BOWATER INC
Form 8-K
June 12, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 8-K

CURRENT REPORT

Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Date of Report (Date of earliest event reported): June 6, 2008

BOWATER INCORPORATED

(Exact name of Registrant as Specified in Charter)

Delaware	**1-8712**	**62-0721803**
(State or other Jurisdiction of Incorporation or Organization)	**(Commission File Number)**	**(I.R.S. Employer Identification Number)**

Bowater Incorporated

55 East Camperdown Way

P.O. Box 1028

Greenville, South Carolina	**29602**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (864) 271-7733

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions (see General Instruction A.2. below):

¨ Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)

¨ Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)

¨ Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))

¨ Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))

Item 1.01 Entry into a Material Definitive Agreement.

On June 6, 2008, Bowater Incorporated (Bowater), a subsidiary of AbitibiBowater Inc. (AbitibiBowater), entered into an amendment (the Amendment) to its Canadian credit agreement. The Amendment to the Canadian credit agreement was entered into among Bowater and certain subsidiaries and affiliates of Bowater, Bowater Canadian Forest Products Inc., an indirect subsidiary of Bowater (BCFPI), AbitibiBowater, certain lenders party thereto and The Bank of Nova Scotia, as Administrative Agent for the various lenders under the credit agreement. The Amendment principally (i) extends the maturity date of the credit facility from May 28, 2008 to June 5, 2009, (ii) imposes additional reporting obligations on BCFPI and implements more extensive eligibility criteria for the assets that may be used in determining the borrowing base under the facility, thereby reducing the funds available under the credit facility and (iii) reduces the aggregate commitment of all the lenders party thereto from $165,000,000 to $143,750,000.

The foregoing description of the Amendment does not purport to be complete and is qualified in its entirety by reference to the Amendment, which is filed as Exhibit 10.1 hereto, and is incorporated herein by reference.

Item 9.01 Financial Statements and Exhibits.

(d) Exhibits

10.1 Seventh Amendment, dated as of June 6, 2008, to the Credit Agreement dated as of May 31, 2006 by and among Bowater Canadian Forest Products Inc., Bowater Incorporated, certain subsidiaries and affiliates of Bowater party thereto, AbitibiBowater Inc., the Lenders and the U.S. Lenders party thereto and The Bank of Nova Scotia, as administrative agent for the Lenders party thereto.

SIGNATURES

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

BOWATER INCORPORATED

By: /s/ William G. Harvey
Name: William G. Harvey
Title: Vice President and Treasurer

Dated: June 12, 2008

EXHIBIT INDEX

Exhibit No.	**Description of Exhibit**
10.1	Seventh Amendment, dated as of June 6, 2008, to the Credit Agreement dated as of May 31, 2006 by and among Bowater Canadian Forest Products Inc., Bowater Incorporated, certain subsidiaries and affiliates of Bowater party thereto, AbitibiBowater Inc., the Lenders and the U.S. Lenders party thereto and The Bank of Nova Scotia, as administrative agent for the Lenders party thereto.

8, 2010

John A. Shelley, Director

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LSB Industries, Inc.

Consolidated Financial Statements
And Schedules for Inclusion in Form 10-K
For the Fiscal Year ended December 31, 2009

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of LSB Industries, Inc.

We have audited the accompanying consolidated balance sheets of LSB Industries, Inc. as of December 31, 2009 and 2008, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2009. Our audits also included the financial statement schedules listed in the Index at Item 15(a)(2). These financial statements and schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedules based on our audits.

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 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 LSB Industries, Inc. at December 31, 2009 and 2008, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2009, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedules, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 14 to the consolidated financial statements, in 2007, the Company adopted a new accounting principle related to uncertain income tax provisions.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), LSB Industries, Inc.'s internal control over financial reporting as of December 31, 2009, 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 8, 2010 expressed an unqualified opinion thereon.

ERNST & YOUNG LLP

Oklahoma City, Oklahoma
March 8, 2010
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LSB Industries, Inc.

Consolidated Balance Sheets

	December 31,	
	2009	2008
	(In Thousands)	
Assets		
Current assets:		
Cash and cash equivalents	$ 61,739	$ 46,204
Restricted cash	30	893
Short-term investments	10,051	-
Accounts receivable, net	57,762	78,846
Inventories	51,013	60,810
Supplies, prepaid items and other:		
Prepaid insurance	4,136	3,373
Prepaid income taxes	1,642	-
Precious metals	13,083	14,691
Supplies	4,886	4,301
Other	1,626	1,378
Total supplies, prepaid items and other	25,373	23,743
Deferred income taxes	5,527	11,417
Total current assets	211,495	221,913
Property, plant and equipment, net	117,962	104,292
Other assets:		
Debt issuance costs, net	1,652	2,607
Investment in affiliate	3,838	3,628
Goodwill	1,724	1,724
Other, net	1,962	1,603
Total other assets	9,176	9,562
	$ 338,633	$ 335,767

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LSB Industries, Inc.

Consolidated Balance Sheets (continued)

	December 31, 2009	December 31, 2008
	(In Thousands)	
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 37,553	$ 43,014
Short-term financing	3,017	2,228
Accrued and other liabilities	23,054	39,236
Current portion of long-term debt	3,205	1,560
Total current liabilities	66,829	86,038
Long-term debt	98,596	103,600
Noncurrent accrued and other liabilities	10,626	9,631
Deferred income taxes	11,975	6,454
Commitments and contingencies (Note 15)		
Stockholders' equity:		
Series B 12% cumulative, convertible preferred stock, $100 par value; 20,000 shares issued and outstanding	2,000	2,000
Series D 6% cumulative, convertible Class C preferred stock, no par value; 1,000,000 shares issued and outstanding	1,000	1,000
Common stock, $.10 par value; 75,000,000 shares authorized, 25,369,095 shares issued (24,958,330 at December 31, 2008)	2,537	2,496
Capital in excess of par value	129,941	127,337
Accumulated other comprehensive loss	-	(120)
Retained earnings	41,082	19,804
	176,560	152,517
Less treasury stock, at cost:		
Common stock, 4,143,362 shares (3,848,518 at December 31, 2008)	25,953	22,473
Total stockholders' equity	150,607	130,044
	$ 338,633	$ 335,767

See accompanying notes.

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LSB Industries, Inc.

Consolidated Statements of Income

	Year ended December 31,		
	2009	2008	2007
	(In Thousands, Except Per Share Amounts)		
Net sales	$ 531,838	$ 748,967	$ 586,407
Cost of sales	394,424	610,087	453,814
Gross profit	137,414	138,880	132,593
Selling, general and administrative expense	96,374	86,646	75,033
Provisions for losses on accounts receivable	90	371	858
Other expense	527	1,184	1,186
Other income	(287)	(8,476)	(3,495)
Operating income	40,710	59,155	59,011
Interest expense	6,746	11,381	12,078
Gains on extinguishment of debt	(1,783)	(5,529)	-
Non-operating other income, net	(130)	(1,096)	(1,264)
Income from continuing operations before provisions for income taxes and equity in earnings of affiliate	35,877	54,399	48,197
Provisions for income taxes	15,024	18,776	2,540
Equity in earnings of affiliate	(996)	(937)	(877)
Income from continuing operations	21,849	36,560	46,534
Net loss (income) from discontinued operations	265	13	(348)
Net income	21,584	36,547	46,882
Dividends, dividend requirements and stock dividends on preferred stocks	306	306	5,608
Net income applicable to common stock	$ 21,278	$ 36,241	$ 41,274
Income (loss) per common share:			
Basic:			
Income from continuing operations	$ 1.01	$ 1.71	$ 2.09
Net income (loss) from discontinued operations	(.01)	-	.02
Net income	$ 1.00	$ 1.71	$ 2.11
Diluted:			
Income from continuing operations	$ .97	$ 1.58	$ 1.82
Net income (loss) from discontinued operations	(.01)	-	.02
Net income	$ .96	$ 1.58	$ 1.84

See accompanying notes.

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LSB Industries, Inc.

Consolidated Statements of Stockholders' Equity

	Common Stock Shares	Non-Redeemable Preferred Stock	Common Stock Par Value	Capital in Excess of Par Value	Accumulated Other Comprehensive Loss	Accumulated Deficit	Treasury Stock - Preferred	Treasury Stock - Common	Total
					(In Thousands)				
Balance at December 31, 2006	20,215	$ 28,870	$ 2,022	$ 79,838	$ (701)	$ (47,962)	$ (797)	$ (17,636)	$ 43,634
Net income						46,882			46,882
Amortization of cash flow hedge					290				290
Total comprehensive income									47,172
Dividends paid on preferred stocks						(2,934)			(2,934)
Cumulative effect adjustment (See Note 14)						(120)			(120)
Stock-based compensation				421					421
Conversion of debentures to common stock	565		57	3,681					3,738
Exercise of stock options	582		58	1,480				(16)	1,522
Exercise of warrant	113		12	381					393
Income tax benefit from exercise of stock options				1,740					1,740
Exchange of 305,807 shares of non-redeemable preferred stock for 2,262,965 shares of common stock	2,263	(15,290)	226	27,367		(12,303)			-
Conversion of 167,475 shares of non-redeemable preferred stock for 724,993 shares of common stock	725	(8,374)	72	8,301					(1)
Redemption of 25,820 shares of		(1,291)							(1,291)

non-redeemable preferred stock									
Cancellation of 18,300 shares of non-redeemable preferred stock (1)		(915)		118			797		-
Conversion of 98 shares of redeemable preferred stock to common stock	4			9					9
Balance at December 31, 2007	24,467	$ 3,000	$ 2,447	$123,336	$ (411)	$(16,437)	$ -	$(17,652)	$94,283

(1) These shares represent the shares of Series 2 Preferred previously held as treasury stock. As the result of the cancellation, no shares of Series 2 Preferred were issued and outstanding at December 31, 2007.

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LSB Industries, Inc.

Consolidated Statements of Stockholders' Equity (continued)

	Common Stock Shares	Non-Redeemable Preferred Stock	Common Stock Par Value	Capital in Excess of Par Value	Accumulated Other Comprehensive Loss	Retained Earnings	Treasury Stock - Common	Total
				(In Thousands)				
Net income						$ 36,547		$ 36,547
Amortization of cash flow hedge					291			291
Total comprehensive income								36,838
Dividends paid on preferred stocks						(306)		(306)
Stock-based compensation				811				811
Exercise of stock options	490		49	797				846
Income tax benefit from exercise of stock options				2,390				2,390
Acquisition of 400,000 shares of common stock							(4,821)	(4,821)
Conversion of 38 shares of redeemable preferred stock to common stock	1			3				3
Balance at December 31, 2008	24,958	3,000	2,496	127,337	(120)	19,804	(22,473)	130,044
Net income						21,584		21,584
Amortization of cash flow hedge					120			120
Total comprehensive income								21,704
Dividends paid on preferred stocks						(306)		(306)
Stock-based compensation				1,021				1,021
Exercise of stock options	409		41	848			(280)	609
Excess income tax benefit associated with stock-based compensation				731				731
Acquisition of 275,900 shares of common stock							(3,200)	(3,200)
Conversion of 36 shares of redeemable preferred stock to common stock	2			4				4
Balance at December 31, 2009	25,369	$ 3,000	$ 2,537	$ 129,941	$ -	$ 41,082	$ (25,953)	$ 150,607

See accompanying notes.

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LSB Industries, Inc.

Consolidated Statements of Cash Flows

	Year ended December 31, 2009	2008	2007
	(In Thousands)		
Cash flows from continuing operating activities			
Net income	$ 21,584	$ 36,547	$ 46,882
Adjustments to reconcile net income to net cash provided by continuing operating activities:			
Net loss (income) from discontinued operations	265	13	(348)
Deferred income taxes	11,231	(263)	(4,700)
Gains on extinguishment of debt	(1,783)	(5,529)	-
Losses on sales and disposals of property and equipment	378	158	378
Gain on litigation judgment associated with property, plant and equipment	-	(3,943)	-
Depreciation of property, plant and equipment	15,601	13,830	12,271
Amortization	757	1,186	2,082
Stock-based compensation	1,021	811	421
Provisions for losses on accounts receivable	90	371	858
Provision for (realization of) losses on inventory	(2,404)	3,824	(384)
Provision for (realization of) losses on firm sales commitments	371	-	(328)
Provisions for impairment on long-lived assets	-	192	250
Equity in earnings of affiliate	(996)	(937)	(877)
Distributions received from affiliate	786	735	765
Changes in fair value of commodities contracts	(138)	5,910	172
Changes in fair value of interest rate contracts	(508)	2,863	580
Cash provided (used) by changes in assets and liabilities (net of effects of discontinued operations):			
Accounts receivable	22,118	(8,776)	(4,392)
Inventories	11,880	(7,758)	(11,044)
Prepaid and accrued income taxes	(2,738)	(2,836)	3,909
Other supplies and prepaid items	230	(4,145)	(4,857)
Accounts payable	(6,154)	2,214	(5,110)
Commodities contracts	(5,922)	(172)	(408)
Customer deposits	(2,607)	(6,283)	6,587
Deferred rent expense	(1,424)	(2,876)	(931)
Other current and noncurrent liabilities	(3,965)	6,879	5,023
Net cash provided by continuing operating activities	57,673	32,015	46,799

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LSB Industries, Inc.

Consolidated Statements of Cash Flows (continued)

	Year ended December 31, 2009	2008	2007
	(In Thousands)		
Cash flows from continuing investing activities			
Capital expenditures	$ (28,891)	$ (32,108)	$ (14,341)
Proceeds from property insurance recovery associated with property, plant and equipment	364	-	-
Proceeds from litigation judgment associated with property, plant and equipment	-	5,948	-
Payment of legal costs relating to litigation judgment associated with property, plant and equipment	-	(1,884)	-
Proceeds from sales of property and equipment	15	74	271
Purchase of short-term investments	(10,051)	-	-
Proceeds from (deposits of) current and noncurrent restricted cash	863	(690)	3,478
Purchase of interest rate cap contracts	-	-	(621)
Other assets	(360)	(379)	(168)
Net cash used by continuing investing activities	(38,060)	(29,039)	(11,381)
Cash flows from continuing financing activities			
Proceeds from revolving debt facilities	519,296	662,402	529,766
Payments on revolving debt facilities	(519,296)	(662,402)	(556,173)
Proceeds from 5.5% convertible debentures, net of fees	-	-	56,985
Proceeds from Secured Term Loan	-	-	50,000
Proceeds from other long-term debt, net of fees	8,566	-	2,424
Payments on Senior Secured Loan	-	-	(50,000)
Acquisitions of 5.5% convertible debentures	(8,938)	(13,207)	-
Payments on other long-term debt	(2,327)	(1,047)	(8,248)
Payments of debt issuance costs	(26)	-	(1,403)
Proceeds from short-term financing and drafts payable	3,866	3,178	1,456
Payments on short-term financing and drafts payable	(3,077)	(1,869)	(3,523)
Proceeds from exercises of stock options	609	846	1,522
Proceeds from exercise of warrant	-	-	393
Purchases of treasury stock	(3,200)	(4,821)	-
Excess income tax benefit associated with stock-based compensation	911	2,390	1,740
Dividends paid on preferred stocks	(306)	(306)	(2,934)
Acquisition of non-redeemable preferred stock	-	-	(1,292)
Net cash provided (used) by continuing financing activities	(3,922)	(14,836)	20,713
Cash flows of discontinued operations:			
Operating cash flows	(156)	(160)	(162)
Net increase (decrease) in cash and cash equivalents	15,535	(12,020)	55,969
Cash and cash equivalents at beginning of year	46,204	58,224	2,255
Cash and cash equivalents at end of year	$ 61,739	$ 46,204	$ 58,224

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LSB Industries, Inc.

