

GALLAGHER ARTHUR J & CO

Form 10-Q

July 26, 2007

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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 June 30, 2007

or

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

Commission File Number 1-9761

ARTHUR J. GALLAGHER & CO.

(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of

incorporation or organization)

Two Pierce Place, Itasca, Illinois 60143-3141

(Address of principal executive offices) (Zip code)

(630) 773-3800

(Registrant's telephone number, including area code)

36-2151613
(I.R.S. Employer

Identification No.)

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(Former name, former address and former fiscal year, if changed since last report)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

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

The number of outstanding shares of the registrant's Common Stock, \$1.00 par value, as of June 30, 2007 was 95,300,000.

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Table of Contents**Part I Financial Information****Item 1. Financial Statements (Unaudited)****Arthur J. Gallagher & Co.****Consolidated Statement of Earnings****(Unaudited - in millions, except per share data)**

	Three-month period ended June 30,		Six-month period ended June 30,	
	2007	2006	2007	2006
Commissions	\$ 237.1	\$ 214.4	\$ 435.5	\$ 396.6
Retail contingent commissions	2.2	0.9	3.0	1.9
Fees	168.1	146.3	314.2	278.0
Investment income - Brokerage and Risk Management	8.2	6.9	15.7	15.2
Investment income - Financial Services	28.2	5.5	59.5	9.8
Investment gains (losses)	(3.0)	(3.4)	1.1	(3.4)
Total revenues	440.8	370.6	829.0	698.1
Compensation	238.1	219.3	461.7	424.8
Operating	90.1	76.5	172.7	150.1
Investment expenses	37.0	12.0	81.4	16.4
Interest	3.2	2.1	3.8	4.2
Depreciation	7.3	7.5	15.0	14.9
Amortization	7.9	5.5	15.7	11.0
Total expenses	383.6	322.9	750.3	621.4
Earnings before income taxes	57.2	47.7	78.7	76.7
Provision for income taxes	13.4	11.1	15.1	23.0
Net earnings	\$ 43.8	\$ 36.6	\$ 63.6	\$ 53.7
Basic net earnings per share	\$.45	\$.38	\$.65	\$.56
Diluted net earnings per share	.44	.37	.64	.55
Dividends declared per common share	\$.31	\$.30	\$.62	\$.60

See notes to consolidated financial statements.

Table of Contents**Arthur J. Gallagher & Co.****Consolidated Balance Sheet****(In millions)**

	June 30, 2007 (Unaudited)	December 31, 2006
Cash and cash equivalents	\$ 210.9	\$ 208.0
Restricted cash	692.8	588.9
Unconsolidated investments - current	41.8	49.2
Premiums and fees receivable	1,493.0	1,422.3
Other current assets	106.6	107.8
Total current assets	2,545.1	2,376.2
Unconsolidated investments - noncurrent	27.4	32.5
Fixed assets related to consolidated investments - net	2.0	32.5
Other fixed assets - net	76.1	70.6
Deferred income taxes	294.6	286.8
Other noncurrent assets	108.9	91.8
Goodwill - net	376.1	316.6
Amortizable intangible assets - net	271.5	213.1
Total assets	\$ 3,701.7	\$ 3,420.1
Premiums payable to insurance and reinsurance companies	\$ 2,165.7	\$ 1,958.8
Accrued compensation and other accrued liabilities	253.9	316.4
Unearned fees	39.6	39.7
Income taxes payable		51.0
Other current liabilities	7.2	26.5
Corporate related borrowings	229.5	
Investment related borrowings - current	3.5	8.9
Total current liabilities	2,699.4	2,401.3
Investment related borrowings - noncurrent		25.9
Other noncurrent liabilities	219.5	128.8
Total liabilities	2,918.9	2,556.0
Stockholders' equity:		
Common stock - issued and outstanding 95.3 shares in 2007 and 98.4 shares in 2006	95.3	98.4
Capital in excess of par value	201.6	285.7
Retained earnings	478.4	475.0
Accumulated other comprehensive earnings	7.5	5.0
Total stockholders' equity	782.8	864.1
Total liabilities and stockholders' equity	\$ 3,701.7	\$ 3,420.1

See notes to consolidated financial statements.

Table of Contents**Arthur J. Gallagher & Co.****Consolidated Statement of Cash Flows****(Unaudited in millions)**

	Six-month period ended June 30,	
	2007	2006
Cash flows from operating activities:		
Net earnings	\$ 63.6	\$ 53.7
Adjustments to reconcile net earnings to net cash provided (used) by operating activities:		
Net (gain) loss on investments and other	(1.1)	3.4
Depreciation and amortization	30.7	25.9
Amortization of deferred compensation and restricted stock	3.7	5.7
Stock-based compensation expense	6.2	8.2
Increase in restricted cash	(88.7)	(79.1)
Increase in premiums receivable	(53.9)	(192.3)
Increase in premiums payable	173.9	302.0
Decrease in other current assets	15.2	9.4
Net change in accrued compensation and other accrued liabilities	(60.3)	(137.0)
Net change in fees receivable/unearned fees	0.7	(20.3)
Net change in income taxes payable	(1.3)	(0.1)
Net change in deferred income taxes	(5.3)	(0.1)
Other	(10.4)	(5.3)
Net cash provided (used) by operating activities	73.0	(25.9)
Cash flows from investing activities:		
Net additions to fixed assets	(17.1)	(19.0)
Cash paid for acquisitions, net of cash acquired	(97.5)	(39.3)
Proceeds from sale of consolidated operation	0.7	
Net proceeds from investment transactions	0.4	0.2
Net cash used by investing activities	(113.5)	(58.1)
Cash flows from financing activities:		
Proceeds from issuance of common stock	13.0	16.4
Tax benefit from issuance of common stock	2.4	6.7
Repurchases of common stock	(137.9)	(12.3)
Dividends paid	(60.2)	(55.8)
Borrowings on line of credit facilities	245.9	37.0
Repayments on line of credit facilities	(16.4)	(2.0)
Repayments of long-term debt	(3.4)	(1.4)
Net cash provided (used) by financing activities	43.4	(11.4)
Net increase (decrease) in cash and cash equivalents	2.9	(95.4)
Cash and cash equivalents at beginning of period	208.0	317.8
Cash and cash equivalents at end of period	\$ 210.9	\$ 222.4
Supplemental disclosures of cash flow information:		
Interest paid	\$ 3.8	\$ 4.7

Income taxes paid

See notes to consolidated financial statements.

