporated by reference to Exhibit 10.4 of Amendment No. 5 to the Company s Form 10 filed with the Commission on December 10, 2007).
10.5	Form of Forestar Real Estate Group Supplemental Employee Retirement Plan (incorporated by reference to Exhibit 10.5 of Amendment No. 5 to the Company s Form 10 filed with the Commission on December 10, 2007).
10.6	Form of Forestar Real Estate Group 2007 Stock Incentive Plan (incorporated by reference to Exhibit 10.6 of Amendment No. 5 to the Company s Form 10 filed with the Commission on December 10, 2007).
10.7	Form of Forestar Real Estate Group Director s Fee Deferral Plan (incorporated by reference to Exhibit 10.7 of Amendment No. 5 to the Company s Form 10 filed with the Commission on December 10, 2007).
10.8	Revolving and Term Credit Agreement, dated as of December 14, 2007, among Forestar (USA) Real Estate Group Inc., as borrower, and Forestar Real Estate Group Inc. and certain wholly-owned subsidiaries of the Company, as guarantors, and KeyBank National Association, as lender, swing line lender and agent; General Electric Credit Corporation and AgFirst Farm Credit Bank, as co-syndication agents; KeyBanc Capital Markets, as sole arranger and sole book managers; and the lenders party thereto (incorporated by reference to Exhibit 10.1 of the Company s Current Report on Form 8-K filed with the Commission on December 17, 2007).
10.9	Form of Indemnification Agreement to be entered into between the Company and each of its directors (incorporated by reference to Exhibit 10.9 of Amendment No. 5 to the Company s Form 10 filed with the Commission on December 10, 2007).
10.10	Form of Change in Control Agreement between the Company and its named executive officers (incorporated by reference to Exhibit 10.10 of Amendment No. 5 to the Company s Form 10 filed with the Commission on December 10, 2007).
10.11	Employment Agreement between the Company and James M. DeCosmo dated August 9, 2007 (incorporated by reference to Exhibit 10.11 of Amendment No. 5 to the Company s Form 10 filed with the Commission on December 10, 2007).
10.12	Form of Nonqualified Stock Option Agreement(1).
10.13	Form of Restricted Stock Agreement (Tier 1) (1).
10.14	Form of Restricted Stock Units Agreement for senior executives (incorporated by reference to Exhibit 10.2 of the Company s Current Report on Form 8-K filed with the Commission on February 12, 2009).
10.15	Form of Stock Appreciation Rights Agreement (incorporated by reference to Exhibit 10.1 of the Company s Current Report on Form 8-K filed with the Commission on February 12, 2009).
10.16	First Amendment to Forestar Group Inc. Director s Fee Deferral Plan(1).
21.1	List of Subsidiaries of the Company(1).
23	Consent of Ernst & Young LLP(1).
31.1	Certification of Chief Executive Officer pursuant to Exchange Act rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002(1).
31.2	

	Certification of Chief Financial Officer pursuant to Exchange Act rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002(1).
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002(1).
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002(1).

Management contract or compensatory plan or arrangement.

(1) Filed herewith.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Forestar Group Inc.

By: /s/ James M. DeCosmo

James M. DeCosmo

President and Chief Executive Officer

Date: March 5, 2009

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Capacity	Date
/s/ James M. DeCosmo James M. DeCosmo	Director, President and Chief Executive Officer (Principal Executive Officer)	March 5, 2009
/s/ Christopher L. Nines Christopher L. Nines	Chief Financial Officer (Principal Financial Officer)	March 5, 2009
/s/ Charles D. Jehl Charles D. Jehl	Chief Accounting Officer (Principal Accounting Officer)	March 5, 2009
/s/ Kenneth M. Jastrow, II Kenneth M. Jastrow, II	Chairman of the Board	March 5, 2009
/s/ Louis R. Brill Louis R. Brill	Director	March 5, 2009
/s/ Kathleen Brown Kathleen Brown	Director	March 5, 2009
/s/ William G. Currie William G. Currie	Director	March 5, 2009

/s/ Michael E. Dougherty	Director	March 5, 2009
Michael E. Dougherty		
/s/ James A. Johnson	Director	March 5, 2009
James A. Johnson		
/s/ Thomas H. McAuley	Director	March 5, 2009
Thomas H. McAuley		
/s/ William C. Powers, Jr.	Director	March 5, 2009
William C. Powers, Jr.		
/s/ James A. Rubright	Director	March 5, 2009
James A. Rubright		
/s/ Richard M. Smith	Director	March 5, 2009
Richard M. Smith		

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MANAGEMENT S ANNUAL REPORT
ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of Forestar is responsible for establishing and maintaining adequate internal control over financial reporting. Management has designed our internal control over financial reporting to provide reasonable assurance that our published financial statements are fairly presented, in all material respects, in conformity with generally accepted accounting principles.

Management is required by paragraph (c) of Rule 13a-15 of the Securities Exchange Act of 1934, as amended, to assess the effectiveness of our internal control over financial reporting as of each year end. In making this assessment, management used the *Internal Control Integrated Framework* issued in July 1994 by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Management conducted the required assessment of the effectiveness of our internal control over financial reporting as of year end. Based upon this assessment, management believes that our internal control over financial reporting is effective as of year-end 2008.

Ernst & Young LLP, the independent registered public accounting firm that audited our financial statements included in this Form 10-K, has also audited our internal control over financial reporting. Their attestation report follows this report of management.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of Forestar Group Inc.:

We have audited Forestar Group Inc. and subsidiaries (Forestar Group) internal control over financial reporting as of December 31, 2008 based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Forestar Group s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting including in the accompanying Management s Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the effectiveness of the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed 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. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Forestar Group maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008 based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Forestar Group as of December 31, 2008 and December 29, 2007 and the related consolidated statements of income, shareholders equity, and cash flows for each of the three years in the period ended December 31, 2008 and our report dated March 4, 2009 expressed an unqualified opinion thereon.

Ernst & Young LLP

Austin, Texas

March 4, 2009

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders of Forestar Group Inc.:

We have audited the accompanying consolidated balance sheets of Forestar Group Inc. and subsidiaries (Forestar Group) as of December 31, 2008 and December 29, 2007, and the related consolidated statements of income, shareholders equity, and cash flows for each of the three years in the period ended December 31, 2008. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits. The financial statements of CL Realty, L.L.C., (a Limited Liability Company in which Forestar Group has a 50% interest), have been audited by other auditors whose report has been furnished to us, and our opinion on the consolidated financial statements, insofar as it relates to the amounts included for CL Realty, L.L.C., is based solely on the report of the other auditors. In the consolidated financial statements, Forestar Group s investment in CL Realty, L.L.C. is stated at $51,963,000 and $50,189,000, respectively, at December 31, 2008 and December 29, 2007, and Forestar Group s equity in the net income of CL Realty, L.L.C. is stated at $3,377,000 and $1,700,000, for the years then ended.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Forestar Group at December 31, 2008 and December 29, 2007, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles. Also in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Forestar Group s internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 4, 2009 expressed an unqualified opinion thereon.

Ernst & Young LLP

Austin, Texas
March 4, 2009

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FORESTAR GROUP INC.

CONSOLIDATED BALANCE SHEETS

	At Year-End 2008	At Year-End 2007
	(In thousands, except share data)	
ASSETS		
Cash and cash equivalents	$ 8,127	$ 7,520
Real estate	610,586	552,210
Investment in unconsolidated ventures	117,554	101,687
Timber	50,989	54,593
Receivables, net of allowance for bad debts of $226 in 2008 and 2007	4,262	3,767
Prepaid expense	2,425	2,267
Property and equipment, net of accumulated depreciation of $2,994 in 2008 and $2,455 in 2007	6,211	1,568
Deferred tax asset	17,184	5,106
Other assets	17,238	20,008
TOTAL ASSETS	$ 834,576	$ 748,726
LIABILITIES AND STOCKHOLDERS EQUITY		
Accounts payable	$ 7,438	$ 8,002
Accrued employee compensation and benefits	3,389	3,857
Accrued interest	1,199	896
Accrued property taxes	6,808	4,459
Other accrued expenses	11,448	15,318
Other liabilities	12,940	8,349
Debt	337,402	266,015
TOTAL LIABILITIES	380,624	306,896
COMMITMENTS AND CONTINGENCIES		
MINORITY INTEREST IN CONSOLIDATED VENTURES	6,660	8,629
STOCKHOLDERS EQUITY		
Preferred stock, par value $0.01 per share, 25,000,000 authorized shares, none issued		
Common stock, par value $1.00 per share, 200,000,000 authorized shares, 35,839,390 issued at December 31, 2008 and 35,380,385 issued at December 29, 2007	35,839	35,380
Additional paid-in capital	377,810	373,026
Retained earnings	36,769	24,795
Accumulated other comprehensive income	(1,260)	
Treasury stock, at cost, 90,819 shares at December 31, 2008	(1,866)	

TOTAL STOCKHOLDERS EQUITY	447,292	433,201
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$ 834,576	$ 748,726

Please read the notes to the consolidated financial statements.

FORESTAR GROUP INC.

CONSOLIDATED STATEMENTS OF INCOME

	For the Year		
	2008	2007	2006
	(In thousands, except per share amounts)		
REVENUES			
Real estate sales	$ 73,555	$ 117,890	$ 151,785
Commercial operating properties and other	25,304	24,839	28,366
Real estate	98,859	142,729	180,151
Mineral resources	47,671	20,818	27,980
Fiber resources and other	13,192	14,439	17,429
	159,722	177,986	225,560
EXPENSES			
Cost of real estate sales	(38,395)	(58,046)	(90,629)
Cost of commercial operating properties and other	(16,736)	(17,936)	(17,307)
Cost of fiber resources	(3,357)	(3,672)	(3,455)
Other operating	(43,200)	(30,441)	(27,201)
General and administrative	(22,228)	(18,624)	(15,144)
	(123,916)	(128,719)	(153,736)
OPERATING INCOME	35,806	49,267	71,824
Equity in earnings of unconsolidated ventures	4,642	3,732	19,371
Minority interest in consolidated ventures	(2,235)	(5,771)	(3,231)
Interest expense	(21,283)	(9,229)	(6,229)
Other non-operating income	279	705	79
INCOME BEFORE TAXES	17,209	38,704	81,814
Income tax expense	(5,235)	(13,909)	(29,970)
NET INCOME	$ 11,974	$ 24,795	$ 51,844
WEIGHTED AVERAGE COMMON SHARES OUTSTANDING			
Basic	35,455	35,380	35,380
Diluted	35,892	35,380	35,380
NET INCOME PER COMMON SHARE			
Basic	$ 0.34	$ 0.70	$ 1.47
Diluted	$ 0.33	$ 0.70	$ 1.47

Please read the notes to the consolidated financial statements.