Consolidated Statements of Cash Flows (continued)

	Year ended December 31,		
	2009	2008	2007
		(In Thousands)	
Supplemental cash flow information:			
Cash payments for:			
Interest on long-term debt and other	$ 6,908	$ 6,562	$ 9,162
Income taxes, net of refunds	$ 5,559	$ 19,469	$ 1,646
Noncash investing and financing activities:			
Receivables associated with property insurance claims	$ 846	$ -	$ -
Debt issuance costs	$ 34	$ -	$ 3,026
Current and noncurrent other assets, accounts payable, other liabilities, and long-term debt associated with additions of property, plant and equipment	$ 5,023	$ 7,975	$ 1,937
Debt issuance costs associated with the acquisitions of the 5.5% convertible debentures	$ 379	$ 764	$ -
Debt issuance costs associated with 7% convertible debentures converted to common stock	$ -	$ -	$ 266
7% convertible debentures converted to common stock	$ -	$ -	$ 4,000
Series 2 preferred stock converted to common stock of which $12,303,000 was charged to accumulated deficit in 2007	$ -	$ -	$ 27,593

See accompanying notes.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements

1. Basis of Presentation

The accompanying consolidated financial statements include the accounts of LSB Industries, Inc. (the “Company”, “We”, “Us”, or “Our”) and its subsidiaries. We are a manufacturing, marketing and engineering company. Primarily through our wholly-owned subsidiary ThermaClime, Inc. (“ThermaClime”) and its subsidiaries, we are principally engaged in the manufacture and sale of geothermal and water source heat pumps and air handling products (the "Climate Control Business") and the manufacture and sale of chemical products (the "Chemical Business"). The Company and ThermaClime are holding companies with no significant assets or operations other than cash, cash equivalents, short-term investments, and our investments in our subsidiaries. Entities that are 20% to 50% owned and for which we have significant influence are accounted for on the equity method. All material intercompany accounts and transactions have been eliminated.

Certain reclassifications have been made in our consolidated financial statements for 2008 and 2007 to conform to our consolidated financial statement presentation for 2009, including the change in our classification of principal payments under capital lease obligations from “capital expenditures” that are included in net cash used by continuing investing activities to “payments on other long-term debt” that are included in net cash used by continuing financing activities. This change in classification is consistent with the underlying principles of United States generally accepted accounting principles (“GAAP”). This change resulted in a decrease in net cash used by continuing investing activities and an increase in net cash used by financing activities of $448,000 for 2008 and a decrease in net cash provided by financing activities of $467,000 for 2007.

2. Summary of Significant Accounting Policies

Use of Estimates - The preparation of consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents - Investments, which consist of highly liquid investments with original maturities of three months or less, are considered cash equivalents.

Restricted Cash - Restricted cash consists of cash balances that are legally restricted or designated by the Company for specific purposes.

Short-Term Investments - Investments, which consist of certificates of deposit with an original maturity of 13 weeks, are considered short-term investments. These investments are carried at cost which approximates fair value. All of these investments were held by financial institutions within the United States and none of these investments were in excess of the federally insured limits.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Accounts Receivable and Credit Risk - Our sales to contractors and independent sales representatives are generally subject to a mechanic's lien in the Climate Control Business. Our other sales are generally unsecured. Credit is extended to customers based on an evaluation of the customer's financial condition and other factors. Credit losses are provided for in the consolidated financial statements based on historical experience and periodic assessment of outstanding accounts receivable, particularly those accounts which are past due (determined based upon how recently payments have been received). Our periodic assessment of accounts and credit loss provisions are based on our best estimate of amounts that are not recoverable.

Inventories - Inventories are priced at the lower of cost or market, with cost being determined using the first-in, first-out ("FIFO") basis. Finished goods and work-in-process inventories include material, labor, and manufacturing overhead costs. At December 31, 2009 and 2008, we had inventory reserves for certain slow-moving inventory items (primarily Climate Control products) and inventory reserves for certain nitrogen-based inventories produced by our Chemical Business because cost exceeded the net realizable value.

Precious Metals - Precious metals are used as a catalyst in the Chemical Business manufacturing process. Precious metals are carried at cost, with cost being determined using the FIFO basis. Because some of the catalyst consumed in the production process cannot be readily recovered and the amount and timing of recoveries are not predictable, we follow the practice of expensing precious metals as they are consumed. Occasionally, during major maintenance or capital projects, we may be able to perform procedures to recover precious metals (previously expensed) which have accumulated over time within the manufacturing equipment. Recoveries of precious metals are recognized at historical FIFO costs. When we accumulate precious metals in excess of our production requirements, we may sell a portion of the excess metals.

Property, Plant and Equipment - Property, plant and equipment are carried at cost. For financial reporting purposes, depreciation is primarily computed using the straight-line method over the estimated useful lives of the assets. Leases meeting capital lease criteria have been capitalized and included in property, plant and equipment. Amortization of assets under capital leases is included in depreciation expense. No provision for depreciation is made on construction in progress or capital spare parts until such time as the relevant assets are put into service. Maintenance, repairs and minor renewals are charged to operations while major renewals and improvements are capitalized in property, plant and equipment.

Impairment of Long-Lived Assets - Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amounts may not be recoverable. If assets to be held and used are considered to be impaired, the impairment to be recognized is the amount by which the carrying amounts of the assets exceed the fair values of the assets as measured by the present value of future net cash flows expected to be generated by the assets or their appraised value. Assets to be disposed are reported at the lower of the carrying amounts of the assets or fair values less costs to sell. At December 31, 2009, we had no long-lived assets to be classified as assets held for sale.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

For 2008 and 2007, we obtained estimates from external sources and made internal estimates based on inquiry and other techniques of the fair values of certain capital spare parts and idle assets in our Chemical Business and certain non-core equipment included in our Corporate assets in order to determine recoverability of the carrying amounts of such assets.

Debt Issuance Costs - Debt issuance costs are amortized over the term of the associated debt instrument. In general, if debt is extinguished prior to maturity, the associated debt issuance costs, if any, are written off and included in the gain or loss on extinguishment of debt.

Goodwill - Goodwill is reviewed for impairment at least annually. As of December 31, 2009 and 2008, goodwill was $1,724,000 of which $103,000 and $1,621,000 relates to business acquisitions in prior periods in the Climate Control and Chemical Businesses, respectively.

Accrued Insurance Liabilities - We are self-insured up to certain limits for group health, workers' compensation and general liability claims. Above these limits, we have commercial insurance coverage for our contractual exposure on group health claims and statutory limits under workers' compensation obligations. We also carry excess umbrella insurance of $50 million for most general liability and auto liability risks. We have a separate $30 million insurance policy covering pollution liability at our Chemical Business facilities. Additional pollution liability coverage for our other facilities is provided in our general liability and umbrella policies. Our accrued insurance liabilities are based on estimates of claims, which include the incurred claims amounts plus estimates of future claims development calculated by applying our historical claims development factors to our incurred claims amounts. We also consider the reserves established by our insurance adjustors and/or estimates provided by attorneys handling the claims, if any. In addition, our accrued insurance liabilities include estimates of incurred, but not reported, claims and other insurance-related costs. Potential legal fees and other directly related costs associated with insurance claims are not accrued but rather are expensed as incurred. Accrued insurance liabilities are included in accrued and other liabilities. It is possible that the actual development of claims could exceed our estimates.

Product Warranty - Our Climate Control Business sells equipment that has an expected life, under normal circumstances and use, that extends over several years. As such, we provide warranties after equipment shipment/start-up covering defects in materials and workmanship.

Generally, the base warranty coverage for most of the manufactured equipment in the Climate Control Business is limited to eighteen months from the date of shipment or twelve months from the date of start-up, whichever is shorter, and to ninety days for spare parts. The warranty provides that most equipment is required to be returned to the factory or an authorized representative and the warranty is limited to the repair and replacement of the defective product, with a maximum warranty of the refund of the purchase price. Furthermore, companies within the Climate Control Business generally disclaim and exclude warranties related to merchantability or fitness for any particular purpose and disclaim and exclude any liability for consequential or incidental damages. In some cases, the customer may purchase or a specific

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

product may be sold with an extended warranty. The above discussion is generally applicable to such extended warranties, but variations do occur depending upon specific contractual obligations, certain system components, and local laws.

Our accounting policy and methodology for warranty arrangements is to measure and recognize the expense and liability for such warranty obligations using a percentage of net sales, based upon our historical warranty costs. We also recognize the additional warranty expense and liability to cover atypical costs associated with a specific product, or component thereof, or project installation, when such costs are probable and reasonably estimable. It is possible that future warranty costs could exceed our estimates.

Plant Turnaround Costs - We expense the costs relating to planned major maintenance activities ("Turnarounds") as they are incurred by our Chemical Business.

Executive Benefit Agreements - We have entered into benefit agreements with certain key executives. Costs associated with these individual benefit agreements are accrued based on the estimated remaining service period when such benefits become probable they will be paid. Total costs accrued equal the present value of specified payments to be made after benefits become payable.

Income Taxes - We recognize deferred tax assets and liabilities for the expected future tax consequences attributable to tax net operating loss ("NOL") carryforwards, tax credit carryforwards, and differences between the financial statement carrying amounts and the tax basis of our assets and liabilities. We establish valuation allowances if we believe it is more-likely-than-not that some or all of deferred tax assets will not be realized. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

In addition, we do not recognize a tax benefit unless we conclude that it is more-likely-than-not that the benefit will be sustained on audit by the taxing authority based solely on the technical merits of the associated tax position. If the recognition threshold is met, we recognize a tax benefit measured at the largest amount of the tax benefit that, in our judgment, is greater than 50% likely to be realized. We also record interest related to unrecognized tax positions in interest expense and penalties in operating other expense.

We reduce income tax expense for investment tax credits in the year the credit arises and is earned.

Income tax benefits credited to equity relate to tax benefits associated with amounts that are deductible for income tax purposes but do not affect earnings. These benefits are principally generated from exercises of non-qualified stock options.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Contingencies - We accrue for contingent losses when such losses are probable and reasonably estimable. Estimates of potential legal fees and other directly related costs associated with loss contingencies are not accrued but rather are expensed as incurred. In addition, we recognize contingent gains when such gains are realized or realizable and earned. Our Chemical Business is subject to specific federal and state regulatory compliance laws and guidelines. We have developed policies and procedures related to regulatory compliance. We must continually monitor whether we have maintained compliance with such laws and regulations and the operating implications, if any, and amount of penalties, fines and assessments that may result from noncompliance. Loss contingency liabilities are included in current and noncurrent accrued and other liabilities and are based on current estimates that may be revised in the near term.

Asset Retirement Obligations - We are obligated to monitor certain discharge water outlets at our Chemical Business facilities should we discontinue the operations of a facility. We also have certain facilities in our Chemical Business that contain asbestos insulation around certain piping and heated surfaces, which we plan to maintain or replace, as needed, with non-asbestos insulation through our standard repair and maintenance activities to prevent deterioration. Since we currently have no plans to discontinue the use of these facilities and the remaining lives of the facilities are indeterminable, an asset retirement liability has not been recognized. Currently, there is insufficient information to estimate the fair value of the asset retirement obligations. However, we will continue to review these obligations and record a liability when a reasonable estimate of the fair value can be made.

Stock Options - Equity award transactions with employees are measured based on the estimated fair value of the equity awards issued. For equity awards with only service conditions that have a graded vesting period, we recognize compensation cost on a straight-line basis over the requisite service period for the entire award. In addition, we issue new shares of common stock upon the exercise of stock options.

Revenue Recognition - We recognize revenue for substantially all of our operations at the time title to the goods transfers to the buyer and there remain no significant future performance obligations by us. Revenue relating to construction contracts is recognized using the percentage-of-completion method based primarily on contract costs incurred to date compared with total estimated contract costs. Changes to total estimated contract costs or losses, if any, are recognized in the period in which they are determined. Sales of warranty contracts are recognized as revenue ratably over the life of the contract. See discussion above under "Product Warranty" for our accounting policy for recognizing warranty expense.

Recognition of Insurance Recoveries - If an insurance claim relates to a recovery of our losses, we recognize the recovery when it is probable and reasonably estimable. If our insurance claim relates to a contingent gain, we recognize the recovery when it is realized or realizable and earned. Amounts recoverable from our insurance carriers are included in accounts receivable.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Cost of Sales - Cost of sales includes materials, labor and overhead costs to manufacture the products sold plus inbound freight, purchasing and receiving costs, inspection costs, internal transfer costs and warehousing costs (excluding certain handling costs directly related to loading product being shipped to customers in our Chemical Business which are included in selling, general and administrative expense). In addition, recoveries and gains from precious metals (Chemical Business), sales of material scrap (Climate Control Business), and business interruption insurance claims are reductions to cost of sales. Also gains and losses (realized and unrealized) from our commodities and foreign currency futures/forward contracts are included in cost of sales. In addition, provision for losses, if any, on firm sales commitments are included in cost of sales.

Selling, General and Administrative Expense - Selling, general and administrative expense ("SG&A") includes costs associated with the sales, marketing and administrative functions. Such costs include personnel costs, including benefits, advertising costs, commission expenses, warranty costs, office and occupancy costs associated with the sales, marketing and administrative functions. SG&A also includes outbound freight in our Climate Control Business and certain handling costs directly related to product being shipped to customers in our Chemical Business. These handling costs primarily consist of personnel costs for loading product into transportation equipment, rent and maintenance costs related to the transportation equipment, and certain indirect costs. Also, SG&A includes expenses associated with the start up of our previously idled chemical facility located in Pryor, Oklahoma (the "Pryor Facility") that we are in the process of activating.

Shipping and Handling Costs - For the Chemical Business in 2009, 2008, and 2007, shipping costs of $15,897,000, $16,333,000, and $15,209,000, respectively, are included in net sales as these costs relate to amounts billed to our customers. In addition, in 2009, 2008, and 2007, handling costs of $5,691,000, $5,432,000, and $5,249,000, respectively, are included in SG&A as discussed above under "Selling, General and Administrative Expense." For the Climate Control Business, shipping and handling costs of $7,910,000, $11,047,000, and $11,057,000 are included in SG&A for 2009, 2008, and 2007, respectively.