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Notes to June 30, 2007 Consolidated Financial Statements (Unaudited)

1. Nature of Operations and Basis of Presentation

Arthur J. Gallagher & Co. (Gallagher) provides insurance brokerage and risk management services to a wide variety of commercial, industrial, institutional and governmental organizations. Commission revenue is primarily generated through the negotiation and placement of insurance for its clients. Fee revenue is primarily generated by providing other risk management services including claims management, information management, risk control services and appraisals in either the property/casualty (P/C) market or human resource/employee benefit market. Investment income and other revenue is generated from Gallagher's investment portfolio, which includes fiduciary funds and tax advantaged and other investments. Gallagher is headquartered in Itasca, Illinois, has operations in eight countries and does business in 100 countries globally through a network of correspondent brokers and consultants.

The accompanying unaudited consolidated financial statements have been prepared by Gallagher pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in annual financial statements have been omitted pursuant to such rules and regulations. Gallagher believes the disclosures are adequate to make the information presented not misleading. The unaudited consolidated financial statements included herein are, in the opinion of management, prepared on a basis consistent with the audited consolidated financial statements for the year ended December 31, 2006 and include all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the information set forth. The quarterly results of operations are not necessarily indicative of results of operations for subsequent quarters or the full year. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto included in Gallagher's Annual Report on Form 10-K for the year ended December 31, 2006.

2. Effect of New Accounting Pronouncements

Income Taxes

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes – an Interpretation of SFAS No.109. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement of Financial Accounting Standards (SFAS) No.109, Accounting for Income Taxes. FIN 48 also prescribes a recognition threshold and measurement of a tax position taken or expected to be taken in an enterprise's tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. Accordingly, Gallagher adopted FIN 48 effective January 1, 2007. The adoption of FIN 48 did not have any impact on Gallagher's consolidated financial position.

Gallagher had \$67.2 million of gross unrecognized tax benefits as of January 1, 2007. The total amount of net unrecognized tax benefits that, if recognized, would affect the effective tax rate was \$59.7 million as of January 1, 2007. Gallagher accrues interest and penalties related to unrecognized tax benefits in its provision for income taxes. As of January 1, 2007, Gallagher had accrued interest and penalties related to unrecognized income tax benefits of \$5.2 million.

Gallagher and its subsidiaries file income tax returns in the U.S. Federal jurisdiction, in various states and in foreign jurisdictions. As of January 1, 2007, Gallagher has been examined by the Internal Revenue Service (IRS) through calendar year 2004, except for 2003, which the IRS declined to examine. Gallagher has not been contacted by the IRS for examination of any years subsequent to 2004. Gallagher is generally no longer subject to state and local income examination for years prior to 2002. However, a number of state and local examinations are currently ongoing.

Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurement, which provides enhanced guidance for using fair value to measure assets and liabilities. SFAS 157 also responds to investors' requests for expanded information about the extent to which entities measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. SFAS 157 applies whenever other standards require or permit assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances.

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Under SFAS 157, fair value refers to the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the market in which the reporting entity transacts business. SFAS 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing the asset or liability. In support of this principle, the standard establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data, for example, the reporting entity's own data. Fair value measurements are required to be separately disclosed by level within the fair value hierarchy.

SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and for all interim periods within those fiscal years. Gallagher is currently evaluating the impact that the adoption of SFAS 157 will have, if any, on its consolidated financial statements and notes thereto.

Fair Value Option

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, which provides companies with an option to report selected financial assets and liabilities at fair value. The objective of SFAS 159 is to reduce both the complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently.

U.S. generally accepted accounting principles (GAAP) have required different measurement attributes for different assets and liabilities that can create artificial volatility in earnings. SFAS 159 helps to mitigate this type of accounting-induced volatility by enabling companies to report related assets and liabilities at fair value. SFAS 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities.

SFAS 159 requires companies to provide additional information that will help investors and other users of financial statements to more easily understand the effect of the company's choice to use fair value on its earnings. SFAS 159 also requires entities to display the fair value of those assets and liabilities for which the company has chosen to use fair value on the face of the balance sheet. SFAS 159 does not eliminate disclosure requirements included in other accounting standards, including requirements for disclosures about fair value measurements included in SFAS 157 and SFAS 107, Disclosures about Fair Value of Financial Instruments.

SFAS 159 is effective as of the beginning of an entity's first fiscal year beginning after November 15, 2007.

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3. Investments

The following is a summary of Gallagher's unconsolidated investments and the related outstanding letters of credit (LOCs), financial guarantees and funding commitments (in millions):

	June 30, 2007		December 31, 2006		June 30, 2007	
	Current	Noncurrent	Current	Noncurrent	LOCs & Financial Guarantees	Funding Commitments

Unconsolidated Investments:

Direct and indirect investments in Asset Alliance Corporation (AAC):