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FORESTAR GROUP INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS /PARENT S EQUITY

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Treasury Stock Shares	Treasury Stock Amount	Accumulated Other Comprehensive Income	Retained Earnings	Parent s Equity	T
				(In thousands, except share data)					
es at December 31,		$	$		$	$	$	$ 381,290	$ 3
ome								51,844	
sactions with ompany								(15,082)	(
es at December 30,		$	$		$	$	$	$ 418,052	$ 4
ome							24,795		
sactions with ompany								(9,646)	
f from -Inland	35,380,385	35,380	373,026	(53)				(408,406)	
es at December 29,	35,380,385	$ 35,380	$ 373,026	(53)	$	$	$ 24,795	$	$ 4
ome							11,974		
zed losses on rate swap, net of $679						(1,260)			
ehensive income									$
es of common stock	182,976	183	(183)						
es of restricted	214,426	214	(214)						
es from exercises of tions	61,603	62	835						
withheld for payroll				(52,482)	(1,194)				
xchanged for exercised				(27,394)	(646)				
res of restricted			7	(10,890)	(26)				
ased compensation			4,254						
efit from exercise cted stock units and tions and vested d stock			85						

s at December 31,									
	35,839,390	$ 35,839	$ 377,810	(90,819)	$ (1,866)	$ (1,260)	$ 36,769	$	$ 4

Please read the notes to the consolidated financial statements.

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FORESTAR GROUP INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Year		
	2008	2007	2006
		(In thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$ 11,974	$ 24,795	$ 51,844
Adjustments:			
Depreciation and amortization	7,673	2,915	2,355
Deferred income taxes	(11,399)	(19,544)	(4,912)
Equity in earnings of unconsolidated ventures	(4,642)	(3,732)	(19,371)
Distributions of earnings of unconsolidated ventures	1,053	2,863	1,519
Minority interest in consolidated ventures	2,235	5,771	3,231
Distributions of earnings to minority interests	(4,427)	(11,042)	(426)
Share-based compensation	4,516	1,397	1,275
Non-cash real estate cost of sales	34,766	46,975	86,393
Real estate development and acquisition expenditures	(99,189)	(140,013)	(159,886)
Reimbursements from utility or improvement districts	674	10,628	5,790
Other changes in real estate	(522)	(1,364)	(2,174)
Gain on termination of timber lease	(1,627)	(2,243)	
Cost of timber cut	2,968	4,060	3,441
Deferred income	681		
Asset impairments	3,000	6,518	
Other	(538)	(65)	286
Changes in:			
Receivables	22	659	(313)
Prepaid expenses and other	1,058	(66)	(298)
Accounts payable and other accrued liabilities	(165)	7,507	3,541
Net cash (used for) operating activities	(51,889)	(63,981)	(27,705)
CASH FLOWS FROM INVESTING ACTIVITIES:			
Property, equipment, software and reforestation	(5,197)	(3,198)	(3,991)
Investment in unconsolidated ventures	(17,845)	(14,492)	(17,611)
Return of investment in unconsolidated ventures	6,168	3,239	22,208
Notes receivable sold or collected		491	5,493
Proceeds from sale of property and equipment	52	166	1,311
Proceeds from termination of timber lease	155	2,966	
Net cash (used for) provided by investing activities	(16,667)	(10,828)	7,410
CASH FLOWS FROM FINANCING ACTIVITIES:			
Payments of debt	(80,165)	(22,534)	(89,144)
Additions to debt	151,552	226,446	30,636
Note payable to Temple-Inland, net		(93,063)	97,678
Dividends and other transfers to Temple-Inland		(29,101)	(21,516)
Deferred financing fees	(1,619)	(10,010)	

Return of investment to minority interest	(14)	(906)	(91)
Exercise of stock options	897		
Payroll taxes on restricted stock and stock options	(1,858)		
Tax benefit from share-based compensation	85		
Other	285	1,147	140
Net cash provided by financing activities	69,163	71,979	17,703
Net increase (decrease) in cash and cash equivalents	607	(2,830)	(2,592)
Cash and cash equivalents at beginning of year	7,520	10,350	12,942
Cash and cash equivalents at year-end	$ 8,127	$ 7,520	$ 10,350
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:			
Cash paid during the year for:			
Interest	$ 18,348	$ 10,014	$ 4,309
Income taxes	$ 18,414	$ 33,428	$ 125
SUPPLEMENTAL DISCLOSURE OF NON-CASH INFORMATION:			
Capitalized interest	$ 943	$ 695	$ 543
Lessor construction allowances	1,296		

Please read the notes to the consolidated financial statements.

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FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Summary of Significant Accounting Policies

Background

Prior to December 28, 2007, we were a wholly-owned subsidiary of Temple-Inland Inc. On December 28, 2007, Temple-Inland distributed all of the issued and outstanding shares of our common stock to its stockholders. In connection with the spin-off, Temple-Inland contributed the assets, liabilities, operations and cash flow of its real estate development and minerals operations to us. Our operations consist of the former real estate segment of Temple-Inland and several smaller real estate operations and assets previously included in Temple-Inland s other business segments, and the minerals operations previously included in Temple-Inland s forest products segment. We converted to a Delaware corporation before the spin-off.

Basis of Presentation

Our consolidated financial statements include the accounts of Forestar Group Inc., all subsidiaries, ventures, and other entities in which we have a controlling interest and variable interest entities of which we are the primary beneficiary. We eliminate all material intercompany accounts and transactions. Minority interest in consolidated pass-through entities is recognized before income taxes. We account for our investment in other entities in which we have significant influence over operations and financial policies using the equity method (we recognize our share of the entities income or loss and any preferential returns and treat distributions as a reduction of our investment). We account for our investment in other entities in which we do not have significant influence over operations and financial policies using the cost method (we recognize as income only distribution of accumulated earnings).

In 2007 and 2006, our consolidated financial statements reflect the historical accounts of the real estate development, minerals and fiber operations contributed to us and have been derived from the historical financial statements and accounts of Temple-Inland. These operations were conducted within separate legal entities and their subsidiaries or within segments or components of segments of Temple-Inland.

We prepare our financial statements in accordance with generally accepted accounting principles, which require us to make estimates and assumptions about future events. Actual results can, and probably will, differ from those we currently estimate. Examples of significant estimates include those related to allocating costs to real estate and measuring assets for impairment.

In 2008, we changed our fiscal year from a 52/53 week year ending the Saturday closest to December 31 to a calendar year. In 2007 and 2006, our fiscal year ended on the Saturday closest to December 31. All of the periods presented had 52 weeks. Fiscal year 2007 ended on December 29, 2007 and fiscal year 2006 ended on December 30, 2006.

In 2007 and 2006, we used Temple-Inland as a source of capital and for services such as environmental, finance, financial reporting, human resources, internal audit, insurance, legal, tax and technology. The estimated costs of these services were allocated to us and are included in general and administrative expense.

In addition, we have also included other expenses incurred by Temple-Inland but not directly attributable to us such as costs associated with investor relations and executive officers. The allocations were based on actual usage or in some cases estimated usage based on Temple-Inland s net investment in us relative to its other segments, revenues, operating profits, employee count, or similar measures. These allocated costs, which include salaries and benefits, totaled

$7,909,000 in 2007 and $7,128,000 in 2006.

For 2007 and 2006, we believe the assumptions and methodologies used to derive the allocations in our financial statements are reasonable; however, they may not necessarily be indicative of what expenses would have been had we been a separate stand-alone company. We have no practical way of determining what expenses we would have incurred if we would have been a stand-alone company in 2007 and 2006.

FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Cash and Cash Equivalents

Cash and cash equivalents include cash and other short-term instruments with original maturities of three months or less. At year end 2008, restricted cash included in cash and cash equivalents was $2,159,000.

Cash Flows

Expenditures for the acquisition and development of real estate are classified as operating activities. Expenditures for the acquisition of commercial operating properties are classified as investing activities.

Capitalized Software

We capitalize purchased software costs as well as the direct internal and external costs associated with software we develop for our own use. We amortize these capitalized costs using the straight-line method over estimated useful lives ranging from three to seven years. The carrying value of capitalized software was $2,604,000 at year-end 2008 and $2,720,000 at year-end 2007 and is included in other assets. The amortization of these capitalized costs was $784,000 in 2008, $370,000 in 2007 and $6,000 in 2006 and is included in general and administrative expense.

Derivative Instruments

We periodically enter into interest rate agreements in the normal course of business to mitigate the risk inherent in interest rate fluctuations. We account for derivative financial instruments in accordance with Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities.* We defer and include in other comprehensive income changes in the fair value of derivative instruments designated as cash flow hedges. We recognize the ineffective portion of these hedges in income.

Environmental Obligations and Asset Retirement Obligations

We recognize environmental remediation liabilities on an undiscounted basis when environmental assessments or remediation are probable and we can reasonably estimate the cost. We adjust these liabilities as further information is obtained or circumstances change. We currently do not have any asset retirement obligations.