Advertising Costs - Costs in connection with advertising and promotion of our products are expensed as incurred. For 2009, 2008, and 2007 such costs amounted to $5,915,000, $2,180,000, and $1,791,000, respectively.

Derivatives, Hedges and Financial Instruments - Derivatives are recognized in the balance sheet and are measured at fair value. Changes in fair value of derivatives are recorded in results of operations unless the normal purchase or sale exceptions apply or hedge accounting is elected.

Income per Common Share - Net income applicable to common stock is computed by adjusting net income by the amount of preferred stock dividends, dividend requirements and stock dividends. Basic income per common share is based upon net income applicable to common stock and the weighted-average number of common shares outstanding during each

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

year. Diluted income per share is based on net income applicable to common stock plus preferred stock dividends and dividend requirements on preferred stock assumed to be converted, if dilutive, and interest expense including amortization of debt issuance cost, net of income taxes, on convertible debt assumed to be converted, if dilutive, and the weighted-average number of common shares and dilutive common equivalent shares outstanding, and the assumed conversion of dilutive convertible securities outstanding.

Recently Issued Accounting Pronouncements - In March 2008, the Financial Accounting Standards Board ("FASB") issued new accounting standards requiring enhanced disclosures about an entity's derivative and hedging activities for the purpose of improving the transparency of financial reporting. The new disclosure requirements became effective for the Company on January 1, 2009 and were applied prospectively. See Note 16 - Derivatives, Hedges and Financial Instruments.

3. Income Per Share

The following is a summary of certain transactions which affected basic income per share or diluted income per share, if dilutive:

During 2009,

- we purchased 275,900 shares of treasury stock;
- we issued 409,325 shares of our common stock as the result of the exercise of stock options;
- we acquired $11,100,000 aggregate principal amount of our 5.5% Convertible Senior Subordinated Notes due 2012 (the "2007 Debentures"); and
- we paid cash dividends on our Series B 12% cumulative, convertible preferred stock ("Series B Preferred"), Series D 6% cumulative, convertible Class C preferred stock ("Series D Preferred") and noncumulative redeemable preferred stock ("Noncumulative Preferred") totaling approximately $240,000, $60,000 and $6,000, respectively.

During 2008,

- we purchased 400,000 shares of treasury stock;
- we issued 490,304 shares of our common stock as the result of the exercise of stock options;
- we granted 417,000 shares of stock options;
- we acquired $19,500,000 aggregate principal amount of our 2007 Debentures; and
- we paid cash dividends on our Series B Preferred, Series D Preferred and Noncumulative Preferred totaling approximately $240,000, $60,000 and $6,000, respectively.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

3. Income Per Share (continued)

During 2007,

- we sold $60,000,000 of the 2007 Debentures;
- the remaining $4,000,000 of the 7% Convertible Senior Subordinated Debentures due 2011 (the "2006 Debentures") was converted into 564,789 shares of common stock;
- we issued 2,262,965 shares of common stock for 305,807 shares of our Series 2 $3.25 convertible, exchangeable Class C preferred stock ("Series 2 Preferred") that were tendered pursuant to a tender offer;
- we redeemed 25,820 shares of our Series 2 Preferred and issued 724,993 shares of common stock for 167,475 shares of our Series 2 Preferred;
- we received shareholders' approval in granting 450,000 shares of non-qualified stock options on June 14, 2007;
- we issued 582,000 and 112,500 shares of our common stock as the result of the exercise of stock options and a warrant, respectively;
- we paid cash dividends of approximately $678,000 on the shares of Series 2 Preferred which we redeemed as discussed above; and
- we paid cash dividends on the Series B Preferred, Series D Preferred and Noncumulative Preferred totaling approximately $1,890,000, $360,000 and $6,000, respectively.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

3. Income Per Share (continued)

The following table sets forth the computation of basic and diluted net income per share:

	2009	2008	2007
	(Dollars In Thousands, Except Per Share Amounts)		
Numerator:			
Net income	$ 21,584	$ 36,547	$ 46,882
Dividends and dividend requirements on Series B Preferred	(240)	(240)	(240)
Dividends and dividend requirements on Series D Preferred	(60)	(60)	(60)
Dividends on Noncumulative Preferred	(6)	(6)	(6)
Dividend requirements on shares of Series 2 Preferred which did not exchange pursuant to tender offer or redemption in 2007 or exchange agreements in 2006	-	-	(272)
Dividends and dividend requirements on shares of Series 2 Preferred which were redeemed in 2007	-	-	(59)
Dividend requirements and stock dividend on shares of Series 2 Preferred pursuant to tender offer in 2007 (1)	-	-	(4,971)
Total dividends, dividend requirements and stock dividends on preferred stocks	(306)	(306)	(5,608)
Numerator for basic net income per share - net income applicable to common stock	21,278	36,241	41,274
Dividends and dividend requirements on preferred stock assumed to be converted, if dilutive	306	306	637
Interest expense including amortization of debt issuance costs, net of income taxes, on convertible debt assumed to be converted, if dilutive	-	1,624	1,276
Numerator for diluted net income per common share	$ 21,584	$ 38,171	$ 43,187
Denominator:			
Denominator for basic net income per common share - weighted-average shares	21,294,780	21,170,418	19,579,664
Effect of dilutive securities:			
Convertible preferred stock	938,006	939,126	1,478,012
Stock options	255,660	544,994	1,160,100
Convertible notes payable	4,000	1,478,200	1,200,044
Warrant	-	-	77,824
Dilutive potential common shares	1,197,666	2,962,320	3,915,980
Denominator for dilutive net income per common share – adjusted weighted-average shares and assumed conversions	22,492,446	24,132,738	23,495,644
Basic net income per common share	$ 1.00	$ 1.71	$ 2.11
Diluted net income per common share	$ .96	$ 1.58	$ 1.84

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

3. Income Per Share (continued)

(1) As discussed in Note 18 - Non-Redeemable Preferred Stock, in February 2007 we began a tender offer to exchange shares of our common stock for up to 309,807 of the 499,102 outstanding shares of the Series 2 Preferred. The tender offer expired on March 12, 2007 and our board of directors accepted the shares tendered on March 13, 2007. Because the exchanges under the tender offer were pursuant to terms other than the original terms, the transactions were considered extinguishments of the preferred stock. In addition, the transactions qualified as induced conversions. The excess of the fair value of the common stock issued over the fair value of the securities issuable pursuant to the original conversion terms was subtracted from net income in computing net income per share. Because our Series 2 Preferred are cumulative and the dividend requirements have been included in computing net income per share in previous periods and as an element of the exchange transactions, we effectively settled the dividends in arrears, the amount subtracted from net income in 2007 represents the excess of the fair value of the common stock issued over the fair value of the securities issuable pursuant to the original conversion terms less the dividends in arrears as March 13, 2007.

The following weighted-average shares of securities were not included in the computation of diluted net income per common share as their effect would have been antidilutive:

	2009	2008	2007
Convertible notes payable	1,070,160	-	-
Stock options	398,699	506,142	240,068
Series 2 Preferred pursuant to tender offer in 2007 (A)	-	-	261,090
	1,468,859	506,142	501,158

(A) The shares associated with the tender offer in 2007 were considered separately from other convertible shares of securities in computing net income per common share for 2007.

4. Accounts Receivable, net

	December 31,	
	2009	2008
	(In Thousands)	
Trade receivables	$ 55,318	$ 78,092
Insurance claims	1,517	252
Other	1,603	1,231
	58,438	79,575
Allowance for doubtful accounts	(676)	(729)
	$ 57,762	$ 78,846

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

4. Accounts Receivable, net (continued)

Concentrations of credit risk with respect to trade receivables are limited due to the large number of customers comprising our customer bases and their dispersion across many different industries and geographic areas, however, eight customers (including their affiliates) account for approximately 24% of our total net receivables at December 31, 2009.

5. Inventories

	Finished Goods	Work-in-Process	Raw Materials	Total
		(In Thousands)		
December 31, 2009:				
Climate Control products	$6,680	$2,466	$19,410	$28,556
Chemical products	14,734	-	3,384	18,118
Industrial machinery and components	4,339	-	-	4,339
	$25,753	$2,466	$22,794	$51,013
December 31, 2008:				
Climate Control products	$7,550	$2,954	$21,521	$32,025
Chemical products	18,638	-	5,656	24,294
Industrial machinery and components	4,491	-	-	4,491
	$30,679	$2,954	$27,177	$60,810

At December 31, 2009 and 2008, inventory reserves for certain slow-moving inventory items (Climate Control products) were $1,198,000 and $514,000, respectively. In addition, inventory reserves for certain nitrogen-based inventories provided by our Chemical Business were $478,000 and $3,627,000 at December 31, 2009 and 2008, respectively, because cost exceeded the net realizable value.

Changes in our inventory reserves are as follows:

	Balance at Beginning of Year	Additions-Provision for (realization of) losses	Deductions-Write-offs/ disposals	Balance at End of Year
		(In Thousands)		
2009	$ 4,141	$ (2,404)	$ 61	$ 1,676
2008	$ 473	$ 3,824	$ 156	$ 4,141
2007	$ 1,255	$ (384)	$ 398	$ 473

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

5. Inventories (continued)

The provision for (realization of) losses is included in cost of sales in the accompanying consolidated statements of income.

6. Precious Metals

At December 31, 2009 and 2008, precious metals were $13,083,000 and $14,691,000, respectively, and are included in supplies, prepaid items and other in the accompanying consolidated balance sheets.

Precious metals expense, net, consists of the following:

	2009	2008	2007
		(In Thousands)	
Precious metals expense	$ 5,879	$ 7,786	$ 6,352
Recoveries of precious metals	(2,578)	(1,458)	(1,783)
Gains on sales of precious metals	-	-	(2,011)
Precious metals expense, net	$ 3,301	$ 6,328	$ 2,558

Precious metals expense, net is included in cost of sales in the accompanying consolidated statements of income.

7. Property, Plant and Equipment

	Useful lives in years	December 31, 2009	2008
		(In Thousands)	
Machinery, equipment and automotive	3-20	$ 186,822	$ 173,678
Buildings and improvements	7-30	29,403	28,457
Furniture, fixtures and store equipment	3	5,986	6,716
Assets under capital leases	10	2,544	1,076
Land improvements	10	677	-
Construction in progress	N/A	17,223	8,514
Capital spare parts	N/A	3,253	2,344
Land	N/A	4,082	4,082
		249,990	224,867
Less accumulated depreciation		132,028	120,575
		$ 117,962	$ 104,292

Machinery, equipment and automotive primarily includes the categories of property and equipment and estimated useful lives as follows: chemical processing plants and plant infrastructure (15-20 years); production, fabrication, and assembly equipment (7-15 years);

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

7. Property, Plant and Equipment (continued)

certain processing plant components (3-10 years); and trucks, automobiles, trailers, and other rolling stock (3-7 years). At December 31, 2009 and 2008, assets capitalized under capital leases consist of machinery, equipment and automotive. Accumulated depreciation for assets capitalized under capital leases were $428,000 and $193,000 at December 31, 2009 and 2008, respectively.

8. Debt Issuance Costs, net

Debt issuance costs of $1,652,000 and $2,607,000 are net of accumulated amortization of $3,368,000 and $2,980,000 as of December 31, 2009 and 2008, respectively.

During 2009, we acquired a portion of the 2007 Debentures. As a result, approximately $379,000 of the unamortized debt issuance costs associated with the 2007 Debentures acquired was charged against the gain on extinguishment of debt in 2009.

During 2008, we acquired a portion of the 2007 Debentures. As a result, approximately $764,000 of the unamortized debt issuance costs associated with the 2007 Debentures acquired was charged against the gain on extinguishment of debt in 2008.

During 2007, we incurred debt issuance costs of $4,429,000 which included $3,224,000 relating to the 2007 Debentures and $1,139,000 relating to the $50 million loan agreement ("Secured Term Loan"). In addition, the remaining portion of the 2006 Debentures was converted into our common stock. As a result of the conversions, approximately $266,000 of the remaining unamortized debt issuance costs associated with the 2006 Debentures were charged against capital in excess of par value in 2007. Also, the senior secured loan due in 2009 was repaid with the proceeds from the Secured Term Loan. As a result, approximately $1,331,000 of the remaining unamortized debt issuance and other debt-related costs associated with the senior secured loan was charged to interest expense in 2007.

9. Investment in Affiliate

Cepolk Holding, Inc. ("CHI"), a subsidiary of the Company, is a limited partner and has a 50% equity interest in Cepolk Limited Partnership ("Partnership") which is accounted for on the equity method. The Partnership owns an energy savings project located at the Ft. Polk Army base in Louisiana ("Project"). At December 31, 2009 and 2008, our investment was $3,838,000 and $3,628,000, respectively. As of December 31, 2009, the Partnership and general partner to the Partnership is indebted to a term lender ("Lender") of the Project for approximately $2,083,000 with a term extending to December 2010. CHI has pledged its limited partnership interest in the Partnership to the Lender as part of the Lender's collateral securing all obligations under the loan. This guarantee and pledge is limited to CHI's limited partnership interest and does not expose CHI or the Company to liability in excess of CHI's limited partnership interest. No liability has been established for this pledge since it was entered into prior to January 1, 2003. CHI has no recourse provisions or available collateral that would enable CHI to recover its partnership interest should the Lender be required to perform under this pledge.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

10. Current and Noncurrent Accrued and Other Liabilities

	December 31, 2009	2008
	(In Thousands)	
Accrued payroll and benefits	$ 5,900	$ 6,422
Deferred revenue on extended warranty contracts	4,884	4,028
Accrued insurance	3,667	2,687
Accrued death benefits	3,356	2,971
Accrued warranty costs	3,138	2,820
Fair value of derivatives	1,929	8,347
Accrued interest	1,593	2,003
Accrued executive benefits	1,102	1,111
Accrued commissions	1,035	2,433
Accrued precious metals costs	782	1,298
Accrued contractual manufacturing obligations	732	2,230
Customer deposits	635	3,242
Billings in excess of costs and estimated earnings on uncompleted contracts	616	1,882
Accrued income taxes	608	1,704
Deferred rent expense	-	1,424
Other	3,703	4,265
	33,680	48,867
Less noncurrent portion	10,626	9,631
Current portion of accrued and other liabilities	$ 23,054	$ 39,236

11. Accrued Warranty Costs

Changes in our product warranty obligation (accrued warranty costs) are as follows:

	Balance at Beginning of Year	Additions-Charged to Costs and Expenses	Deductions-Costs Incurred	Balance at End of Year
	(In Thousands)			
2009	$2,820	$5,252	$4,934	$3,138
2008	$1,944	$5,514	$4,638	$2,820
2007	$1,251	$3,325	$2,632	$1,944

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

12. Redeemable Preferred Stock

At December 31, 2009 and 2008, we had 511 shares and 547 shares, respectively, outstanding of Noncumulative Preferred. Each share of Noncumulative Preferred, $100 par value, is convertible into 40 shares of our common stock at the option of the holder at any time and entitles the holder to one vote. The Noncumulative Preferred is redeemable at par at the option of the holder or the Company. The Noncumulative Preferred provides for a noncumulative annual dividend of 10%, payable when and as declared. During 2009, 2008, and 2007, our board of directors declared and we paid dividends totaling $6,000 ($10.00 per share), in each of the respective years on the then outstanding Noncumulative Preferred. At December 31, 2009 and 2008, the Noncumulative Preferred was $48,000 and $52,000, respectively, and is classified as accrued and other liabilities in the accompanying consolidated balance sheets.

13. Long-Term Debt

	December 31, 2009	December 31, 2008
	(In Thousands)	
Working Capital Revolver Loan due 2012 (A)	$ -	-
5.5% Convertible Senior Subordinated Notes due 2012 (B)	29,400	40,500
Secured Term Loan due 2012 (C)	50,000	50,000
Other, with a current weighted-average interest rate of 6.30%, most of which is secured by machinery, equipment and real estate (D)	22,401	14,660
	101,801	105,160
Less current portion of long-term debt (E)	3,205	1,560
Long-term debt due after one year (E)	$ 98,596	$ 103,600

(A) ThermaClime and its subsidiaries (the "Borrowers") are parties to a $50 million revolving credit facility (the "Working Capital Revolver Loan") that provides for advances based on specified percentages of eligible accounts receivable and inventories for ThermaClime, and its subsidiaries. The Working Capital Revolver Loan, as amended, accrues interest at a base rate (generally equivalent to the prime rate) plus .50% or LIBOR plus 1.75% and matures on April 13, 2012. The interest rate at December 31, 2009 was 3.75%. Interest is paid monthly, if applicable. The facility provides for up to $8.5 million of letters of credit. All letters of credit outstanding reduce availability under the facility. As of December 31, 2009, amounts available for borrowing under the Working Capital Revolver Loan were approximately $49.2 million. Under the Working Capital Revolver Loan, as amended, the lender also requires the Borrowers to pay a letter of credit fee equal to 1% per annum of the undrawn amount of all outstanding letters of credit, an unused line fee equal to .375% per annum for the excess amount available under the facility not drawn and various other audit, appraisal and valuation charges.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

13. Long-Term Debt (continued)

The lender may, upon an event of default, as defined, terminate the Working Capital Revolver Loan and make the balance outstanding, if any, due and payable in full. The Working Capital Revolver Loan is secured by the assets of all the ThermaClime entities other than El Dorado Nitric Company and its subsidiaries ("EDN") but excluding the assets securing the Secured Term Loan discussed in (C) below and certain distribution-related assets of El Dorado Chemical Company ("EDC"). EDN is neither a borrower nor guarantor of the Working Capital Revolver Loan. The carrying value of the pledged assets is approximately $194 million at December 31, 2009.

The Working Capital Revolver Loan, as amended, requires ThermaClime to meet certain financial covenants, including an EBITDA requirement of greater than $25 million, a minimum fixed charge coverage ratio of not less than 1.10 to 1, and a maximum senior leverage coverage ratio of not greater than 4.50 to 1. These requirements are measured quarterly on a trailing twelve-month basis and as defined in the agreement. ThermaClime was in compliance with those covenants during 2009. The Working Capital Revolver Loan also contains covenants that, among other things, limit the Borrowers' (which does not include the Company) ability, without consent of the lender and with certain exceptions, to:

- incur additional indebtedness,
- incur liens,
- make restricted payments or loans to affiliates who are not Borrowers,
- engage in mergers, consolidations or other forms of recapitalization, or
- dispose assets.

The Working Capital Revolver Loan also requires all collections on accounts receivable be made through a bank account in the name of the lender or their agent.

(B) On June 28, 2007, we entered into a purchase agreement with each of twenty two qualified institutional buyers ("QIBs"), pursuant to which we sold $60 million aggregate principal amount of the 2007 Debentures in a private placement to the QIBs pursuant to the exemptions from the registration requirements of the Securities Act of 1933, as amended (the "Act"), afforded by Section 4(2) of the Act and Regulation D promulgated under the Act. We received net proceeds of approximately $57 million, after discounts and commissions. In connection with the closing, we entered into an indenture (the "Indenture") with UMB Bank, as trustee, governing the 2007 Debentures. UMB Bank receives customary compensation from us for such services.

The 2007 Debentures bear interest at the rate of 5.5% per year and mature on July 1, 2012. Interest is payable in arrears on January 1 and July 1 of each year, which began on January 1, 2008.

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13. Long-Term Debt (continued)

The 2007 Debentures are unsecured obligations and are subordinated in right of payment to all of our existing and future senior indebtedness, including indebtedness under our revolving debt facilities. The 2007 Debentures are effectively subordinated to all present and future liabilities, including trade payables, of our subsidiaries.

During 2009 and 2008, we acquired $11.1 million and $19.5 million, respectively, aggregate principal amount of the 2007 Debentures for approximately $8.9 million and $13.2 million, respectively, with each purchase being negotiated. As a result, we recognized a gain on extinguishment of debt of approximately $1.8 million and $5.5 million, respectively, after writing off the unamortized debt issuance costs associated with the 2007 Debentures acquired. As the result of these acquisitions, only $29.4 million of the 2007 Debentures remain outstanding at December 31, 2009. In addition, see discussion concerning $5.0 million of the 2007 Debentures being held by Jack E. Golsen, our Chairman of the Board and Chief Executive Officer ("CEO"), members of his immediate family (spouse and children), entities owned by them and trusts for which they possess voting or dispositive power as trustee (collectively, the "Golsen Group") in Note 23 - Related Party Transactions.

The 2007 Debentures are convertible by the holders in whole or in part into shares of our common stock prior to their maturity. The conversion rate of the 2007 Debentures for the holders electing to convert all or any portion of a debenture is 36.4 shares of our common stock per $1,000 principal amount of debentures (representing a conversion price of $27.47 per share of common stock), subject to adjustment under certain conditions as set forth in the Indenture.

We may redeem some or all of the 2007 Debentures at any time on or after July 2, 2010, at a price equal to 100% of the principal amount of the 2007 Debentures, plus accrued and unpaid interest, all as set forth in the Indenture. The redemption price will be payable at our option in cash or, subject to certain conditions, shares of our common stock (valued at 95% of the weighted average of the closing sale prices of the common stock for the 20 consecutive trading days ending on the fifth trading day prior to the redemption date), subject to certain conditions being met on the date we mail the notice of redemption.

If a designated event (as defined in the Indenture) occurs prior to maturity, holders of the 2007 Debentures may require us to repurchase all or a portion of their 2007 Debentures for cash at a repurchase price equal to 101% of the principal amount of the 2007 Debentures plus any accrued and unpaid interest, as set forth in the Indenture. If a fundamental change (as defined in the Indenture) occurs on or prior to June 30, 2010, under certain circumstances, we will pay, in addition to the repurchase price, a make-whole premium on the 2007 Debentures converted in connection with, or tendered for repurchase upon, the fundamental change. The make-whole premium will be payable in our common stock or the same form of consideration into which our common stock has been exchanged or converted in the fundamental change. The amount of the make-whole premium, if any, will be based on our stock price on the effective date of the fundamental change. No make-whole premium will be paid if our stock price in connection with the fundamental change is less than or equal to $23.00 per share.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

13. Long-Term Debt (continued)

At maturity, we may elect, subject to certain conditions as set forth in the Indenture, to pay up to 50% of the principal amount of the outstanding 2007 Debentures, plus all accrued and unpaid interest thereon to, but excluding, the maturity date, in shares of our common stock (valued at 95% of the weighted average of the closing sale prices of the common stock for the 20 consecutive trading days ending on the fifth trading day prior to the maturity date), if the common stock is then listed on an eligible market, the shares used to pay the 2007 Debentures and any interest thereon are freely tradable, and certain required opinions of counsel are received.

In 2007, we used a portion of the net proceeds to redeem our remaining outstanding shares of Series 2 Preferred; to repay certain outstanding mortgages and equipment loans; to pay dividends in arrears on our outstanding shares of Series B Preferred and Series D Preferred, all of which were owned by an affiliate; to reduce the outstanding borrowings under the Working Capital Revolver Loan; and to invest in highly liquid investments to be available for working capital.

In connection with using a portion of the net proceeds of the 2007 Debentures to initially reduce the outstanding borrowings under the Working Capital Revolver Loan, ThermaClime entered into a $25 million demand promissory note ("Demand Note") with the Company. During 2009, ThermaClime made principal payments totaling $15 million on the Demand Note.

(C) In November 2007, ThermaClime and certain of its subsidiaries entered into a $50 million Secured Term Loan with a certain lender. Proceeds from the Secured Term Loan were used to repay the previous senior secured loan. The Secured Term Loan matures on November 2, 2012.

The Secured Term Loan accrues interest at a defined LIBOR rate plus 3%, which LIBOR rate is adjusted on a quarterly basis. The interest rate at December 31, 2009 was approximately 3.28%. The Secured Term Loan requires only quarterly interest payments with the final payment of interest and principal at maturity.

The Secured Term Loan is secured by the real property and equipment located at our El Dorado and Cherokee Facilities. The carrying value of the pledged assets is approximately $63 million at December 31, 2009.

The Secured Term Loan borrowers are subject to numerous covenants under the agreement including, but not limited to, limitation on the incurrence of certain additional indebtedness and liens, limitations on mergers, acquisitions, dissolution and sale of assets, and limitations on declaration of dividends and distributions to us, all with certain exceptions. At December 31, 2009, the carrying value of the restricted net assets of ThermaClime and its subsidiaries was approximately $79 million. As defined in the agreement, the Secured Term Loan borrowers are also subject to a minimum fixed charge coverage ratio of not less than 1.10 to 1 and a maximum leverage ratio of not greater than 4.50 to 1. Both of these requirements are measured quarterly on a trailing twelve-month basis. The Secured Term Loan borrowers were in compliance with these financial covenants for the year ended December 31, 2009.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

13. Long-Term Debt (continued)

The maturity date of the Secured Term Loan can be accelerated by the lender upon the occurrence of a continuing event of default, as defined.

The Working Capital Revolver Loan agreement (discussed in (A) above) and the Secured Term Loan contain cross-default provisions. If ThermaClime fails to meet the financial covenants of either of these agreements, the lenders may declare an event of default.

(D) Amounts include capital lease obligations of $1,742,000 and $716,000 at December 31, 2009 and 2008, respectively.

(E) Maturities of long-term debt for each of the five years after December 31, 2009 are as follows (in thousands):

2010	$ 3,205
2011	3,283
2012	82,766
2013	3,499
2014	2,630
Thereafter	6,418
	$ 101,801

14. Income Taxes

Provisions (benefits) for income taxes are as follows:

	2009	2008	2007
		(In Thousands)	
Current:			
Federal	$ 2,456	$ 17,388	$ 5,260
State	1,337	1,651	1,980
Total Current	$ 3,793	$ 19,039	$ 7,240
Deferred:			
Federal	$ 9,611	$ 595	$ (4,095)
State	1,620	(858)	(605)
Total Deferred	$ 11,231	$ (263)	$ (4,700)
Provisions for income taxes	$ 15,024	$ 18,776	$ 2,540

For 2009, the current provision for federal income taxes of approximately $2.5 million includes regular federal income tax after the consideration of permanent and temporary differences between income for GAAP and tax purposes. The current provision for state income taxes of approximately $1.3 million in 2009 includes regular state income tax and provisions for uncertain state income tax positions as discussed below. In addition to the income tax provision from continuing operations, we allocated an income tax benefit of approximately $0.2 million to discontinued operations.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

14. Income Taxes (continued)

The 2009 deferred tax provision of $11.2 million results from the recognition of changes in our prior year deferred tax assets and liabilities, and the utilization of state NOL carryforwards and other temporary differences. We reduce income tax expense for investment tax credits in the year they arise and are earned. The gross amount of the investment tax credits available to offset state income taxes is approximately $0.5 million and includes credits for the tax years 2004-2009. The investment tax credits do not expire and carryforward indefinitely.

During 2009, we utilized approximately $2.2 million of state NOL carryforwards to reduce the tax liability. We have remaining state tax NOL carryforwards of approximately $12.9 million that begin expiring in 2010.

During 2009, we determined it was more-likely-than-not that approximately $7.1 million of the state NOL carryforwards would not be able to be utilized before expiration and a valuation allowance for the deferred tax assets associated with these state NOL carryforwards, net of federal benefit, of approximately $0.4 million was maintained. We considered both positive and negative evidence in our determination. The negative evidence considered primarily included our history of losses by certain entities and jurisdictions, both as to amount and trend and uncertainties surrounding our ability to generate sufficient taxable income in the individual states to utilize these state NOL carryforwards.

Our overall effective tax rate of 40.7% in 2009 was primarily impacted by tax return to provision adjustments, permanent tax differences and tax credits.

For 2008, the current provision for federal income taxes of approximately $17.4 million includes regular federal income tax after the consideration of permanent and temporary differences between income for GAAP and tax purposes. The current provision for state income taxes of approximately $1.7 million in 2008 includes regular state income tax and provisions for uncertain state income tax positions as discussed below. At December 31, 2007, we had federal and state NOL carryforwards and we utilized all of the federal NOL carryforwards during 2008 and a significant portion of the state NOL carryforwards.

The 2008 deferred tax benefit of $0.3 million results from the recognition of changes in our prior year deferred tax assets and liabilities, and the utilization of state NOL carryforwards and other temporary differences.

During 2008, we performed a detailed analysis of all our deferred tax assets and liabilities and determined that our state net NOL carryforwards were understated by approximately $34.2 million. The addition of the tax benefits of these state NOL carryforwards increased our deferred tax assets and decreased our deferred tax expense by approximately $1.1 million, net of the valuation allowance discussed below. During 2008, we utilized the remaining federal NOL carryforwards of approximately $0.7 million and approximately $32.8 million of state NOL carryforwards to reduce tax expense.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

14. Income Taxes (continued)

During 2008, we determined it was more-likely-than-not that approximately $6.7 million of the state NOL carryforwards would not be able to be utilized before expiration and a valuation allowance for the deferred tax assets associated with these state NOL carryforwards, net of federal benefit, of approximately $0.3 million was established. We considered both positive and negative evidence in our determination. The negative evidence considered primarily included our history of losses by certain entities and jurisdictions, both as to amount and trend and uncertainties surrounding our ability to generate sufficient taxable income in the individual states to utilize these state NOL carryforwards.

Our overall effective tax rate in 2008 is reduced by permanent tax differences, the effect of the change to prior year deferred items and the provision for uncertain tax positions.

The current provision for federal income taxes of $5.3 million for 2007 includes regular federal income tax and alternative minimum income tax (“AMT”). The current provision of state income taxes of $2.0 million for 2007 includes the provision for 2007 state income taxes, as well as $1.0 million for uncertain state income tax positions recognized as discussed below.