Fair Value of Financial Instruments

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*. This standard defines fair value, establishes a framework for measuring fair value in accounting principles generally accepted in the United States of America, and expands disclosure about fair value measurements. This pronouncement applies under other accounting standards that require or permit fair value measurements. Accordingly, this statement does not require any new fair value measurement. This statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. SFAS 157 is amended by FASB Staff Position (FSP) FAS 157-2, *Effective Date of FASB Statement 157*, which delays the effective date of SFAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). This FSP partially defers the effective date of SFAS 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of this FSP. We adopted SFAS 157 on

January 1, 2008, except as it applies to those nonfinancial assets and nonfinancial liabilities as noted in FSP FAS 157-2. The partial adoption of SFAS 157 did not have a material impact on our consolidated financial position or results of operations.

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FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In addition, SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities,* which permits the election of fair value as the initial and subsequent measurement method for many financial assets and financial liabilities, was effective for us in 2008. We did not elect the fair value option.

Please read **Note 7** and **Note 8** for information about fair value of our financial instruments.

Impairment of Long-Lived Assets

We review long-lived assets held for use for impairment when events or circumstances indicate that their carrying value may not be recoverable. Impairment exists if the carrying amount of the long-lived asset is not recoverable from the undiscounted cash flows expected from its use and eventual disposition. We determine the amount of the impairment loss by comparing the carrying value of the long-lived asset to its estimated fair value. In the absence of quoted market prices, we determine estimated fair value generally based on the present value of future probability weighted cash flows expected from the use and eventual disposition of the long-lived asset. We recognized asset impairments of $3,000,000 in 2008, $6,518,000 in 2007 and none in 2006. Impairment charges are included in cost of real estate sales.

Income Taxes

We provide deferred income taxes using current tax rates for temporary differences between the financial accounting carrying value of assets and liabilities and their tax accounting carrying values. We recognize and value income tax exposures for the various taxing jurisdictions where we operate based on laws, elections, commonly accepted tax positions, and management estimates. We include tax penalties and interest in income tax expense. In 2007 and 2006, we were included in Temple-Inland s consolidated federal income tax return prior to our spin-off, and our income tax expense was computed as if we filed a separate tax return. We provide a valuation allowance for any deferred tax asset that is not likely to be recoverable in future periods.

Beginning first quarter 2007, we adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). We determined that no material unrecognized deferred tax assets or liabilities existed at the date of adoption, and accordingly, the adoption of FIN 48 did not impact our financial condition or results of operations. In addition, we believe that no material unrecognized deferred tax assets or liabilities existed at year-end 2008. We classify interest and penalties related to underpayments of income tax as income tax expense.

Mineral Interests

We acquire real estate that may include the subsurface rights associated with the property, including minerals. We capitalize the costs of acquiring these mineral interests. We amortize the cost assigned to unproved interests, principally acquisition costs, using the straight-line method over appropriate periods based on our experience, generally no longer than 10 years. Costs assigned to individual unproven interests are minimal and amortized on an aggregate basis. When we lease these interests to third party oil and gas exploration and production entities, any related unamortized costs are accounted for using the cost recovery method from the cash proceeds received from lease bonus payments. We have fully amortized all previously-capitalized acquisition costs and did not capitalize any costs in 2008 or 2007.

When we lease our mineral interests to third party exploration and production entities, we retain a royalty interest and may take an additional participation in production, including a non-operating working interest. Non-operating working interests refer to well interests in which we pay a share of the costs to drill, complete and operate a well and receive a proportionate share of the production revenues. We use the successful efforts method to account for our mineral interest participations. Mineral interests and non-operating working interests, net of amortization, are included in property and equipment on our balance sheet.

FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

We do not know the oil and gas reserves related to our royalty interests. We do not make such estimates, and the lessees do not make this reserve information available to us.

Operating Leases

We occupy office space in various locations under operating leases. The lease agreements may contain rent escalation clauses, construction allowances and/or contingent rent provisions. For scheduled rent escalation clauses, we recognize the minimum rent expense on a straight-line basis and record the difference between the recognized rent expense and the amounts payable under the lease as deferred lease credits included in other liabilities in the consolidated balance sheets. Deferred lease credits are amortized over the lease term. For construction allowances, we record leasehold improvement assets included in property and equipment in the consolidated balance sheets amortized over the shorter of their economic lives or the lease term. The related deferred lease credits are amortized as a reduction of rent expense over the lease term.

Property and Equipment

We carry property and equipment at cost less accumulated depreciation. We capitalize the cost of significant additions and improvements, and we expense the cost of repairs and maintenance. We capitalize interest costs incurred on major construction projects. We depreciate these assets using the straight-line method over their estimated useful lives as follows:

	Estimated Useful Lives	Carrying Value At Year-End 2008 (In thousands)
Buildings and building improvements	10 to 40 years	$ 4,800
Office and other equipment	2 to 10 years	4,405
		9,205
Less accumulated depreciation		(2,994)
		$ 6,211

Depreciation expense of property and equipment was $650,000 in 2008, $392,000 in 2007 and $341,000 in 2006. We expense operating leases ratably over the shorter of the useful life or the lease term.

Real Estate

We carry real estate at the lower of cost or fair value less cost to sell. We capitalize interest costs and property taxes once development begins, and we continue to capitalize throughout the development period. We also capitalize

infrastructure, improvements, amenities, and other development costs incurred during the development period. We determine the cost of real estate sold using the relative sales value method. When we sell real estate from projects that are not finished, we include in the cost of real estate sold estimates of future development costs though completion, allocated based on relative sales values. These estimates of future development costs are reevaluated at least annually, with any adjustments being allocated prospectively to the remaining units available for sale.

Commercial properties are carried at cost less accumulated depreciation computed using the straight-line method over their estimated useful lives (three to 39 years).

We have agreements with utility or improvement districts, principally in Texas, whereby we agree to convey to the districts water, sewer and other infrastructure-related assets we have constructed in connection with projects within their jurisdiction. The reimbursement for these assets ranges from 70 to 100 percent of allowable cost as defined by the district. The transfer is consummated and we receive payment when the

FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

districts have a sufficient tax base to support funding of their bonds. The cost we incur in constructing these assets is included in capitalized development costs, and upon collection, we remove the assets from capitalized development costs. We provide an allowance to reflect our past experiences related to claimed allowable development costs.

Reclassifications

In 2008, we changed our reportable segments to reflect our post-spin management of the operations transferred to us by Temple-Inland and all prior period information has been reclassified to conform to current year presentation.

Revenue

Real Estate

We recognize revenue from sales of real estate when a sale is consummated, the buyer s initial investment is adequate, any receivables are probable of collection, the usual risks and rewards of ownership have been transferred to the buyer, and we do not have significant continuing involvement with the real estate sold. If we determine that the earnings process is not complete, we defer recognition of any gain until earned. We recognize revenue from hotel room sales and other guest services when rooms are occupied and other guest services have been rendered.

We exclude from revenue amounts we collect from utility or improvement districts related to the conveyance of water, sewer, and other infrastructure related assets. We also exclude from revenue amounts we collect for timber sold on land being developed. These proceeds reduce capitalized development costs. We exclude from revenue amounts we collect from customers that represent sales tax or other taxes that are based on the sale. These amounts are included in other accrued expenses until paid.

Mineral Resources

We recognize revenue from mineral bonus payments when we have received an executed agreement with the exploration company transferring the rights to any oil or gas it may find and requiring drilling be done within a specified period, the payment has been collected, and we have no obligation to refund the payment. We recognize revenue from delay rentals if drilling has not started within the specified period, when the payment has been collected, and we have no further obligation. We recognize revenue from mineral royalties and non-operating working interests when the minerals have been delivered to the buyer, the value is determinable, and we are reasonably sure of collection.

Fiber Resources

We recognize revenue from timber sales upon passage of title, which occurs at delivery; when the price is fixed and determinable; and we are reasonably sure of collection. We recognize revenue from hunting and recreational leases on the straight-line basis over the lease term if we are reasonably sure of collection.

Share-Based Compensation

Our directors and certain of our employees participate in and have received share-based compensation awards under our 2007 Stock Incentive Plan, which was approved by our sole stockholder prior to the spin-off.

Prior to the spin-off, we participated in Temple-Inland s share-based compensation plans, and as a result, certain of our employees received share-based compensation awards under those plans. The expense for those

FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

awards was allocated to us by Temple-Inland and was determined by Temple-Inland using the following accounting principles:

> Beginning January 2006, Temple-Inland adopted the modified prospective application method contained in SFAS No. 123 (revised December 2004), *Share-Based Payment* (SFAS 123(R)), to account for share-based payments. As a result, Temple-Inland applied this pronouncement to new awards or modifications of existing awards in 2006. Prior to adopting SFAS 123(R), Temple-Inland had been expensing, over the service period, the fair value of share-based compensation awards granted, modified, or settled in 2003 through 2005, using the prospective transition method of accounting contained in SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure, an amendment of FASB Statement No. 123.*

Please read **Note 16** for additional information about share-based compensation.

Timber

We carry timber at cost, less the cost of timber cut. We expense the cost of timber cut based on the relationship of the timber carrying value to the estimated volume of recoverable timber multiplied by the amount of timber cut. We include the cost of timber cut in cost of fiber resources in the income statement. We determine the estimated volume of recoverable timber using statistical information and other data related to growth rates and yields gathered from physical observations, models, and other information gathering techniques. Changes in yields are generally due to adjustments in growth rates and similar matters and are accounted for prospectively as changes in estimates. We capitalize reforestation costs incurred in developing viable seedling plantations (up to two years from planting), such as site preparation, seedlings, planting, fertilization, insect and wildlife control, and herbicide application. We expense all other costs, such as property taxes and costs of forest management personnel, as incurred. Once the seedling plantation is viable, we expense all costs to maintain the viable plantations, such as fertilization, herbicide application, insect and wildlife control, and thinning, as incurred.

Pending Accounting Pronouncements

SFAS No. 141(R), *Applying the Acquisition Method* SFAS No. 141(R) requires valuation of assets and liabilities acquired to be based upon fair values and eliminates recognition of minority interest as well as the inclusion of transaction costs in the purchase price. SFAS No. 141(R) is effective for business combinations occurring after year-end 2008.