The 2007 benefit for deferred taxes of $4.7 million results from the reversal of valuation allowance on deferred tax assets, the benefit of AMT credits, and other temporary differences. At December 31, 2006, we had regular NOL carryforwards of approximately $49.9 million. Our future tax benefits (NOL carryforwards and other temporary differences) are subject to a valuation allowance if it is determined that it is more-likely-than-not that such asset will not be realized. In determining whether it is more-likely-than-not that we will not realize such tax asset, we consider all negative and positive evidence (with more weight given to evidence that is “objective and verifiable”) in making the determination. Prior to 2007, we had valuation allowances in place against the net deferred tax assets arising from the NOL carryforwards and other temporary differences. Prior to 2007, management considered certain negative evidence in determining that it was “more-likely-than-not” that the net deferred tax assets would not be utilized in the foreseeable future, thus a valuation allowance was required.

The negative evidence considered primarily included our history of losses, both as to amount and trend and uncertainties surrounding our ability to generate sufficient taxable income to utilize these NOL carryforwards.

As the result of improving financial results during 2007 including some unusual transactions (settlement of pending litigation and insurance recovery of business interruption claim) and our expectation of generating taxable income in the future, we determined in the third quarter of 2007 that there was sufficient objective and verifiable evidence to conclude that it was more-likely-than-not that we would be able to realize the net deferred tax assets. As a result, we reversed the valuation allowances as a benefit for income taxes and recognized deferred tax assets and deferred tax liabilities.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

14. Income Taxes (continued)

When non-qualified stock options ("NSOs") are exercised, the grantor of the options is permitted to deduct the spread between the fair market value of the stock issued and the exercise price of the NSOs as compensation expense in determining taxable income. Income tax benefits related to stock-based compensation deductions in excess of the compensation expense recorded for financial reporting purposes are not recognized in earnings as a reduction of income tax expense for financial reporting purposes. As a result, the stock-based compensation deduction recognized in our income tax return will exceed the stock-based compensation expense recognized in earnings. The excess tax benefit realized (i.e., the resulting reduction in the current tax liability) related to the excess stock-based compensation tax deduction of $0.9 million, $2.4 million and $1.7 million in 2009, 2008, and 2007, respectively, is accounted for as an increase in capital in excess of par value rather than a decrease in the provision for income taxes.

In addition, if the grantor of NSOs will not currently reduce its tax liability from the excess tax benefit deduction taken at the time of the taxable event (option exercised) because it has a NOL carryforward that is increased by the excess tax benefit, then the tax benefit should not be recognized until the deduction actually reduces current taxes payable. At December 31, 2009 and 2008, we had approximately $0.2 million and $0.6 million, respectively, in unrecognized federal and state tax benefits resulting from the exercise of NSOs. We estimate that the remaining portion of the benefit at December 31, 2009 will be realized in 2010 when our current tax liability is reduced by these items.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

14. Income Taxes (continued)

Temporary differences and carryforwards which gave rise to deferred tax assets and liabilities at December 31, 2009 and 2008 include:

	2009	2008
	(In Thousands)	
Deferred tax assets		
Amounts not deductible for tax purposes:		
Allowance for doubtful accounts	$ 747	$ 775
Asset impairment	735	683
Inventory reserves	691	1,614
Deferred compensation	3,718	3,445
Other accrued liabilities	4,204	3,260
Uncertain income tax positions	242	411
Hedging	853	3,610
Other	681	452
Capitalization of certain costs as inventory for tax purposes	1,152	1,123
Net operating loss carryforwards	644	865
State tax credits	523	392
Total deferred tax assets	14,190	16,630
Less valuation allowance on deferred tax assets	(358)	(268)
Net deferred tax assets	$ 13,832	$ 16,362
Deferred tax liabilities		
Accelerated depreciation used for tax purposes	$ 16,488	$ 9,860
Excess of book gain over tax gain resulting from sale of assets	356	340
Prepaid and other insurance reserves	1,690	-
Debt purchased at a discount	713	-
Investment in unconsolidated affiliate	1,033	1,199
Total deferred tax liabilities	$ 20,280	$ 11,399
Net deferred tax assets (liabilities)	$ (6,448)	$ 4,963
Consolidated balance sheet classification:		
Net current deferred tax assets	$ 5,527	$ 11,417
Net non-current deferred tax liabilities	(11,975)	(6,454)
Net deferred tax assets (liabilities)	$ (6,448)	$ 4,963
Net deferred tax assets (liabilities) by tax jurisdiction:		
Federal	$ (6,525)	$ 3,609
State	77	1,354
Net deferred tax assets (liabilities)	$ (6,448)	$ 4,963

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

14. Income Taxes (continued)

All of our income before taxes relates to domestic operations. Detailed below are the differences between the amount of the provision for income taxes and the amount which would result from the application of the federal statutory rate to "Income from continuing operations before provision for income taxes" for the year ended December 31:

	2009	2008	2007
		(In Thousands)	
Provisions for income taxes at federal statutory rate	$ 12,906	$ 19,363	$ 17,176
Federal credits	(211)	-	-
State current and deferred income taxes	1,832	2,213	1,939
Provision (benefit) for uncertain tax positions	(87)	(74)	1,047
Other permanent differences	299	327	451
Domestic production activities deduction	(282)	(820)	-
Effect of change to prior year deferred items (A)	-	(1,827)	-
Changes in the valuation allowance (A)	90	268	(18,476)
Effect of tax return to tax provision reconciliation	676	-	-
State tax credits	(108)	(392)	-
Other	(91)	(282)	403
Provisions for income taxes	$ 15,024	$ 18,776	$ 2,540

(A) During 2008, we performed a detailed analysis of all our deferred tax assets and liabilities and determined that our deferred tax assets were understated by approximately $1,827,000. As a part of our analysis, we reviewed the realizability of these deferred tax assets and determined that a valuation allowance of approximately $268,000 was required. Accordingly, the addition of the deferred tax assets and the associated valuation allowance resulted in a tax benefit of $1,559,000 in our income tax provision for 2008.

As of December 31, 2006, we had $300,000 accrued for an uncertain tax position related to state income taxes. As the result of new accounting principles becoming effective January 1, 2007, we recognized a $120,000 increase in the liability for uncertain tax positions related to state income taxes, which was accounted for as an increase to the January 1, 2007 accumulated deficit balance. In 2007, we commissioned a nexus study by an independent public accounting firm to determine if we and our subsidiaries had any activities that would create nexus and to calculate the potential additional state income tax liability. As a result of this nexus study, we recognized additional current state income tax expense in 2007, which was partially offset by a deferred tax benefit from additional state NOL carryforwards.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

14. Income Taxes (continued)

During 2008, we entered into multiple voluntary disclosure agreements with various states and resolved many of our outstanding state tax liabilities for payments of approximately $606,000. The settlement of many of these liabilities was for less than the amounts previously estimated and accrued. As a result, we reduced the uncertain tax position liability and state tax provision by $504,000. Additionally during 2008, we evaluated if we and our subsidiaries had any new nexus creating activities in any state taxing jurisdictions that had not previously been considered. As a result, we recognized additional state income tax expense of $391,000 in 2008.

During 2009, we continued to negotiate voluntary disclosure agreements with various states and resolved some of our outstanding state tax liabilities for payments of approximately $65,000. We evaluated if we and our subsidiaries had any new nexus creating activities in any state taxing jurisdiction that had not previously been considered and if all prior identifications of nexus creating activities were still warranted. As a result, we reduced our state income tax expense by $225,000 in 2009.

A reconciliation of the beginning and ending amount of unrecognized tax benefits (uncertain tax position liability) is as follows:

	2009	2008	2007
		(In Thousands)	
Balance at beginning of year	$ 898	$ 1,617	$ 420
Additions based on tax positions related to the current year	48	-	192
Additions based on tax positions of prior years	82	391	1,031
Reductions for tax positions of prior years	(355)	(504)	(26)
Settlements	(65)	(606)	-
Balance at end of year	$ 608	$ 898	$ 1,617

If the tax benefit of these uncertain tax positions were recognized in the financial statements, the tax benefit would decrease the annual effective tax rate by reducing the total state tax provision by approximately $400,000, $300,000 and $700,000, net of federal expense, in 2009, 2008, and 2007, respectively.

During 2009, 2008, and 2007, we recognized $150,000, $181,000 and $253,000, respectively, in interest and penalties associated with unrecognized tax benefits. We had approximately $150,000 and $288,000 accrued for interest and penalties at December 31, 2009 and 2008, respectively.

We plan to continue to negotiate voluntary disclosure agreements and file prior year tax returns with various taxing authorities in 2010. Therefore, we anticipate that the total amount of unrecognized tax benefits will decrease by approximately $20,000 by December 31, 2010 as a result of state tax payments made as part of the voluntary disclosure agreement process or other resolutions.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

14. Income Taxes (continued)

We and certain of our subsidiaries file income tax returns in the U.S. federal jurisdiction and various state jurisdictions. The federal tax returns for 1997 through 2005 remain subject to examination for the purpose of determining the amount of remaining tax NOL and other carryforwards. With few exceptions, the 2006-2008 years remain open for all purposes of examination by the IRS and other major tax jurisdictions.

15. Commitments and Contingencies

Capital and Operating Leases - We and our subsidiaries lease certain property, plant and equipment under capital leases and non-cancelable operating leases. Leased assets meeting capital lease criteria have been capitalized and the present value of the related lease payments is included in long-term debt. Future minimum payments on leases with initial or remaining terms of one year or more at December 31, 2009, are as follows:

	Capital Leases	Operating Leases	Total
		(In Thousands)	
2010	$ 631	$ 4,606	$ 5,237
2011	527	3,949	4,476
2012	413	3,374	3,787
2013	349	2,446	2,795
2014	35	2,150	2,185
Thereafter	-	934	934
Total minimum lease payments	1,955	$ 17,459	$ 19,414
Less amounts representing interest	213		
Present value of minimum lease payments included in long-term debt	$ 1,742		

Expenses associated with our operating lease agreements, including month-to-month leases, was $8,584,000 in 2009, $13,801,000 in 2008 and $13,793,000 in 2007. Renewal options are available under certain of the lease agreements for various periods at approximately the existing annual rental amounts.

Purchase and Sales Commitments - We have the following significant purchase and sales commitments.

Bayer Agreement - During October 2008, subsidiaries within our Chemical Business, EDN and EDC, entered into a new Nitric Acid Supply, Operating and Maintenance Agreement (the “Bayer Agreement”) with Bayer replacing a previous agreement between EDN, EDC and Bayer entered into during 1997. EDN operates Bayer’s nitric acid plant (the “Baytown Facility”) located within Bayer’s chemical manufacturing complex. The Bayer Agreement became effective on June 24, 2009, and is for an initial term of five years, with certain renewal options.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

15. Commitments and Contingencies (continued)

Under the terms of the Bayer Agreement, Bayer purchases from EDN all of Bayer's requirements for nitric acid for use in Bayer's chemical manufacturing complex located in Baytown, Texas at a price covering EDN's costs plus a profit, with certain performance obligations on EDN's part. EDN purchases from Bayer ammonia, certain utilities, chemical additives and services as required for production of nitric acid at the Baytown Facility.

On June 23, 2009, Bayer purchased all of the nitric acid production assets comprising the Baytown Facility from a third party, except certain assets that are owned by EDN for use in the production process. EDN continues to be responsible for the maintenance and operation of the Baytown Facility in accordance with the terms of the Bayer Agreement.

If there is a change in control of EDN, Bayer has the right to terminate the Bayer Agreement upon payment of certain fees to EDN.

Anhydrous ammonia purchase agreement - Effective January 1, 2009, under an agreement with its principal supplier of anhydrous ammonia, Koch Nitrogen Company ("Koch"), EDC purchases a majority of its anhydrous ammonia requirements for its chemical production facility located in El Dorado, Arkansas (the "El Dorado Facility") through at least December 2010. See discussion concerning an extension of this agreement in Note 24 - Subsequent Events.

Ammonium nitrate supply agreement - In 2001, EDC entered into a long-term cost-plus industrial grade ammonium nitrate supply agreement ("Supply Agreement") with Orica USA, Inc. ("Orica"). Under the Supply Agreement, as amended, EDC will supply from the El Dorado Facility approximately 210,000 tons of industrial grade ammonium nitrate per year, which is approximately 81% of the plant's manufacturing capacity for that product, for a term through June 2011. See discussion concerning a new supply agreement in Note 24 - Subsequent Events.

UAN supply agreement - In 2009, one of our subsidiaries, Pryor Chemical Company ("PCC"), entered into a contract with Koch under which Koch agreed to purchase and distribute substantially all of the UAN produced at the Pryor Facility through June 30, 2014, but Koch has an option to terminate the agreement after November 1, 2010. Pursuant to the terms of the contract, the UAN will be priced at market prices less a distribution fee and certain shipping costs. As of December 31, 2009, the Pryor Facility was still in the process of being activated. As a result, sales of UAN by PCC did not occur in 2009 but are expected to commence in 2010.

Other purchase and sales commitments - See Note 16 - Derivatives, Hedges and Financial Instruments for our commitments relating to derivative contracts at December 31, 2009. In addition, we also had standby letters of credit outstanding of approximately $1.4 million at December 31, 2009. We also had deposits from customers of $0.6 million for forward sales commitments including $0.3 million relating to our Climate Control Business and $0.3 million relating to our Chemical Business at December 31, 2009.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

15. Commitments and Contingencies (continued)

Performance and Payment Bonds – We are contingently liable to sureties in respect of certain insurance bonds issued by the sureties in connection with certain contracts entered into by our subsidiaries in the normal course of business. These insurance bonds primarily represent guarantees of future performance of our subsidiaries. As of December 31, 2009, we have agreed to indemnify the sureties for payments, up to $22.9 million, made by them in respect of such bonds. Approximately $21.7 million of these insurances bonds expire in 2010 while the remaining $1.2 million expire in 2011.

Universal Shelf Registration Statement - During 2009, our board of directors granted management the authority to file a universal shelf registration statement on Form S-3 with the Securities and Exchange Commission (“SEC”). The shelf registration statement and related amendments have been filed and declared effective by the SEC.

Although we do not have any current plans to offer or sell any securities under the shelf registration statement, the shelf registration statement give us the ability to offer and sell up to $200 million of our securities consisting of common stock, preferred stock, debt (senior and subordinated), warrants, units or a combination thereof. We may offer and sell such securities from time to time and through one or more methods of distribution, subject to market conditions and our capital needs. The terms of any offering under the shelf registration statement would be established at the time of such offering and will be described in a prospectus supplement filed with the SEC prior to completion of the offering.

Employment and Severance Agreements - We have an employment agreement and severance agreements with several of our officers. The agreements, as amended, provide for annual base salaries, bonuses and other benefits commonly found in such agreements. In the event of termination of employment due to a change in control (as defined in the agreements), the agreements provide for payments aggregating $10.8 million at December 31, 2009.

Legal Matters - Following is a summary of certain legal matters involving the Company.