SFAS No. 160, *Noncontrolling Interests* SFAS No. 160 clarifies the classification of noncontrolling interests in consolidated statement of financial position and the accounting for and reporting of transactions between the reporting entity and holders of such noncontrolling interest. Under the new standard, noncontrolling interests will be classified as equity, net income will encompass the total income of all consolidated subsidiaries with separate disclosure on the face of the income statement of the attribution of that income between the controlling and noncontrolling interests and changes in the noncontrolling ownership interest will be accounted for as a change to the controlling interest s equity. SFAS No. 160 is effective for our first quarter 2009. Based on our current understanding, we do not expect that adoption will have a significant effect on our earnings or financial position. At year-end 2008, minority interest in consolidated ventures was $6,660,000.

SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities-an amendment of SFAS No. 133*
SFAS No. 161 requires enhanced disclosures about derivative instruments including how and why they are used; how they are accounted for; and how they affect an entity s financial position, financial performance and cash flows. SFAS No. 161 is effective for our first quarter 2009. Based on our current understanding, we do not expect that adoption will have a significant effect on our earnings or financial position.

FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2 Real Estate

Real estate consists of:

	At Year-End	
	2008	2007
	(In thousands)	
Entitled, developed and under development projects	$ 445,394	$ 387,157
Undeveloped land	143,749	142,348
Commercial operating properties	43,987	43,479
	633,130	572,984
Accumulated depreciation	(22,544)	(20,774)
	$ 610,586	$ 552,210

Included in entitled, developed, and under development projects are the estimated costs of assets we expect to convey to utility or improvement districts of $76,173,000 in 2008 and $40,843,000 in 2007, including $49,529,000 at year-end 2008 and $25,516,000 at year-end 2007 related to our Cibolo Canyons project near San Antonio, Texas. These costs relate to water, sewer and other infrastructure assets for which the utility or improvement districts have agreed to reimburse us. We billed these districts $27,581,000 in 2008 and $37,137,000 in 2007, and we collected from these districts $674,000 in 2008 and $10,628,000 in 2007. We expect to collect the remaining amounts billed in 2008 and 2007 when these districts achieve adequate tax bases to support payment.

We recognized asset impairments of $3,000,000 in 2008, $6,518,000 in 2007 and none in 2006. Impairment charges are included in cost of real estate sales and in 2008 and 2007, and are related to residential projects principally in Texas.

Depreciation expense primarily related to commercial operating properties was $1,770,000 in 2008, $2,014,000 in 2007 and $2,008,000 in 2006 and is included in other operating expense.

Please read **Schedule III** for additional information.

Note 3 Investment in Unconsolidated Ventures

At year-end 2008, we had ownership interests ranging from 25 to 50 percent in 15 ventures that we account for using the equity method. We have no real estate ventures that are accounted for using the cost method. Our three largest ventures at year-end 2008 are CL Realty, Temco and Palisades West. We own a 50 percent interest in both CL Realty and Temco and Cousins Real Estate Corporation owns the other 50 percent interest. We own a 25 percent interest in Palisades West, Cousins Properties Incorporated owns a 50 percent interest and Dimensional Fund Advisors LP owns the remaining 25 percent. Information regarding these ventures follows:

CL Realty, L.L.C. was formed in 2002 for the purpose of developing residential and mixed-use communities in Texas and across the southeastern United States. At year-end 2008, the venture had 15 residential and mixed-use communities, of which 10 are in Texas, 3 are in Florida and 2 are in Georgia, representing about 7,600 residential lots and 560 commercial acres.

Temco Associates, LLC was formed in 1991 for the purpose of acquiring and developing residential real estate sites in Georgia. At year-end 2008, the venture had 5 residential and mixed-use communities, representing about 1,500 residential lots, all of which are located in Paulding County, Georgia. The venture also owns approximately 5,600 acres of undeveloped land in Paulding County, Georgia. In 2008, the venture sold approximately 486 acres of undeveloped land for $6,300 per acre.

FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Palisades West LLC was formed in 2006 for the purpose of constructing a commercial office park in Austin, Texas. The project includes two office buildings totaling approximately 375,000 square feet and an accompanying parking garage. Construction of the project was completed in fourth quarter 2008 and is approximately 67% leased. Our remaining commitment for investment in this venture as of year-end 2008 is $2,792,000. We have entered into a 10-year operating lease for approximately 32,000 square feet that we occupy as our corporate headquarters effective in fourth quarter 2008. Please read **Note 14** for additional information about operating leases.

Combined summarized balance sheet information for our ventures accounted for using the equity method follows:

	December 31, 2008					December 29, 2007				
	CL Realty	Temco	Palisades West	Other Ventures	Total	CL Realty	Temco	Palisades West	Other Ventures	T
					(In thousands)					
te	$ 124,417	$ 60,791	$ 120,953	$ 94,094	$ 400,255	$ 122,659	$ 59,992	$ 38,627	$ 36,434	$ 2
ets	126,726	61,832	123,290	102,930	414,778	124,419	63,481	40,444	84,879	3
ngs, ly urse[a]	4,901	3,198		75,638	83,737	6,350	3,397		62,888	
bilities	8,683	3,570	50,548	89,580	152,381	9,903	4,437	7,584	74,981	
	118,043	58,262	72,742	13,350	262,397	114,516	59,044	32,860	9,898	2
stment tate : e of ity[b]	59,022	29,131	18,779	18,295	125,227	57,258	29,522	9,362	13,228	1
nized gain[c]	(7,059)			(614)	(7,673)	(7,069)			(614)	
ent in e	$ 51,963	$ 29,131	$ 18,779	$ 17,681	$ 117,554	$ 50,189	$ 29,522	$ 9,362	$ 12,614	$ 1

FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Combined summarized income statement information for our ventures accounted for using the equity method follows:

	For the Year		
	2008	2007	2006
	(In thousands)		
Revenues:			
CL Realty	$ 8,065	$ 7,392	$ 51,367
Temco	6,426	8,305	51,470
Palisades West	1,421	267	
Other ventures	12,865	14,495	33,053
Total	$ 28,777	$ 30,459	$ 135,890
Earnings:			
CL Realty	$ 6,781	$ 3,400	$ 16,892
Temco	940	258	16,986
Palisades West	1,218	230	
Other ventures	(2,489)	(406)	(2,609)
Total	$ 6,450	$ 3,482	$ 31,269
Our equity in their earnings:			
CL Realty[c][d]	$ 3,377	$ 1,700	$ 8,431
Temco[d]	469	129	8,493
Palisades West	304	58	
Other ventures[b]	482	1,499	1,538
Recognition of deferred gain[c]	10	346	909
Total	$ 4,642	$ 3,732	$ 19,371

(a) Includes current maturities of debt of $21,150,000 in 2008 and $36,337,000 in 2007.

(b) Our share of the equity in other ventures reflects our ownership interests ranging from 25 to 50 percent, excluding venture losses that exceed our investment where we are not obligated to fund those losses.

(c) In 2003, we contributed real estate with a $13,800,000 carrying value to CL Realty in exchange for $13,800,000 cash and a 50 percent interest in the partnership. We deferred the $14,587,000 gain on the sale and are recognizing it as the partnership sells the real estate to third parties. The deferred gain is reflected as an offset to our investment in unconsolidated ventures.

(d) Beginning in 2006, we eliminated our historic one-month lag in accounting for our investment in CL Realty and Temco as financial information became more readily available. The one-time effect of eliminating this one-month lag was to increase our equity in earnings for 2006 by $754,000 for CL Realty and $350,000 for Temco.

In 2008, we invested $17,845,000 in these ventures and received $7,221,000 in distributions; in 2007, we invested $14,492,000 in these ventures and received $6,102,000 in distributions; and in 2006, we invested $17,611,000 in these ventures and received $23,727,000 in distributions. Distributions include both return of investments and distributions of earnings.

We provide development services for some of these ventures for which we receive a fee. Fees for these services were $120,000 in 2008, $344,000 in 2007 and $729,000 in 2006 and are included in real estate revenues.

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FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4 Receivables

Receivables consist of:

	At Year-End 2008	2007
	(In thousands)	
Seller financing notes receivable, average interest rate of 6.9% in 2008 and 7.8% in 2007	$ 410	$ 411
Notes receivable, average interest rate of 9.6% in 2008 and 2007	1,336	1,314
Accrued interest and other	2,742	2,268
	$ 4,488	$ 3,993
Allowance for bad debts	(226)	(226)
	$ 4,262	$ 3,767

Seller financing notes receivable are generally secured by a deed of trust with a 10 percent down payment and mature through 2009. In November 2006, we ceased providing seller financing in connection with the sale of residential lots.

Notes receivable are funds advanced to potential venture partners and will be converted to an equity interest in a venture or collected. It is anticipated that these notes will be satisfied by year-end 2009.

Other receivables are miscellaneous operating receivables arising in the normal course of business. We expect to collect $1,625,000 in 2009.

Note 5 Timber

We have about 340,000 acres of timber on our undeveloped land, located primarily in Georgia. We capitalized reforestation expenditures of $282,000 in 2008, $411,000 in 2007 and $1,409,000 in 2006. The cost of timber cut was $2,968,000 in 2008, $4,060,000 in 2007 and $3,441,000 in 2006.

Note 6 Debt

Debt consists of:

	At Year-End 2008	2007
	(In thousands)	
	$ 175,000	$ 175,000

Term loan facility average interest rate of 4.77% at year-end 2008 and 8.63% at year-end 2007		
Revolving loan facility average interest rate of 5.12% at year-end 2008	59,900	
Secured promissory note interest rate of 3.01% at year-end 2008 and 7.3% at year-end 2007	16,000	16,431
Other indebtedness due through 2011 at variable interest rates based on prime (3.25% at December 31, 2008) and at fixed interest rates ranging from 6.00% to 9.50% secured primarily by real estate including non-recourse debt of consolidated ventures	86,502	74,584
	$ 337,402	$ 266,015

Our senior credit facility and other debt agreements contain terms, conditions and financial covenants customary for such agreements including minimum levels of interest coverage and limitations on leverage. At year-end 2008, we had complied with the terms, conditions and financial covenants of these agreements.

Our senior credit facility provides for a $175,000,000 term loan and a $290,000,000 revolving line of credit. We may, upon notice to the lenders, request an increase in the credit facility to provide for a total of $500,000,000. The revolving line of credit may be prepaid at any time without penalty. The term loan may be prepaid at any time; however, repayment prior to June 1, 2009 requires a fee of 1.00% of the principal amount. There is no prepayment fee for the term loan on or after June 1, 2009. The senior credit facility

FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

matures December 1, 2010. The revolving line of credit includes a $100,000,000 sublimit for letters of credit, of which $13,135,000 was outstanding at year-end 2008. Total borrowings under our senior credit facility (including the face amount of letters of credit) may not exceed a borrowing base formula, and include a $35,000,000 minimum liquidity requirement at each quarter-end. At year-end 2008, we had $187,933,000 in net unused borrowing capacity under our senior credit facility.

At our option, we can borrow at LIBOR plus 4 percent or Prime plus 2 percent. All borrowings under the senior credit facility are secured by (a) an initial pledge of approximately 250,000 acres of undeveloped land, (b) assignments of current and future leases, rents and contracts, including our mineral leases, (c) a security interest in our primary operating account, (d) pledge of the equity interests in current and future material operating subsidiaries or joint venture interests, or if such pledge is not permitted, a pledge of the right to distributions from such entities, and (e) negative pledge (without a mortgage) on all other wholly-owned assets. The senior credit facility provides for releases of real estate provided that borrowing base compliance is maintained.

We incurred origination and other fees related to our credit facility of $10,573,000, of which $6,928,000 is unamortized at year-end 2008 and is included in other assets. Amortization of deferred financing fees in connection with our senior credit facility was $3,506,000 in 2008, $139,000 in 2007 and none in 2006.

At year-end 2008, commercial operating properties having a book value of $21,051,000 were subject to liens in connection with $16,000,000 of debt. On October 1, 2008, we refinanced this debt through 2010 with interest payable at LIBOR plus 2.5 percent or Prime plus 2 percent, at our option.

At year-end 2008, entitled, developed and under development projects having a book value of $162,141,000 was subject to liens in connection with $86,502,000 of principally non-recourse debt. Please read **Schedule III** for additional information.

Maturities of our debt during the next five years are: 2009 $35,207,000; 2010 $264,453,000; 2011 $37,742,000; 2012 $0; 2013 $0; and thereafter $0.

Note 7 Derivative Instruments

We periodically use interest rate agreements in the normal course of business to mitigate the risk inherent in interest rate fluctuations by entering into contracts with major U.S. securities firms.

In first quarter 2008, we entered into a $100,000,000 notional amount interest rate swap agreement that matures in 2010. The swap agreement was designed to offset the cash flow variability of interest rate payments associated with the first $100,000,000 of our variable-rate borrowings. Under this swap agreement, we pay a fixed interest rate of 6.57 percent and receive a floating interest rate of one month LIBOR plus 4 percent (4.77 percent at year-end 2008).

At year-end 2008, the fair value of the interest rate swap agreement was a $1,939,000 liability that is included in other liabilities. In 2008, the fair value of our interest rate swap decreased and as a result we recognized an after-tax loss of $1,260,000 that is included in accumulated other comprehensive income. The fair value of the interest rate swap agreement was determined using quoted prices in active markets for identical assets (Level 1) under SFAS No. 157.

The effectiveness of the hedge relationship is periodically assessed by comparing the present value of the cumulative change in the expected future cash flows on the variable leg of the swap and the present value of the cumulative change in the expected future hedged cash flows. In 2008, hedge ineffectiveness was not significant.

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Note 8 Fair Value of Financial Instruments

The carrying amounts and fair values of our financial instruments follow:

	At Year-End			
	2008		2007	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(In thousands)			
Cash and cash equivalents	$ 8,127	$ 8,127	$ 7,520	$ 7,520
Receivables, net	4,262	4,262	3,767	3,767
Accounts payable	(7,438)	(7,438)	(8,002)	(8,002)
Interest rate swap agreement	(1,939)	(1,939)		
Debt	(337,402)	(337,684)	(266,015)	(266,276)

At year-end 2008 and 2007, carrying amounts of cash and cash equivalents, receivables and accounts payable approximate their fair values due to the short-term nature of these assets and liabilities. The interest rate swap agreement is carried at its fair value at year-end 2008. The carrying amount of debt approximates fair value at year-end 2008 and 2007 since it is primarily made up of variable-rate borrowings. We estimated the fair value of our fixed-rate borrowings using quoted market prices for similar securities (Level 2).

Note 9 Capital Stock

Pursuant to our shareholder rights plan, each share of common stock outstanding is coupled with one-quarter of a preferred stock purchase right (Right). Each Right entitles our shareholders to purchase, under certain conditions, one one-hundredth of a share of newly issued Series A Junior Participating Preferred Stock at an exercise price of $100. Rights will be exercisable only if someone acquires beneficial ownership of 20 percent or more of our common shares or commences a tender or exchange offer, upon consummation of which they would beneficially own 20 percent or more of our common shares. We will generally be entitled to redeem the Rights at $0.001 per Right at any time until the 10th business day following public announcement that a 20 percent position has been acquired. The Rights will expire on December 11, 2017.

Please read **Note 16** for information about additional shares of common stock that could be issued under terms of our share-based compensation plans.

As a result of our spin-off from Temple-Inland, all of Temple-Inland s outstanding share-based compensation awards were equitably adjusted into separate awards: one related to our common stock, one related to Temple-Inland common stock and one related to Guaranty common stock. All awards issued as part of this adjustment are subject to their original vesting schedules.

At year-end 2008, Temple-Inland and Guaranty directors and employees held 27,000 equity-settled restricted stock awards on our stock.

The following table summarizes outstanding stock option awards on our stock held by Temple-Inland and Guaranty directors and employees at year-end 2008:

	Shares (In thousands)	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (Current Value Less Exercise Price) (In thousands)
Outstanding	1,805	$ 19.26	5	$ 142
Exercisable	1,440	$ 17.06	4	$ 142

FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 10 Other Comprehensive Income

Other comprehensive income consists of:

	For the Year		
	2008	2007	2006
	(In thousands)		
Net income	$ 11,974	$ 24,795	$ 51,844
Change in fair value of interest rate swap agreement, net of taxes	(1,260)		
Other comprehensive income	$ 10,714	$ 24,795	$ 51,844

Note 11 Net Income per Share

Our basic and diluted weighted average common shares outstanding used to compute net income per share are as follows:

	For the Year		
	2008	2007	2006
	(In thousands)		
Weighted average common shares outstanding basic	35,455	35,380	35,380
Dilutive effect of stock options	305		
Dilutive effect of restrict stock and restricted stock units	132		
Weighted average common shares outstanding diluted	35,892	35,380	35,380

For 2007 and 2006, we computed basic and diluted net income per share based upon the number of shares of our common stock distributed by Temple-Inland on December 28, 2007.

At year-end 2008, the effect of 1,713,000 stock options and unvested shares of restricted stock were not included in the computation of diluted weighted average shares outstanding because their impact would have been anti-dilutive.

Note 12 Income Taxes

Income tax expense consists of:

For the Year

	2008	2007	2006
		(In thousands)	
Current tax provision:			
U.S. Federal	$ (14,954)	$ (28,782)	$ (29,954)
State and other	(1,680)	(3,133)	(4,928)
	(16,634)	(31,915)	(34,882)
Deferred tax provision:			
U.S. Federal	11,124	16,509	3,708
State and other	275	1,497	1,204
	11,399	18,006	4,912
Income tax expense	$ (5,235)	$ (13,909)	$ (29,970)

Our 2008 income tax expense reflects a benefit of $800,000 from a federal income tax rate change for qualified timber gains due to the Food, Conservation and Energy Act of 2008.

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In 2006, Texas enacted a margin tax to replace the franchise tax, which for us resulted in a lower overall Texas tax rate. As a result, in 2006 we recognized a one-time, non-cash benefit of $780,000 related to the reduction of previously provided deferred state income taxes.

We were included in the federal consolidated income tax return of Temple-Inland prior to our spin-off.

A reconciliation of the federal statutory rate to the effective income tax rate on continuing operations follows:

	For the Year		
	2008	**2007**	**2006**
Federal statutory rate	35%	35%	35%
State, net of federal benefit	5	3	3
Finalization of deferred tax balance transferred at spin-off	2		
Percentage depletion	(6)	(2)	(1)
Qualified timber gains	(5)		
Other	(1)		
Effective tax rate	30%	36%	37%

Significant components of deferred taxes are:

	At Year-End	
	2008	**2007**
	(In thousands)	
Deferred Tax Assets:		
Real estate	$ 44,711	$ 37,632
Employee benefits	3,594	1,141
Accruals not deductible until paid	986	840
Other	696	
Gross deferred tax assets	49,987	39,613
Deferred Tax Liabilities:		
Undeveloped land	(25,869)	(27,020)
Timber	(5,638)	(6,153)
Other	(1,296)	(1,334)
Gross deferred tax liabilities	(32,803)	(34,507)
Net Deferred Tax Asset	$ 17,184	$ 5,106

We, or Temple-Inland prior to our spin-off, file income tax returns in the U.S. federal jurisdiction and various state jurisdictions. With few exceptions, we are no longer subject to U.S. federal, state and local income tax examinations by tax authorities for years before 2005. We have no significant unrecognized deferred tax assets or liabilities at year-end 2008 or 2007.

Note 13 Litigation and Environmental Contingencies

We are involved in various legal proceedings that arise from time to time in the ordinary course of doing business and believe that adequate reserves have been established for any probable losses. We do not believe that the outcome of any of these proceedings should have a significant adverse effect on our financial position, long-term results of operations or cash flows. It is possible; however, that charges related to these matters could be significant to our results or cash flows in any one accounting period.