A. Environmental Matters

Our operations are subject to numerous environmental laws (“Environmental Laws”) and to other federal, state and local laws regarding health and safety matters (“Health Laws”). In particular, the manufacture and distribution of chemical products are activities which entail environmental risks and impose obligations under the Environmental Laws and the Health Laws, many of which provide for certain performance obligations, substantial fines and criminal sanctions for violations. There can be no assurance that material costs or liabilities will not be incurred by us in complying with such laws or in paying fines or penalties for violation of such laws. The Environmental Laws and Health Laws and enforcement policies thereunder relating to our Chemical Business have in the past resulted, and could in the future result, in compliance expenses, cleanup costs, penalties or other liabilities relating to the handling, manufacture, use, emission, discharge or disposal of effluents at or from our facilities or the use or disposal of

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

15. Commitments and Contingencies (continued)

certain of its chemical products. Historically, significant expenditures have been incurred by subsidiaries within our Chemical Business in order to comply with the Environmental Laws and Health Laws and are reasonably expected to be incurred in the future.

We will recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. We are obligated to monitor certain discharge water outlets at our Chemical Business facilities should we discontinue the operations of a facility. We also have certain facilities in our Chemical Business that contain asbestos insulation around certain piping and heated surfaces, which we plan to maintain or replace, as needed, with non-asbestos insulation through our standard repair and maintenance activities to prevent deterioration. Since we currently have no plans to discontinue the use of these facilities and the remaining life of the facilities is indeterminable, an asset retirement liability has not been recognized. Currently, there is insufficient information to estimate the fair value of the asset retirement obligations. However, we will continue to review these obligations and record a liability when a reasonable estimate of the fair value can be made.

1. Discharge Water Matters

The El Dorado Facility owned by EDC generates process wastewater, which includes cooling tower and boiler blowdowns, contact storm water and miscellaneous spills and leaks from process equipment. The process water discharge, storm-water runoff and miscellaneous spills and leaks are governed by a state National Pollutant Discharge Elimination System ("NPDES") water discharge permit issued by the Arkansas Department of Environmental Quality ("ADEQ"), which permit is to be renewed every five years. The ADEQ issued to EDC a NPDES water discharge permit in 2004, and the El Dorado Facility had until June 1, 2007 to meet the compliance deadline for the more restrictive limits under the 2004 NPDES permit. In order to meet the El Dorado Facility's June 2007 limits, the El Dorado Facility has significantly reduced the contaminant levels of its wastewater.

The El Dorado Facility has demonstrated its ability to comply with the more restrictive permit limits, and believes that if it is required to meet the more restrictive dissolved minerals permit levels, it will be able to do so. The El Dorado Facility is currently having discussions with the ADEQ to modify and reduce the permit levels as to dissolved minerals, but, although the rule is a state rule, any revisions must also be approved by the United States Environmental Protection Agency ("EPA") before it can become effective. Once the rule change is complete, the permit limits can be modified to incorporate achievable dissolved minerals permit levels. The ADEQ and the El Dorado Facility also entered into a Consent Administrative Order ("CAO") which authorized the El Dorado Facility to continue operating through December 31, 2009 without incurring permit violations pending the modification of the permit to implement the revised rule.

In March 2009, the EPA notified the ADEQ that it disapproved the dissolved mineral rulemaking due to insufficient documentation. Representatives of EDC, ADEQ and the EPA have met to determine what additional information was required by the EPA. During January 2010, EDC

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

15. Commitments and Contingencies (continued)

received an Administrative Order from the EPA noting certain violations of the permit and requesting EDC to demonstrate compliance with the permit or provide a plan and schedule for returning to compliance. EDC has provided the EPA a response which states that the El Dorado Facility is now in compliance with the permit that the El Dorado Facility expects to maintain compliance and that all but fifteen of the alleged violations were resolved through the CAO with the ADEQ. During the meeting with the EPA prior to the issuance of the Administrative Order, the EPA advised EDC that its primary objective is to bring the El Dorado Facility into compliance with the permit requirements, but reserved the right to access penalties for past and continuing violations of the permit. As a result, it is unknown whether the EPA might elect to pursue civil penalties against EDC. Therefore, no liability has been established at December 31, 2009.

In addition, EDC has entered into a CAO that recognizes the presence of nitrate contamination in the shallow groundwater at the El Dorado Facility. EDC is addressing the shallow groundwater contamination. The CAO requires the El Dorado Facility to continue semi-annual groundwater monitoring, to continue operation of a groundwater recovery system and to submit a human health and ecological risk assessment to the ADEQ. The final remedy for shallow groundwater contamination, should any remediation be required, will be selected pursuant to the new CAO and based upon the risk assessment. The cost of any additional remediation that may be required will be determined based on the results of the investigation and risk assessment and cannot currently be reasonably estimated. Therefore, no liability has been established at December 31, 2009.

2. Air Matters

The EPA has sent information requests to most, if not all, of the nitric acid plants in the United States, including to us relating to our El Dorado, Cherokee and Baytown Facilities, requesting information under Section 114 of the Clean Air Act as to construction and modification activities at each of these facilities over a period of years to enable the EPA to determine whether these facilities are in compliance with certain provisions of the Clean Air Act. In connection with a review by our Chemical Business of these facilities in obtaining information for the EPA pursuant to the EPA's request, our Chemical Business management believes, subject to further review, investigation and discussion with the EPA, that certain changes to its production equipment may be needed in order to comply with the requirements of the Clean Air Act. If changes to the production equipment at these facilities are required in order to bring this equipment into compliance with the Clean Air Act, the amount of capital expenditures necessary in order to bring the equipment into compliance is unknown at this time but could be substantial.

Further, if it is determined that the equipment at any of our El Dorado, Cherokee and/or Baytown Facilities have not met the requirements of the Clean Air Act, our Chemical Business could be subject to penalties in an amount not to exceed $27,500 per day as to each facility not in compliance and require such facility to be retrofitted with the "best available control technology." We believe this technology is already employed at the Baytown Facility. Currently,

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

15. Commitments and Contingencies (continued)

we believe that certain facilities within our Chemical Business may be required to pay certain penalties and may be required to make certain capital improvements to certain emission equipment as a result of the above described matter; however, at this time we are unable to determine the amount of any penalties that may be assessed, or the cost of additional capital improvements that may be required, by the EPA. Therefore no liability has been established at December 31, 2009.

3. Other Environmental Matters

In December 2002, two of our subsidiaries within our Chemical Business, sold substantially all of their operating assets relating to a Kansas chemical facility ("Hallowell Facility") but retained ownership of the real property. At December 31, 2002, even though we continued to own the real property, we did not assess our continuing involvement with our former Hallowell Facility to be significant and therefore accounted for the sale as discontinued operations. In connection with this sale, our subsidiary leased the real property to the buyer under a triple net long-term lease agreement. However, our subsidiary retained the obligation to be responsible for, and perform the activities under, a previously executed consent order to investigate the surface and subsurface contamination at the real property and a corrective action strategy based on the investigation. In addition, certain of our subsidiaries agreed to indemnify the buyer of such assets for these environmental matters. The successor ("Chevron") of a prior owner of the Hallowell Facility is a participating responsible party and has agreed, within certain limitations, to pay and has been paying one-half of the costs relating to this matter as approved by the Kansas Department of Environmental Quality, subject to reallocation.

Based on additional modeling of the site, our subsidiary and Chevron are pursuing a course with the state of Kansas of long-term surface and groundwater monitoring to track the natural decline in contamination, instead of the soil excavation proposed previously. Our subsidiary and Chevron submitted its final report on the groundwater monitoring and an addendum to the Mitigation Work Plan to the state of Kansas. The data from the monitoring program is being evaluated by the state of Kansas and the potential costs of additional monitoring or required remediation, if any, is unknown.

At December 31, 2009, our estimated allocable portion of the total estimated liability (which is included in current and noncurrent accrued and other liabilities) in connection with this remediation matter is approximately $305,000. This amount is not discounted to its present value. It is reasonably possible that a change in the estimate of our liability will occur in the near term.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

15. Commitments and Contingencies (continued)

B. Other Pending, Threatened or Settled Litigation

1. Climate Control Business

Wetherall v. Climate Master was a proposed class action filed in the Illinois state district court in September 2007 alleging that certain evaporator coils sold by one of our subsidiaries in the Climate Control Business, Climate Master, Inc. ("Climate Master"), in the state of Illinois from 1990 to approximately 2003 were defective. Prior to the hearing on class certification, the trial court granted Climate Master's motion for summary judgment and entered judgment in favor of Climate Master and against the plaintiffs based upon the statute of limitations and further denied class certification as moot because there were no other class representatives. Prior to the appeal deadline, a settlement agreement was entered into between the plaintiffs and Climate Master whereby the plaintiffs waived any right to appeal the judgment in favor of Climate Master for an insignificant amount, which consideration has been paid by Climate Master.

2. Other

The Jayhawk Group

In November 2006, we entered into an agreement with Jayhawk Capital Management, LLC, Jayhawk Investments, L.P., Jayhawk Institutional Partners, L.P. and Kent McCarthy, the manager and sole member of Jayhawk Capital, (collectively, the "Jayhawk Group"), in which the Jayhawk Group agreed, among other things, that if we undertook, in our sole discretion, within one year from the date of agreement a tender offer for our Series 2 Preferred or to issue our common stock for a portion of our Series 2 Preferred pursuant to a private exchange, that it would tender or exchange an aggregate of no more than 180,450 shares of the 340,900 shares of the Series 2 Preferred beneficially owned by the Jayhawk Group, subject to, among other things, the entities owned and controlled by Jack E. Golsen, our Chairman and Chief Executive Officer ("Golsen"), and his immediate family, that beneficially own Series 2 Preferred only being able to exchange or tender approximately the same percentage of shares of Series 2 Preferred beneficially owned by them as the Jayhawk Group is able to tender or exchange under the terms of the agreement. In addition, under the agreement, the Jayhawk Group agreed to vote its shares of our common stock and Series 2 Preferred "for" an amendment to the Certificate of Designation covering the Series 2 Preferred to allow us:

- for a period of five years from the completion of an exchange or tender to repurchase, redeem or otherwise acquire shares of our common stock, without approval of the outstanding Series 2 Preferred irrespective that dividends are accrued and unpaid with respect to the Series 2 Preferred; or
- to provide that holders of Series 2 Preferred may not elect two directors to our board of directors when dividends are unpaid on the Series 2 Preferred if less than 140,000 shares of Series 2 Preferred remain outstanding.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

15. Commitments and Contingencies (continued)

During 2007, we made a tender offer for our outstanding Series 2 Preferred at the rate of 7.4 shares of our common stock for each share of Series 2 Preferred so tendered. In July 2007, we redeemed the balance of our outstanding shares of Series 2 Preferred. Pursuant to its terms, the Series 2 Preferred was convertible into 4.329 shares of our common stock for each share of Series 2 Preferred. As a result of the redemption, the Jayhawk Group converted the balance of its Series 2 Preferred pursuant to the terms of the Series 2 Preferred in lieu of having its shares redeemed.

During November 2008, the Jayhawk Group filed suit against us and Golsen in a lawsuit styled Jayhawk Capital Management, LLC, et al. v. LSB Industries, Inc., et al., in the United States District Court for the District of Kansas at Kansas City. During March 2009, the Jayhawk Group amended its complaint alleging that the Jayhawk Group should have been able to tender all of its Series 2 Preferred pursuant to the tender offer, notwithstanding the above-described agreement, based on the following claims against us and Golsen:

- fraudulent inducement and fraud,
- violation of 10(b) of the Exchange Act and Rule 10b-5,
- violation of 17-12A501 of the Kansas Uniform Securities Act, and
- breach of contract.

The Jayhawk Group seeks damages in an unspecified amount based on the additional number of common shares it allegedly would have received on conversion of all of its Series 2 Preferred through the February 2007 tender offer, plus punitive damages. In addition, the amended complaint seeks damages of approximately $4,000,000 for accrued and unpaid dividends it purports are owed as a result of Jayhawk's July 2007 conversion of its remaining shares of Series 2 Preferred. In May 2008, the General Counsel for the Jayhawk Group offered to settle its claims against us and Golsen in return for a payment of $100,000, representing the approximate legal fees it had incurred investigating the claims at that time. Through counsel, we verbally agreed to the settlement offer and confirmed the agreement by e-mail. Afterward, the Jayhawk Group's General Counsel purported to withdraw the settlement offer, and asserted that Jayhawk is not bound by any settlement agreement. We contend that the settlement agreement is binding on the Jayhawk Group. Both Golsen and we have filed motions to dismiss the plaintiff's complaint in the federal court, and such motions to dismiss are pending. We intend to contest the lawsuit vigorously, and will assert that Jayhawk is bound by an agreement to settle the claims for $100,000. Our insurer, Chartis, has agreed to defend this lawsuit on our behalf and on behalf of Golsen and to indemnify under a reservation of rights to deny liability under certain conditions. We have incurred expenses associated with this matter up to our insurance deductible of $250,000. We believe our insurance coverage is adequate to cover any currently foreseeable losses associated with the Jayhawk claims. As a result, no liability remains outstanding relating to this matter as of December 31, 2009.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

15. Commitments and Contingencies (continued)

Other Claims and Legal Actions

We are also involved in various other claims and legal actions including claims for damages resulting from water leaks and other product liability occurrences. Most of the product liability claims are covered by our general liability insurance which generally includes a deductible of $250,000 per claim. For any claims or legal actions that we have assessed the likelihood of our liability as probable, we have recognized our estimated liability up to the applicable deductible. In the opinion of management, after consultation with legal counsel, if those claims which we have not recognized were determined adversely to us, it would not have a material effect on our business, financial condition or results of operations.

16. Derivatives, Hedges and Financial Instruments

We have three types of contracts that are accounted for on a fair value basis, which are interest rate contracts, commodities futures/forward contracts ("commodities contracts") and foreign exchange contracts as discussed below. All of these contracts are used as economic hedges for risk management purposes but are not designated as hedging instruments. The valuation of these contracts was determined based on quoted market prices or, in instances where market quotes are not available, other valuation techniques or models used to estimate fair values. The valuations of contracts classified as Level 1 are based on quoted prices in active markets for identical contracts. The valuations of contracts classified as Level 2 are based on quoted prices for similar contracts and valuation inputs other than quoted prices that are observable for these contracts. At December 31, 2008, the valuations of contracts classified as Level 3 were based on the average ask/bid prices obtained from a broker relating to a low volume market.

Interest Rate Contracts

As part of our interest rate risk management, we periodically purchase and/or enter into various interest rate contracts. In March 2005, we purchased two interest rate cap contracts for a cost of $590,000, which matured in March 2009. In April 2007, we purchased two interest rate cap contracts for a cost of $621,000, which set a maximum three-month LIBOR base rate of 5.35% on $50 million. In April 2008, we exchanged the two interest rate cap contracts purchased in 2007 for an interest rate cap contract ("2008 Interest Rate Cap Contract"), which sets a maximum three-month LIBOR base rate of 4.56% on $25 million. The cost basis of the 2008 Interest Rate Cap Contract was $239,000 based on the estimated fair value of the two contracts surrendered (which was also the carrying value at the time of the exchange). In April 2008, we also entered into an interest rate swap at no cost, which sets a fixed three-month LIBOR rate of 3.24% on $25 million and matures in April 2012. In September 2008, we exchanged the 2008 Interest Rate Cap Contract for an interest rate swap, which sets a fixed three-month LIBOR rate of 3.595% on $25 million and matures in April 2012. The cost basis of the new interest rate swap is $354,000 based on the estimated fair value of the 2008 Interest Rate Cap Contract surrendered (which was also the carrying value at the time of the exchange).