Environmental remediation liabilities arise from time to time in the ordinary course of doing business, and we believe we have established adequate reserves for any probable losses. We own 288 acres near

FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Antioch, California, portions of which were sites of a Temple-Inland paper manufacturing operation that are in remediation. In 2008, we increased our reserves for environmental remediation by about $2,900,000. We estimate the cost to complete remediation activities will be about $3,900,000, which is included in other accrued expenses and will likely be paid in 2009. Our estimate requires us to make assumptions regarding the scope of required remediation, the effectiveness of planned remediation activities, and approvals by regulatory authorities. Our estimate is subject to revision as new information becomes available.

Note 14 Commitments and Other Contingencies

We lease timberland, facilities and equipment under non-cancelable long-term operating lease agreements. In addition, we have various obligations under other office space and equipment leases of less than one year. Rent expense on timberland was $346,000 in 2008, $428,000 in 2007 and $414,000 in 2006. Rent expense on facilities and equipment was $2,135,000 in 2008, $536,000 in 2007 and $445,000 in 2006. Future minimum rental commitments under non-cancelable operating leases having a remaining term in excess of one year are: 2009 $2,226,000; 2010 $2,123,000; 2011 $2,073,000; 2012 $1,956,000; 2013 $1,763,000 and thereafter $13,605,000.

We have 16 years remaining on a 65-year timber lease of over 16,000 acres. At year-end 2008, the remaining contractual obligation for this lease is $9,106,000.

During 2008, we entered into a 10-year operating lease for approximately 32,000 square feet in the Palisades West Office Park in Austin, Texas. Effective in fourth quarter 2008, we occupy this space as our corporate headquarters. This lease contains predetermined fixed increases of the minimum rental rate during the initial lease term and a construction allowance for leasehold improvements. The remaining contractual obligation for this lease is $12,133,000.

We have a commitment to support third-party construction and ownership of a resort hotel, spa and golf facilities at our Cibolo Canyons mixed-use development near San Antonio, Texas. At year-end 2008, our unfunded commitment was $13,083,000 which is expected to be funded in 2009.

In connection with our unconsolidated venture operations, we have provided performance bonds and letters of credit aggregating $3,151,000 at year-end 2008. Generally these performance bonds and letters of credit would be drawn on due to lack of specific performance by the ventures, such as failure to deliver streets and utilities in accordance with local codes and ordinances. In addition, we own a 25 percent interest in Palisades West LLC to which all the members have committed to make additional proportionate capital contributions, our share of which is $2,792,000 at year-end 2008.

Temple-Inland has received a private letter ruling from the Internal Revenue Service that the spin-off qualifies for tax-free treatment under applicable sections of the Internal Revenue Code, and has also received an opinion of tax counsel that the spin-off so qualifies. However, if the spin-off fails to qualify for tax-free treatment, under the tax matters agreement between Temple-Inland and us we would generally be required to indemnify Temple-Inland against any tax resulting from the distribution of our shares of stock to the extent that such tax resulted from (1) an issuance of our equity securities, a redemption of our equity securities or our involvement in other acquisitions of our equity securities, (2) other actions or failures to act by us or (3) any of our representations or undertakings being incorrect or violated.

Note 15 Segment Information

In first quarter 2008, we changed our reportable segments to reflect our post-spin management of the operations transferred to us from Temple-Inland. All prior period segment information has been reclassified to conform to the current presentation. We operate three business segments: real estate, mineral resources and fiber resources. Real estate secures entitlements and develops infrastructure on our lands for single-family residential and mixed-use communities and manages our undeveloped land and our commercial operating

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properties. Mineral resources manages our oil and gas mineral interests. Fiber resources manages our timber and recreational leases.

We evaluate performance based on segment earnings before unallocated items and income taxes. Segment earnings consist of operating income, equity in earnings of unconsolidated ventures, and minority interest expense in consolidated ventures. Unallocated items consist of general and administrative expense, share-based compensation, other non-operating income and expense, and interest expense. The accounting policies of the segments are the same as those described in the accounting policy note to the consolidated financial statements. Our revenues are derived from our U.S. operations and all of our assets are located in the U.S. No single customer accounts for more than 10 percent of our revenues.

	Real Estate	Mineral Resources	Fiber Resources	Items Not Allocated to Segments[(a)]	Total
For the year or at year-end 2008:					
Revenues	$ 98,859	$ 47,671	$ 13,192	$	$ 159,722
Depreciation and amortization	2,076		36	5,561	7,673
Equity in earnings of unconsolidated ventures	3,480	1,162			4,642
Income (loss) before taxes	9,075	44,076	8,896	(44,838)	17,209
Total assets	732,401	376	51,321	50,478	834,576
Investment in unconsolidated ventures	117,554				117,554
Capital expenditures[(b)]	508	370	282	4,037	5,197
For the year or at year-end 2007:					
Revenues	$ 142,729	$ 20,818	$ 14,439	$	$ 177,986
Depreciation and amortization	2,839		76		2,915
Equity in earnings of unconsolidated ventures	3,732				3,732
Income (loss) before taxes	39,507	18,581	7,950	(27,334)	38,704
Total assets	658,813		55,011	34,902	748,726
Investment in unconsolidated ventures	101,687				101,687
Capital expenditures[(b)]	2,788		410		3,198
For the year or at year-end 2006:					
Revenues	$ 180,151	$ 27,980	$ 17,429	$	$ 225,560
Depreciation and amortization	2,298		57		2,355
Equity in earnings of unconsolidated ventures	19,371				19,371
Income (loss) before taxes	70,271	26,305	6,711	(21,473)	81,814
Total assets	546,911		59,414	13,849	620,174
Investment in unconsolidated ventures	90,444				90,444
Capital expenditures[(b)]	2,558		1,433		3,991

(a) Items not allocated to segments consists of:

	For the Year		
	2008	**2007**	**2006**
		(In thousands)	
Corporate general and administrative	$ (19,318)	$ (11,119)	$ (8,911)
Expense allocation from Temple-Inland (see Note 19)		(6,294)	(5,137)
Share-based compensation (allocated from Temple-Inland in 2007 and 2006, see Note 16)	(4,516)	(1,397)	(1,275)
Interest expense	(21,283)	(9,229)	(6,229)
Other non-operating income	279	705	79
	$ (44,838)	$ (27,334)	$ (21,473)

(b) Consists of expenditures for property and equipment and reforestation.

FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 16 Share-Based Compensation

Post-Spin Awards

A summary of the awards granted under our 2007 Stock Incentive Plan follows.

Cash-settled awards

Cash-settled awards vest 50 percent after year one and 50 percent after year two from the date of grant and provide for accelerated vesting upon retirement, death, disability or if there is a change in control. The following table summarizes the activity of awards granted under our plan for 2008:

	Equivalent Units (In thousands)	Weighted Average Grant Date Fair Value
Non-vested as of December 29, 2007		$
Granted	6	28.85
Vested		
Forfeited	(1)	28.85
Non-vested as of December 31, 2008	5	$ 28.85

The aggregate current value of non-vested awards as of December 31, 2008 is $50,000.

Equity-settled awards

Equity-settled awards in the form of restricted stock units granted to our directors are fully vested at the time of grant and payable upon retirement. The following table summarizes the activity of awards granted under our plan for 2008:

	Equivalent Units (In thousands)	Weighted Average Grant Date Fair Value

Non-vested as of December 29, 2007		$
Granted	86	15.69
Vested	(86)	15.69
Forfeited		
Non-vested as of December 31, 2008		$

The total fair value of awards vested in 2008 was $1,550,000, of which $800,000 are classified as deferred director fees.

FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Restricted stock

Restricted stock awards vest after three years if we achieve a minimum one percent annualized return on assets over such three-year period. The following table summarizes the activity of awards granted under our plan for 2008:

	Restricted Shares (In thousands)	Weighted Average Grant Date Fair Value
Non-vested as of December 29, 2007		$
Granted	215	22.15
Vested		
Forfeited	(8)	28.85
Non-vested as of December 31, 2008	207	$ 21.89

Stock options

Stock options have a ten-year term, generally become exercisable ratably over three to four years and provide for accelerated or continued vesting upon retirement, death, disability or if there is a change in control. Options were granted with an exercise price equal to the market value of our stock on the date of grant. The following table summarizes the activity of awards granted under our plan for 2008:

	Options Outstanding (In thousands)	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term (In years)
Balance as of December 29, 2007		$	
Granted	624	28.85	
Exercised			
Forfeited	(2)	28.85	
Balance as of December 31, 2008	622	$ 28.85	9

Options Exercisable as of December 31, 2008	18	$ 28.85	9

There was no aggregate intrinsic value for stock options outstanding or exercisable at December 31, 2008.

Stock options are valued based upon the Black-Scholes option pricing model. Awards granted in 2008 were valued based upon the following assumptions:

Expected dividend yield	0.0%
Expected stock price volatility	31.0%
Risk-free interest rate	2.7%
Expected life of options (years)	6
Weighted average estimated fair value of options granted	$ 10.22

We have limited historical experience as a stand-alone company so we utilized alternative methods in determining our valuation assumptions. The expected life was based on the simplified method utilizing the midpoint between the vesting period and the contractual life of the awards. The expected stock price volatility was based on historical prices of our peers common stock for a period corresponding to the expected life of the options. Pre-vesting forfeitures are estimated based upon the pool of participants and their expected activity.

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Pre-Spin Awards

Prior to the spin-off, we participated in Temple-Inland s share-based compensation plans, and as a result, certain of our directors and employees received share-based compensation in the form of restricted or performance stock units, restricted stock, or options to purchase shares of Temple-Inland s common stock. Concurrent with Temple-Inland s distribution of our common stock, all outstanding Temple-Inland awards were adjusted into three separate awards: one related to Forestar common stock, one related to Guaranty common stock and one related to Temple-Inland common stock.

In 2007 and 2006, the expense for share-based compensation awards granted to our employees under Temple-Inland s plans was allocated to us by Temple-Inland. We continue to recognize share-based compensation expense over the remaining vesting periods associated with our employees and directors awards in Forestar, Guaranty and Temple-Inland stock.