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

16. Derivatives, Hedges and Financial Instruments (continued)

These contracts are free-standing derivatives and are accounted for on a mark-to-market basis. For 2009, 2008, and 2007, we recognized losses of $729,000, $2,871,000 and $355,000, respectively. In addition, the cash flows relating to the purchase of interest rate contracts are included in cash flows from continuing investing activities. Also the cash flows associated with the interest rate swap payments are included in cash flows from continuing operating activities.

Commodities Contracts

Raw materials for use in our manufacturing processes include copper used by our Climate Control Business and anhydrous ammonia and natural gas used by our Chemical Business. As part of our raw material price risk management, we periodically enter into futures/forward contracts for these materials, which contracts are generally accounted for on a mark-to-market basis. At December 31, 2009, our futures/forward copper contracts were for 750,000 pounds of copper through May 2010 at a weighted-average cost of $3.19 per pound. In addition, we had contractual rights under natural gas call contracts for approximately 150,000 MMBtu of natural gas through February 2010 at a weighted-average price of $6.00 per MMBtu. For 2009, 2008 and 2007, we recognized losses of $1,312,000, $7,717,000 and $1,317,000, respectively, on such contracts. In addition, the cash flows relating to these contracts are included in cash flows from continuing operating activities.

Foreign Exchange Contracts

One of our business operations purchases industrial machinery and related components from vendors outside of the United States. As part of our foreign currency risk management, we periodically enter into foreign exchange contracts, which set the U.S. Dollar/Euro exchange rates. These contracts are free-standing derivatives and are accounted for on a mark-to-market basis. At December 31, 2009, our foreign exchange contracts were for the receipt of approximately 336,000 Euros through April 2010 at a weighted-average contract exchange rate of 1.435. For 2009 and 2008, we recognized losses of $32,000 and $187,000, respectively, on such contracts (none in 2007). In addition, the cash flows relating to these contracts are included in cash flows from continuing operating activities.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

16. Derivatives, Hedges and Financial Instruments (continued)

The following details our assets and liabilities that are measured at fair value on a recurring basis at December 31, 2009 and 2008:

Description	Total Fair Value at December 31, 2009	Fair Value Measurements at December 31, 2009 Using: Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Fair Value at December 31, 2008
	(In Thousands)				
Assets - Supplies, prepaid items and other:					
Commodities contracts	$ 150	$ 121	$ 29	$ -	$ -
Foreign exchange contracts	-	-	-	-	35
Total	$ 150	$ 121	$ 29	$ -	$ 35
Liabilities - Current and noncurrent accrued and other liabilities:					
Commodities contracts	$ -	$ -	$ -	$ -	$ 5,910
Interest rate contracts	1,929	-	1,929	-	2,437
Total	$ 1,929	$ -	$ 1,929	$ -	$ 8,347

The following is a reconciliation of the beginning and ending balances for liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3), which related to commodities contracts:

	2009	2008
	(In Thousands)	
Beginning balance	$ (1,388)	$ -
Total realized and unrealized gain (loss) included in earnings	493	(1,388)
Purchases, issuances, and settlements	895	-
Transfers in and/or out of Level 3	-	-
Ending balance	$ -	$ (1,388)

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

16. Derivatives, Hedges and Financial Instruments (continued)

Realized and unrealized gains (losses) included in earnings and the income statement classifications are as follows:

	2009	2008
	(In Thousands)	
Total gains (losses) included in earnings:		
Cost of sales - Commodities contracts	$ (1,312)	$ (7,717)
Cost of sales - Foreign exchange contracts	(32)	(187)
Interest expense - Interest rate contracts	(729)	(2,871)
	$ (2,073)	$ (10,775)
Change in unrealized gains and losses relating to contracts still held at year end:		
Cost of sales - Commodities contracts	$ 138	$ (5,910)
Cost of sales - Foreign exchange contracts	-	35
Interest expense - Interest rate contracts	508	(2,825)
	$ 646	$ (8,700)

The following discussion of fair values is not indicative of the overall fair value of our assets and liabilities since it does not include all assets, including intangibles.

Our long-term debt agreements are the only financial instruments with fair values significantly different from their carrying amounts. At December 31, 2009 and 2008, the fair value for variable debt, excluding the Secured Term Loan, was believed to approximate their carrying value. At December 31, 2009 and 2008, the estimated fair value of the Secured Term Loan is based on defined LIBOR rates plus 7% and 10%, respectively, utilizing information obtained from the lender. The fair values of fixed rate borrowings, other than the 2007 Debentures, are estimated using a discounted cash flow analysis that applies interest rates currently being offered on borrowings of similar amounts and terms to those currently outstanding while also taking into consideration our current credit worthiness. At December 31, 2009 and 2008, the estimated fair value of the 2007 Debentures is based on quoted prices obtained from a broker for these debentures. The estimated fair value and carrying value of our long-term debt are as follows:

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

16. Derivatives, Hedges and Financial Instruments (continued)

	December 31, 2009		December 31, 2008	
	Estimated Fair Value	Carrying Value	Estimated Fair Value	Carrying Value
	(In Thousands)			
Variable Rate:				
Secured Term Loan	$27,640	$50,000	$20,939	$50,000
Working Capital Revolver Loan	-	-	-	-
Other debt	2,553	2,553	8	8
Fixed Rate:				
5.5% Convertible Senior Subordinated Notes	29,106	29,400	27,338	40,500
Other bank debt and equipment financing	20,231	19,848	14,949	14,652
	$79,530	$101,801	$63,234	$105,160

Other

In 1997, we entered into an interest rate forward agreement to effectively fix the interest rate of a long-term lease commitment (not for trading purposes). In 1999, we executed a long-term lease agreement (initial lease term of ten years) and terminated the forward agreement at a net cost of $2.8 million. We historically accounted for this cash flow hedge under the deferral method (as an adjustment of the initial term lease rentals). As the result of accounting principles becoming effective in 2001, the remaining deferred cost amount was reclassified from other assets to accumulated other comprehensive loss and was being amortized to operations over the term of the lease arrangement, which expired in 2009. At December 31, 2008, accumulated other comprehensive loss consisted of the remaining deferred cost of $120,000 (none at December 31, 2009). The amount amortized to operations was $120,000, $291,000 and $290,000 for 2009, 2008, and 2007, respectively. The associated income tax benefits were minimal in 2009 and 2008 and there were no income tax benefits allocated to these expenses in 2007.

17. Stockholders' Equity

Approval of Stock Incentive Plan in 2008 - During the second quarter of 2008, our board of directors adopted our 2008 Incentive Stock Plan (the "2008 Plan"), which plan was approved by our shareholders at our annual meeting of shareholders held on June 5, 2008. The number of shares of our common stock available for issuance under the 2008 Plan is 1,000,000 shares, subject to adjustment. Under the 2008 Plan, awards may be made to any employee, officer or director of the Company and its affiliated companies. An award may also be granted to any consultant, agent, advisor or independent contractor for bona fide services rendered to the Company or any affiliate (as defined in the 2008 Plan), subject to certain conditions. The 2008 Plan will be administered by the compensation and stock option committee (the "Committee") of our board of directors.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

17. Stockholders' Equity (continued)

Our board of directors or the Committee may amend the 2008 Plan, except that if any applicable statute, rule or regulation requires shareholder approval with respect to any amendment of the 2008 Plan, then to the extent so required, shareholder approval will be obtained. Shareholder approval will also be obtained for any amendment that would increase the number of shares stated as available for issuance under the 2008 Plan. Unless sooner terminated by our board of directors, the 2008 Plan expires on June 5, 2018.

The following may be granted by the Committee under the 2008 Plan:

Stock Options - The Committee may grant either incentive stock options or non-qualified stock options. The Committee sets option exercise prices and terms, except that the exercise price of a stock option may be no less than 100% of the fair market value, as defined in the 2008 Plan, of the shares on the date of grant. At the time of grant, the Committee will have sole discretion in determining when stock options are exercisable and when they expire, except that the term of a stock option cannot exceed 10 years.

Stock Appreciation Rights ("SARs") - The Committee may grant SARs as a right in tandem with the number of shares underlying stock options granted under the 2008 Plan or on a stand-alone basis. SARs are the right to receive payment per share of the SAR exercised in stock or in cash equal to the excess of the share's fair market value, as defined in the 2008 Plan, on the date of exercise over its fair market value on the date the SAR was granted. Exercise of an SAR issued in tandem with stock options will result in the reduction of the number of shares underlying the related stock option to the extent of the SAR exercise.

Stock Awards, Restricted Stock, Restricted Stock Units, and Other Awards - The Committee may grant awards of restricted stock, restricted stock units, and other stock and cash-based awards, which may include the payment of stock in lieu of cash (including cash payable under other incentive or bonus programs) or the payment of cash (which may or may not be based on the price of our common stock).

Stock-Based Compensation - During 2009, the Committee did not grant any awards under the 2008 Plan. During 2008, the Committee approved the grants under the 2008 Plan of 372,000 shares of qualified stock options (the "2008 Qualified Options") to certain employees and our board of directors (with each recipient abstaining as to himself) approved the grants of 45,000 shares of non-qualified stock options ("2008 Non-Qualified Options") to our outside directors. The exercise price of the 2008 Qualified and Non-Qualified Options was equal to the market value of our common stock at the date of grant. The 2008 Qualified and Non-Qualified Options vest at the end of each one-year period at the rate of 16.5% per year for the first five years and the remaining unvested options will vest at the end of the sixth year. Pursuant to the terms of the 2008 Non-Qualified Options, if a termination event occurs, as defined, the non-vested 2008 Non-Qualified Options will become fully vested and exercisable for a period of one year from the date of the termination event. Excluding the non-qualified stock options relating to a termination event, the 2008 Qualified and Non-Qualified Options expire in 2018. The fair value for the

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

17. Stockholders' Equity (continued)

2008 Qualified and Non-Qualified Options was estimated, using an option pricing model, as of the date of the grant, which date was also the service inception date.

On June 19, 2006, the Committee granted 450,000 shares of non-qualified stock options (the "2006 Options") to certain Climate Control Business employees, which were subject to shareholders' approval. The exercise price of the 2006 Options is $8.01 per share, which is based on the market value of our common stock at the date the board of directors granted the shares (June 19, 2006). The 2006 Options vest over a ten-year period at a rate of 10% per year and expire on September 16, 2016 with certain restrictions. The fair value for the 2006 Options was estimated, using an option pricing model, as of the date we received shareholders' approval which occurred during our 2007 annual shareholders' meeting on June 14, 2007. For accounting purposes, the grant date and service inception date is June 14, 2007.

The fair values for the 2008 Qualified and Non-Qualified Options and the 2006 Options were estimated using a Black-Scholes-Merton option pricing model with the following assumptions:

- risk-free interest rate based on an U.S. Treasury zero-coupon issue with a term approximating the estimated expected life as of the grant date;
- a dividend yield based on historical data;
- volatility factors of the expected market price of our common stock based on historical volatility of our common stock since it has been traded on the American Stock Exchange (and subsequently, the New York Stock Exchange), and;
- a weighted-average expected life of the options based on the historical exercise behavior of these employees and outside directors, if applicable.

The following table summarizes information about these granted stock options:

	2009	2008	2007
Weighted-average risk-free interest rate	N/A	2.91%	5.16%
Dividend yield	N/A	-	-
Weighted-average expected volatility	N/A	35.4%	24.7%
Weighted-average expected forfeiture rate	N/A	1.86%	0%
Weighted-average expected life (years)	N/A	5.98	5.76
Total weighted-average remaining vesting period (years)	5.60	6.64	8.46
Total fair value of options granted	N/A	$ 1,503,000	$ 6,924,000
Total stock-based compensation expense (1)	$ 1,021,000	$ 811,000	$ 421,000
Income tax benefit	$ (408,000)	$ (316,000)	$ (164,000)

(1) For 2009 and 2008, $977,000 and $803,000, respectively, is included in SG&A and $44,000, $8,000, respectively, is included in cost of sales. For 2007, the total amount is included in SG&A.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

17. Stockholders' Equity (continued)

For the 2008 Qualified and Non-Qualified Options and the 2006 Options, we will be amortizing the respective total estimated fair value (adjusted for forfeitures) through 2014 and 2016, respectively. At December 31, 2009, the total stock-based compensation expense not yet recognized is $6,145,000 relating to the non-vested stock options.

Qualified Stock Option Plans - At December 31, 2009, we have options outstanding under a 1993 Stock Option and Incentive Plan ("1993 Plan"), a 1998 Stock Option Plan ("1998 Plan") and the 2008 Plan as discussed above. The 1993 and 1998 Plans have expired, and accordingly, no additional options may be granted from these plans. Options granted prior to the expiration of these plans continue to remain valid thereafter in accordance with their terms. As discussed above, under the 2008 Plan, we are authorized to grant awards (including options) to purchase up to 1,000,000 shares of our common stock. At December 31, 2009, there are 590,000 awards available to be granted under the 2008 Plan. At December 31, 2009, there were 3,500 options outstanding related to the 1993 Plan and 61,100 options outstanding relating to the 1998 Plan, all of which were exercisable, and 364,175 options outstanding relating to the 2008 Plan, of which 59,400 were exercisable. The exercise price of the outstanding options granted under these plans was equal to the market value of our common stock at the date of grant.

The following information relates to our qualified stock option plans:

		2009	
	Shares	Weighted-Average Exercise Price	
Outstanding at beginning of year	660,100	$	6.09
Granted	-	$	-
Exercised	(224,325)	$	1.42
Cancelled, forfeited or expired	(7,000)	$	9.69
Outstanding at end of year	428,775	$	8.47
Exercisable at end of year	124,000	$	6.30

		2009		2008		2007
Weighted-average fair value of options granted during year		N/A	$	3.58		N/A
Total intrinsic value of options exercised during the year	$	3,051,000	$	3,140,000	$	1,108,000
Total fair value of options vested during the year	$	220,000	$	-	$	-

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

17. Stockholders' Equity (continued)

The following table summarizes information about qualified stock options outstanding and exercisable at December 31, 2009:

		Stock Options Outstanding		
Exercise Prices	Shares Outstanding	Weighted-Average Remaining Contractual Life in Years	Weighted-Average Exercise Price	Intrinsic Value of Shares Outstanding
$ 2.73	43,500	1.92	$ 2.73	$ 494,000
$ 5.10	21,100	5.92	$ 5.10	190,000
$ 7.86 - $ 8.17	69,000	8.92	$ 7.87	430,000
$ 9.69 - $ 9.97	295,175	8.83	$ 9.69	1,301,000
$ 2.73 - $ 9.97	428,775	8.00	$ 8.47	$ 2,415,000

		Stock Options Exercisable		
Exercise Prices	Shares Exercisable	Weighted-Average Remaining Contractual Life in Years	Weighted-Average Exercise Price	Intrinsic Value of Shares Exercisable
$ 2.73	43,500	1.92	$ 2.73	$ 494,000
$ 5.10	21,100	5.92	$ 5.10	190,000
$ 7.86 - $ 8.17	11,385	8.92	$ 7.87	71,000
$ 9.69 - $ 9.97	48,015	8.83	$ 9.69	212,000
$ 2.73 - $ 9.97	124,000	5.92	$ 6.30	$ 967,000

Non-Qualified Stock Option Plans - Our board of directors approved the grants of non-qualified stock options to our outside directors, our Chief Executive Officer, Chief Financial Officer and certain key employees, included in the tables below. The exercise prices are generally based on the market value of our common stock at the dates of grants.