Cash-settled awards

Cash-settled awards generally vest and are paid after three years from the date of grant or the attainment of defined performance goals, generally measured over a three-year period. A summary of cash-settled awards outstanding to our directors and employees at year-end 2008, following the adjustments described previously, follows:

	Equivalent Units	Aggregate Current Value
	(In thousands)	
Awards on Forestar stock	38	$ 362
Awards on Guaranty stock	38	99
Awards on Temple-Inland stock	114	548
		$ 1,009

In 2008, we paid $166,000 to settle vested cash-settled awards.

Restricted stock

All outstanding restricted stock awards at year-end 2007 vested in first quarter 2008. The total fair value of these awards was $474,000.

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NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Stock options

Stock options have a ten-year term, generally become exercisable ratably over four years and provide for accelerated or continued vesting upon retirement, death, disability or if there is a change in control. Options were granted with an exercise price equal to the market value of Temple-Inland common stock on the date of grant. A summary of stock option awards outstanding to our directors and employees at year-end 2008, following the adjustments described previously, follows:

	Shares (In thousands)	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term (In years)	Aggregate Value (Current Value Less Exercise Price) (In thousands)
Outstanding on Forestar stock	86	$ 21.12	6	$ 7
Outstanding on Guaranty stock	86	13.55	6	
Outstanding on Temple-Inland stock	255	16.90	6	
				$ 7
Exercisable on Forestar stock	57	$ 17.64	5	$ 7
Exercisable on Guaranty stock	57	11.32	5	
Exercisable on Temple-Inland stock	170	14.12	5	
				$ 7

The intrinsic value of options exercised in 2008 was $146,000.

Share-Based Compensation Expense

Share-based compensation expense for post-spin and pre-spin awards consists of:

	For the Year 2008	2007	2006
	(In thousands)		
Cash-settled awards	$ (488)	$ 763	$ 635

Equity-settled awards	750		
Restricted stock	1,264	142	224
Stock options	2,990	492	416
Pre-tax share-based compensation expense	4,516	1,397	1,275
Income tax benefit	(1,355)	(503)	(472)
	$ 3,161	$ 894	$ 803

The fair value of awards granted to retirement-eligible employees and expensed at the date of grant was $1,321,000 in 2008.

Pre-tax share-based compensation expense is included in:

	For the Year		
	2008	2007	2006
	(In thousands)		
General and administrative	$ 2,910	$ 1,211	$ 1,096
Other operating	1,606	186	179
	$ 4,516	$ 1,397	$ 1,275

We did not capitalize any share-based compensation in 2008, 2007 or 2006.

Unrecognized share-based compensation for post-spin awards not vested was $7,311,000 at year-end 2008. It is likely that this cost will be recognized as expense over the next three years. Unrecognized share-

FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

based compensation for pre-spin awards not vested was $542,000 at year-end 2008. It is likely that this cost will be recognized as expense over the next two years.

In connection with restricted stock vested and stock options exercised, we withheld shares having a value of $1,858,000 for payment of payroll taxes in 2008. These shares are accounted for as treasury stock. Payroll taxes on restricted stock and stock options are reflected in financing activities in our consolidated statement of cash flows.

Note 17 Retirement, Pension and Postretirement Plans

Our defined contribution retirement plans include a 401(k) plan, which is funded, and a supplemental plan for key employees, which is unfunded. The expense of our defined contribution retirement plans was $1,134,000 in 2008. The unfunded liability for our supplemental plan was $132,000 at year-end 2008 and is included in other liabilities.

Prior to the spin-off, we participated in Temple-Inland s retirement, pension and postretirement plans. The retirement expense for certain of our employees was $262,000 in 2007 and $223,000 in 2006. The pension and postretirement expense allocated to us by Temple-Inland for certain of our employees was $218,000 in 2007 and $716,000 in 2006. Subsequent to the spin-off, our employees no longer participate in the Temple-Inland postretirement plans, and our employees who participate in Temple-Inland retirement and pension plans will not accrue any additional benefits. The liability for their benefits as of the spin-off date has been retained by Temple-Inland.

Note 18 Summary of Quarterly Results of Operations (Unaudited)

Summarized quarterly financial results for 2008 and 2007 follows:

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(In thousands, except per share data)			
2008				
Total revenues	$ 37,223	$ 51,597	$ 33,943	$ 36,959
Gross profit	19,305	37,629	21,976	22,324
Operating income	4,167	17,849	5,601	8,189
Equity in earnings of unconsolidated ventures	1,534	2,018	1,436	(346)
Income (loss) before taxes	(383)	14,407	1,192	1,993
Net income (loss)	(238)	9,596	872	1,744
Net income (loss) per share basic	(0.01)	0.27	0.02	0.05
Net income (loss) per share diluted	(0.01)	0.27	0.02	0.05
2007				
Total revenues	$ 34,456	$ 56,285	$ 51,632	$ 35,613
Gross profit	16,465	37,272	28,411	16,184
Operating income	2,625	26,380	16,371	3,891
Equity in earnings of unconsolidated ventures	1,499	1,478	1,333	(578)
Income before taxes	1,043	22,781	14,816	64

Net income		661	14,432	9,596	106
Net income per share	basic	0.02	0.41	0.27	
Net income per share	diluted	0.02	0.41	0.27	

Note 19 Pre-Spin Transactions with Temple-Inland

Prior to the spin-off, we reimbursed Temple-Inland for expenses incurred on our behalf and allocated to us. Additional allocated expenses incurred by Temple-Inland but not directly attributable to us were allocated

FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

to us and recognized as expense with a corresponding increase to Temple-Inland s investment, net of tax. Please read **Note 1** for additional information.

A summary of allocated expenses from Temple-Inland follows:

	For the Year 2007	For the Year 2006
	(In thousands)	
Legal, human resources and other administrative costs	$ 2,842	$ 2,178
Variable compensation	883	1,146
Accounting and finance	1,425	954
Information technology support	935	664
Internal audit, governance and other	209	195
	6,294	5,137
Share-based compensation	1,397	1,275
Pension and postretirement	218	716
	$ 7,909	$ 7,128

Prior to the spin-off, we paid income taxes to Temple-Inland as if we filed a separate income tax return. Please read **Note 12** for additional information. In addition, rent paid to a former subsidiary of Temple-Inland was $190,000 in 2007 and $178,000 in 2006.

We own an undivided 15 percent interest in corporate aircraft contributed to us by Temple-Inland at spin-off. Under the terms of the joint ownership agreement, we pay 15 percent of the fixed costs associated with ownership of the aircraft and pay our portion of the variable costs based on our usage. The agreement has a two-year term at which time it can be renewed or terminated. At year-end 2008, the carrying value of the aircraft of $5,319,000 is included in other assets.

Fiber resources and other revenues include sales of timber to Temple-Inland of $12,167,000 in 2007 and $8,867,000 in 2006. Cost of fiber resources includes cost of timber sold to Temple-Inland of $3,241,000 in 2007 and $2,140,000 in 2006.

Note 20 Supplemental Oil and Gas Disclosures (Unaudited)

We lease our oil and gas mineral interests, principally in Texas and Louisiana, to third party oil and gas exploration and production entities for the exploration and production of oil and gas. When we lease our mineral interests, we retain a royalty interest and may take an additional participation in production, including a non-operating working interest. Non-operating working interests refer to well interests in which we pay a share of the costs to drill, complete and operate a well and receive a proportionate share of the production revenues. At year-end 2008, non-operating

working interests capitalized costs were $131,000 and represent our proportionate share of exploration and development costs to date related to one well located in Louisiana. We incurred no exploration or development costs in 2007 or 2006.

We did not acquire any oil or gas mineral interests in 2008, and unamortized costs of our oil and gas mineral interests were not material at year-end 2007 and 2006.

Our royalty revenues are contractually defined and based on a percentage of production and are received in cash. Our royalty revenues fluctuate based on changes in the market prices for oil and gas and other factors affecting the third party oil and gas exploration and production entities including the cost of development and production. In 2007 and 2006, our royalty revenues were allocated to us by Temple-Inland.

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FORESTAR GROUP INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Information about the results of operations of our oil and gas mineral interests follows:

	For the Year		
	2008	2007	2006
	(In thousands)		
Royalty revenues	$ 21,638	$ 13,114	$ 17,381
Production costs	(1,714)		
Exploration expenses			
Depreciation, depletion, amortization and valuation provisions			
Administrative expenses	(3,121)	(2,237)	(1,675)
Income tax expenses	(5,152)	(3,327)	(5,029)
Results of operations	$ 11,651	$ 7,550	$ 10,677

In 2008, production costs represent our share of oil and gas production severance taxes. In 2007 and 2006, oil and gas production severance taxes were reflected as a reduction of royalty revenues and were allocated to us by Temple-Inland.

Other lease revenues, principally bonus and delay rentals, were $26,032,000 in 2008, $7,704,000 in 2007 and $10,599,000 in 2006. In 2008, our share of lease bonus revenues from unconsolidated ventures was $1,162,000.

Estimates of oil and gas reserve information related to our royalty interests are unknown to us. We do not make such estimates and our lessees do not make this information available to us. Our share of oil and gas produced and average unit prices related to our royalty interests follows:

	For the Year		
	2008	2007	2006
Oil (barrels)	87,895	94,909	125,994
Average price per barrel	$ 106.66	$ 65.24	$ 64.14
Gas (thousands of cubic feet (Mcf))	1,363,434	967,268	1,212,290
Average price per Mcf	$ 8.76	$ 6.69	$ 7.95

Note 21 Subsequent Event

On February 11, 2009, we announced the following strategic initiatives to enhance stockholder value: generate significant free cash flow, principally from the sale of approximately 175,000 acres of higher and better use (HBU) timberland; reduce debt by approximately $150 million; and repurchase up to 20 percent of our outstanding shares of common stock. Debt reduction and share repurchases will be funded by proceeds from the asset sales. We are in the process of marketing a portion of our HBU timberland and will classify that portion of the HBU timberland we

anticipate selling as assets held for sale at first quarter-end 2009.

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Forestar Group Inc.

Schedule III Consolidated Real Estate and Accumulated Depreciation

Year-End 2008
(In thousands)

		Initial Cost to Company		Costs Capitalized Subsequent to Acquisition		Gross Amount Carried at End of Period					
Description	**Encumbrances**	**Land**	**Buildings & Improvements**	**Improvements Less Cost of Sales and Other**	**Carrying Costs[a]**	**Land & Land Improvements**	**Buildings & Improvements**	**Total**	**Accumulated Depreciation**	**Date of Construction**	**Date Acquired**
Entitled, Developed, and Under Development Projects:											
CALIFORNIA											
Contra Costa County											
San Joaquin River		$ 12,225		$ (3,430)		$ 8,795		$ 8,795			
COLORADO											
Douglas County											
Pinery West	$ 4,941	7,308		1,412		8,720		8,720		2006	2006
Weld County											
Buffalo Highlands		3,001		603		3,604		3,604		2006	2005
Johnstown Farms		2,749		9,009	$ 188	11,946		11,946		2002	2002
Stonebraker		3,878		1,309		5,187		5,187		2005	2005
GEORGIA											
Bartow County											
Towne West		936		900		1,836		1,836		2007	
Coweta County											
Cedar Creek Preserve		852		244		1,096		1,096			
Corinth Landing		607		582		1,189		1,189			
Coweta South Industrial Park		532		442		974		974			
Fox Hall		166		5,831		5,997		5,997		2007	
Genesee		480		1,031		1,511		1,511			
TEXAS											
Bastrop County											
Hunter s Crossing		3,613		7,352	311	11,276		11,276		2001	2001

The Colony		8,726	12,818	161	21,705	21,705	1999	1999
Bexar County								
Cibolo Canyons		25,568	65,886	928	92,382	92,382	2004	1986
Calhoun County								
Caracol	9,109	8,603	8,237	1,989	18,829	18,829	2006	2006
Harbor Mist		2,822	963		3,785	3,785		2007
Collin County								
Light Farms	30,519	30,101	18,668		48,769	48,769	2007	2007
Maxwell Creek		9,904	(513)	418	9,809	9,809	2000	2000
The Gables at North Hill		2,160	(589)	63	1,634	1,634	2004	2001
Timber Creek	3,431	7,282	2,457		9,739	9,739	2007	2007

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Forestar Group Inc.

Schedule III Consolidated Real Estate and Accumulated Depreciation (Continued)

		Initial Cost to Company		Costs Capitalized Subsequent to Acquisition		Gross Amount Carried at End of Period					
				Improvements							
			Buildings &	Less Cost of Sales and	Carrying	Land & Land	Buildings &		Accumulated	Date of	I
ption	Encumbrances	Land	Improvements	Other	Costs(a)	Improvements	Improvements	Total	Depreciation	Construction	Acc
County											
reek Estates		1,921		4,025	175	6,121		6,121		2006	
County											
Creek	8,368	12,822		3,789		16,611		16,611		2007	
n County											
a	17,822	31,451		10,094		41,545		41,545		2000	
eserve at Pecan		5,855		1,387	313	7,555		7,555		2006	
County											
ark	2	3,946		(2,570)	1,641	3,017		3,017		2002	
County											
head Ranch		12,001		1,422		13,423		13,423			
County											
Lakes		3,514		5,061	312	8,887		8,887	$ (576)	2000	
s County											
a Dunes		12,080		8,225		20,305		20,305		2008	
all County											
Lakes		1,624		4,269	100	5,993		5,993		1997	
County											
o at Judge s Hill	12,310	1,500		12,794	786	15,080		15,080		2006	
dge at Ribelin		23,751		(20,421)	50	3,380		3,380		2006	
nson County											
de at Buttercup		13,149		(5,370)	449	8,228		8,228		1993	
ler Road											
ties		3,552		(2,181)		1,371		1,371		2004	
nterra		4,024		2,652	71	6,747		6,747		2008	
OURI											
ounty											
brook		3,061		(219)	13	2,855		2,855		2003	
I											
County											

ingham Estates		3,284		(608)		88		2,764				2,764		2003
		21,495		(11,021)		2,255		12,729				12,729		
Entitled, oped, and Development ts	**$ 86,502**	**$ 290,543**	**$**	**$ 144,540**		**$ 10,311**		**$ 445,394**	**$**			**$ 445,394**	**$ (576)**	

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Forestar Group Inc.

Schedule III Consolidated Real Estate and Accumulated Depreciation

		Initial Cost to Company		Costs Capitalized Subsequent to Acquisition		Gross Amount Carried at End of Period					
Description	**Encumbrances**	**Land**	**Buildings & Improvements**	**Improvements Less Cost of Sales and Other**	**Carrying Costs (a)**	**Land & Land Improvements**	**Buildings & Improvements**	**Total**	**Accumulated Depreciation**	**Date of Construction**	**Date Acquired**
<u>Undeveloped Land</u>:											
ALABAMA											
Cherokee County											
Undeveloped Land		$ 7,124		$ 19		$ 7,143		$ 7,143			
Cleburne County											
Undeveloped Land		5,582		51		5,633		5,633			
CALIFORNIA											
Los Angeles County											
Land In Entitlement Process		3,969		5,634		9,603		9,603			1997
GEORGIA											
Banks County											
Undeveloped Land		1,895		10		1,905		1,905			
Land In Entitlement Process		488		50		538		538			
Bartow County											
Undeveloped Land		5,585		123		5,708		5,708			
Carroll County											
Undeveloped Land		8,417		129		8,546		8,546			
Land In Entitlement Process		9,308		2,265		11,573		11,573			
Chattooga County											
Undeveloped Land		4,269		45		4,314		4,314			
Cherokee County											
Undeveloped Land		3,835		150		3,985		3,985			
Land In Entitlement Process		2,472		470		2,942		2,942			
Coweta County											
Undeveloped Land		2,059		59		2,118		2,118			
		2,794		547		3,341		3,341			

Land In Entitlement Process				
Dawson County				
Undeveloped Land	2,570	9	2,579	2,579
Land In Entitlement Process	702	899	1,601	1,601
Elbert County				
Undeveloped Land	1,617	29	1,646	1,646
Floyd County				
Undeveloped Land	3,687	63	3,750	3,750

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Forestar Group Inc.

Schedule III Consolidated Real Estate and Accumulated Depreciation (Continued)

		Initial Cost to Company		Costs Capitalized Subsequent to Acquisition		Gross Amount Carried at End of Period					
Description	**Encumbrances**	**Land**	**Buildings & Improvements**	**Improvements Less Cost of Sales and Other**	**Carrying Costs (a)**	**Land & Land Improvements**	**Buildings & Improvements**	**Total**	**Accumulated Depreciation**	**Date of Construction**	**Date Acquired**
Gilmer County											
Undeveloped Land		3,031		21		3,052		3,052			
Gordon County											
Undeveloped Land		3,339		19		3,358		3,358			
Hall County											
Undeveloped Land		906		69		975		975			
Haralson County											
Undeveloped Land		7,582		239		7,821		7,821			
Land In Entitlement Process		701		176		877		877			
Heard County											
Undeveloped Land		10,949		341		11,290		11,290			
Jackson County											
Undeveloped Land		996		60		1,056		1,056			
Land In Entitlement Process		491		271		762		762			
Lumpkin County											
Undeveloped Land		3,120		4		3,124		3,124			
Meriwether County											
Undeveloped Land		1,700		50		1,750		1,750			
Paulding County											
Undeveloped Land		1,406				1,406		1,406			
Pickens County											
Undeveloped Land		3,379		92		3,471		3,471			
Polk County											
Undeveloped Land		4,740		38		4,778		4,778			
Troup County											
Undeveloped Land		4,178		213		4,391		4,391			

Land In Entitlement Process	944	510	1,454	1,454
TEXAS				
Anderson County				
Undeveloped Land	821		821	821

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Forestar Group Inc.

Schedule III Consolidated Real Estate and Accumulated Depreciation (Continued)

		Initial Cost to Company		Costs Capitalized Subsequent to Acquisition		Gross Amount Carried at End of Period				
	Encumbrances	**Land**	**Buildings & Improvements**	**Improvements Less Cost of Sales and Other**	**Carrying Costs[a]**	**Land & Land Improvements**	**Buildings & Improvements**	**Total**	**Accumulated Depreciation**	**D c Const**
ty										
and		1,368				1,368		1,368		
y										
and		1,034		14		1,048		1,048		
ounty										
nent		2,675		295		2,970		2,970		
and		269				269		269		
and		508		31		539		539		
County										
and		1,720				1,720		1,720		
and		6,599		719		7,318		7,318		
nent		685		521		1,206		1,206		
oped	**$**	**$ 129,514**	**$**	**$ 14,235**	**$**	**$ 143,749**	**$**	**$ 143,749**	**$**	
perating Properties:										
&	$ 16,000		$ 16,316	$ 26,402			$ 42,718	$ 42,718	$ (21,667)	
olf Club			1,269				1,269	1,269	(301)	2
cial perties	**$ 16,000**	**$**	**$ 17,585**	**$ 26,402**	**$**	**$**	**$ 43,987**	**$ 43,987**	**$ (21,968)**	

$	102,502	$	420,057	$	17,585	$	185,177	$	10,311	$	589,143	$	43,987	$	633,130	$	(22,544)

(a) We do not capitalize carrying costs until development begins.

Forestar Group Inc.

Schedule III Consolidated Real Estate and Accumulated Depreciation

Reconciliation of real estate:

	2008	2007	2006
		(In thousands)	
Balance at beginning of year	$ 572,984	$ 468,724	$ 392,107
Amounts capitalized	100,639	181,430	178,835
Amounts retired or adjusted	(40,493)	(77,170)	(102,218)
Balance at close of period	$ 633,130	$ 572,984	$ 468,724

Reconciliation of accumulated depreciation:

	2008	2007	2006
		(In thousands)	
Balance at beginning of year	$ (20,774)	$ (20,907)	$ (18,957)
Depreciation expense	(1,770)	(2,014)	(2,008)
Amounts retired or adjusted		2,147	58
Balance at close of period	$ (22,544)	$ (20,774)	$ (20,907)