In addition to the 2008 Plan as discussed above, we have an Outside Directors Stock Option Plan (the "Outside Director Plan"). The Outside Director Plan authorizes the grant of non-qualified stock options to each member of our board of directors who is not an officer or employee of the Company or its subsidiaries. The maximum number of options that may be issued under the Outside Director Plan is 400,000 of which 280,000 are available to be granted at December 31, 2009. At December 31, 2009, there are 45,000 options outstanding related to the 2008 Plan and no options outstanding related to the Outside Director Plan.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

17. Stockholders' Equity (continued)

The following information relates to our non-qualified stock option plans:

	2009 Shares	2009 Weighted-Average Exercise Price
Outstanding at beginning of year	627,500	$ 6.36
Granted	-	$ -
Exercised	(185,000)	$ 3.08
Surrendered, forfeited, or expired	-	$ -
Outstanding at end of year	442,500	$ 7.73
Exercisable at end of year	89,925	$ 6.68

	2009	2008	2007
Weighted-average fair value of options granted during year	N/A	$ 3.80	$ 15.39
Total intrinsic value of options exercised during the year	$ 2,201,000	$ 4,357,000	$ 10,042,000
Total fair value of options vested during the year	$ 721,000	$ 692,000	$ 692,000

The following tables summarize information about non-qualified stock options outstanding and exercisable at December 31, 2009:

Stock Options Outstanding

Exercise Prices	Shares Outstanding	Weighted-Average Remaining Contractual Life in Years	Weighted-Average Exercise Price	Intrinsic Value of Shares Outstanding
$ 2.73	22,500	1.92	$ 2.73	$ 256,000
$ 7.86	45,000	8.92	$ 7.86	281,000
$ 8.01	375,000	6.75	$ 8.01	2,283,000
$ 2.73 - $ 8.01	442,500	6.72	$ 7.73	$ 2,820,000

Stock Options Exercisable

Exercise Prices	Shares Exercisable	Weighted-Average Remaining Contractual Life in Years	Weighted-Average Exercise Price	Intrinsic Value of Shares Exercisable
$ 2.73	22,500	1.92	$ 2.73	$ 256,000

$ 7.86	7,425	8.92	$ 7.86	46,000
$ 8.01	60,000	6.75	$ 8.01	366,000
$ 2.73 - $ 8.01	89,925	5.72	$ 6.68	$ 668,000

LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

17. Stockholders' Equity (continued)

Preferred Share Rights Plan - On January 5, 2009, a renewed shareholder rights plan became effective upon the expiration of our previous shareholder rights plan. The rights plan will impact a potential acquirer unless the acquirer negotiates with our board of directors and the board of directors approves the transaction. Pursuant to the renewed plan, one preferred share purchase right (a "Right") is attached to each currently outstanding or subsequently issued share of our common stock. Prior to becoming exercisable, the Rights trade together with our common stock. In general, the Rights will become exercisable if a person or group (other than the acquirer) acquires or announces a tender or exchange offer for 15% or more of our common stock. Each Right entitles the holder to purchase from us one one-hundredth of a share of Series 4 Junior Participating Preferred Stock, no par value (the "Preferred Stock"), at an exercise price of $47.75 per one one-hundredth of a share, subject to adjustment. If a person or group acquires 15% or more of our common stock, each Right will entitle the holder (other than the acquirer) to purchase shares of our common stock (or, in certain circumstances, cash or other securities) having a market value of twice the exercise price of a Right at such time. Under certain circumstances, each Right will entitle the holder (other than the acquirer) to purchase the common stock of the acquirer having a market value of twice the exercise price of a Right at such time. In addition, under certain circumstances, our board of directors may exchange each Right (other than those held by the acquirer) for one share of our common stock, subject to adjustment. If the Rights become exercisable, holders of our common stock (other than the acquirer), will receive the number of Rights they would have received if their units had been redeemed and the purchase price paid in our common stock. Our board of directors may redeem the Rights at a price of $0.01 per Right generally at any time before 10 days after the Rights become exercisable.

Other - In November 2007, the Jayhawk Group exercised a warrant to purchase 112,500 shares of our common stock for $3.49 per share.

During 2009 and 2008, we purchased 275,900 and 400,000 shares of treasury stock for the average price of $11.60 and $12.05 per share, respectively.

As of December 31, 2009, we have reserved 2.9 million shares of common stock issuable upon potential conversion of convertible debt, preferred stocks and stock options pursuant to their respective terms.

18. Non-Redeemable Preferred Stock

Series B Preferred - The 20,000 shares of Series B Preferred, $100 par value, are convertible, in whole or in part, into 666,666 shares of our common stock (33.3333 shares of common stock for each share of preferred stock) at any time at the option of the holder and entitle the holder to one vote per share. The Series B Preferred provides for annual cumulative dividends of 12% from date of issue, payable when and as declared. All of the outstanding shares of the Series B Preferred are owned by the Golsen Group.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

18. Non-Redeemable Preferred Stock (continued)

Series 2 Preferred - The Series 2 Preferred had no par value and had a liquidation preference of $50.00 per share plus dividends in arrears and was convertible at the option of the holder at any time, unless previously redeemed, into our common stock at an initial conversion price of $11.55 per share (equivalent to a conversion rate of approximately 4.329 shares of common stock for each share of Series 2 Preferred), subject to adjustment under certain conditions. As discussed below, upon the mailing of notice of certain corporate actions, holders had special conversion rights relating to a trade offer in 2007. The Series 2 Preferred was redeemable at our option, in whole or in part, at $50.00 per share, plus dividends in arrears to the redemption date. Dividends on the Series 2 Preferred were cumulative and payable quarterly in arrears. As the result of the transactions discussed below, no shares of Series 2 Preferred were issued and outstanding at December 31, 2009 and 2008.

Jayhawk Agreement in 2006

During November 2006, the Company entered into the Jayhawk Agreement with the Jayhawk Group. Under the Jayhawk Agreement, the Jayhawk Group agreed to tender (discussed below) 180,450 shares of the 346,662 shares of the Series 2 Preferred, if the Company made an exchange or tender offer for the Series 2 Preferred. In addition, as a condition to the Jayhawk Group’s obligation to tender such shares of Series 2 Preferred in an exchange/tender offer, the Jayhawk Agreement further provided that the Golsen Group would exchange only 26,467 of the 49,550 shares of Series 2 Preferred beneficially owned by them. As a result, only 309,807 of the 499,102 shares of Series 2 Preferred outstanding would be eligible to participate in an exchange/tender offer, with the remaining 189,295 being held by the Jayhawk Group and the Golsen Group.

Completion of Tender Offer in 2007

On January 26, 2007, our board of directors approved and on February 9, 2007, we began a tender offer to exchange shares of our common stock for up to 309,807 of the 499,102 outstanding shares of the Series 2 Preferred. The tender offer expired on March 12, 2007 and our board of directors accepted the shares tendered on March 13, 2007. The terms of the tender offer provided for the issuance by the Company of 7.4 shares of common stock in exchange for each share of Series 2 Preferred tendered in the tender offer and the waiver of all rights to the dividends in arrears on the Series 2 Preferred tendered. As a result of this tender offer, we issued 2,262,965 shares of our common stock for 305,807 shares of Series 2 Preferred that were tendered. As a result, we effectively settled the dividends in arrears on the Series 2 Preferred tendered totaling approximately $7.3 million ($23.975 per share).

Because the exchanges under the tender offer were pursuant to terms other than the original terms, the transactions were considered extinguishments of the preferred stock. Also the transactions qualified as induced conversions. Accordingly, we recorded a charge (stock dividend) to accumulated deficit of approximately $12.3 million which equaled the excess of the fair value of the common stock issued over the fair value of the common stock issuable pursuant

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

18. Non-Redeemable Preferred Stock (continued)

to the original conversion terms. To measure fair value, we used the closing price of our common stock on March 13, 2007.

Included in the amounts discussed above and pursuant to the Jayhawk Agreement and the terms of the tender offer, the Jayhawk Group and the Golsen Group tendered 180,450 and 26,467 shares, respectively, of Series 2 Preferred for 1,335,330 and 195,855 shares, respectively, of our common stock. As a result, we effectively settled the dividends in arrears on these shares of Series 2 Preferred tendered totaling approximately $4.96 million with $4.33 million relating to the Jayhawk Group and $0.63 million relating to the Golsen Group.

No fractional shares were issued so cash was paid in lieu of any additional shares in an amount equal to the fraction of a share times the closing price per share of our common stock on the last business day immediately preceding the expiration date of the tender offer.

Completion of Redemption in 2007

On July 11, 2007, our board of directors approved the redemption of all of our remaining outstanding Series 2 Preferred. We mailed a notice of redemption to all holders of record of our Series 2 Preferred on July 12, 2007. The redemption date was August 27, 2007, and each share of Series 2 Preferred that was redeemed received a redemption price of $50.00 plus $26.25 per share in dividends in arrears pro-rata to the date of redemption.

The holders of shares of Series 2 Preferred had the right to convert each share into 4.329 shares of our common stock, which right to convert terminated 10 days prior to the redemption date. If a holder converted its shares of Series 2 Preferred, the holder was not entitled to any dividends in arrears as to the shares of Series 2 Preferred converted. As a result, 167,475 shares of Series 2 Preferred were converted (of which 155,012 shares were converted by the Jayhawk Group) into 724,993 shares of our common stock (of which 671,046 shares were issued to the Jayhawk Group).

As a result of the conversions, only 25,820 shares of Series 2 Preferred were redeemed (of which 23,083 shares were held by the Golsen Group) for a total redemption price of $1,291,000 (of which approximately $1,154,000 was paid to the Golsen Group). In addition, we paid approximately $678,000 in dividends in arrears (of which approximately $606,000 was paid to the Golsen Group). The shares of the Series 2 Preferred were redeemed using a portion of the net proceeds of the 2007 Debentures.

No fractional shares were issued so cash was paid in lieu of any additional shares in an amount equal to the fraction of a share times the closing price per share of our common stock on the day the respective shares were converted.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

18. Non-Redeemable Preferred Stock (continued)

Other Series 2 Preferred Transactions

During 2007, we cancelled 18,300 shares of Series 2 Preferred previously held as treasury stock.

Series D Preferred - The Series D Preferred have no par value and are convertible, in whole or in part, into 250,000 shares of our common stock (1 share of common stock for 4 shares of preferred stock) at any time at the option of the holder. Dividends on the Series D Preferred are cumulative and payable annually in arrears at the rate of 6% per annum of the liquidation preference of $1.00 per share. Each holder of the Series D Preferred shall be entitled to .875 votes per share. All of the outstanding shares of Series D Preferred are owned by the Golsen Group.

Cash Dividends Paid - During 2009 and 2008, we paid the following cash dividends on our non-redeemable preferred stock in each of the respective year:

- $240,000 on the Series B Preferred ($12.00 per share); and
- $60,000 on the Series D Preferred ($0.06 per share).

In addition to the settlement of the dividends in arrears relating to the tender offer in 2007 as discussed above, during 2007, we paid the following cash dividends on our non-redeemable preferred stock:

- $1,890,000 on the Series B Preferred ($94.52 per share);
- $678,000 on the Series 2 Preferred ($26.25 per share); and
- $360,000 on the Series D Preferred ($0.36 per share).

At December 31, 2009, there were no dividends in arrears.

Other - At December 31, 2009, we are authorized to issue an additional 229,490 shares of $100 par value preferred stock and an additional 4,000,000 shares of no par value preferred stock. Upon issuance, our board of directors will determine the specific terms and conditions of such preferred stock.

19. Executive Benefit Agreements and Employee Savings Plans

In 1981, we entered into individual death benefit agreements with certain key executives (“1981 Agreements”). Under the 1981 Agreements, should the executive die while employed, we are required to pay the beneficiary named in the agreement in 120 equal monthly installments aggregating to an amount specified in the agreement. At December 31, 2009, the monthly installments specified in the 1981 Agreements total $34,000 and the aggregate undiscounted death benefits are $4,100,000. The benefits under the 1981 Agreements are forfeited if the respective executive’s employment is terminated for any reason prior to death. The 1981 Agreements may be terminated by the Company at any time and for any reason prior to the death of the employee.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

19. Executive Benefit Agreements and Employee Savings Plans (continued)

In 1992, we entered into individual benefit agreements with certain key executives ("1992 Agreements") that provide for annual benefit payments for life (in addition to salary) ranging from $16,000 to $18,000 payable in monthly installments when the employee reaches age 65. As of December 31, 2009 and 2008, the liability for benefits under the 1992 Agreements is $1,102,000 and $1,111,000, respectively, which is included in current and noncurrent accrued and other liabilities in the accompanying consolidated balance sheets. The liability reflects the present value of the remaining estimated payments at discount rates of 5.06% and 4.97% as of December 31, 2009 and 2008, respectively. Future estimated undiscounted payments aggregate to $2.0 million as of December 31, 2009. For 2009, 2008, and 2007, charges to SG&A for these benefits were $75,000, $166,000 and $106,000, respectively. As part of the 1992 Agreements, should the executive die prior to attaining the age of 65, we will pay the beneficiary named in the agreement in 120 equal monthly installments aggregating to an amount specified in the agreement. This amount is in addition to any amount payable under the 1981 Agreement should that executive have both a 1981 and 1992 agreement. At December 31, 2009, the aggregate undiscounted death benefit payments specified in the 1992 Agreements are $302,000. The benefits under the 1992 Agreements are forfeited if the respective executive's employment is terminated prior to age 65 for any reason other than death. The 1992 Agreements may be terminated by the Company at any time and for any reason prior to the death of the employee.

In 2005, we entered into a death benefit agreement ("2005 Agreement") with our CEO. The Death Benefit Agreement provides that, upon our CEO's death, we will pay to our CEO's designated beneficiary, a lump-sum payment of $2,500,000 to be funded from the net proceeds received by us under certain life insurance policies on our CEO's life that are owned by us. We are obligated to keep in existence life insurance policies with a total face amount of no less than $2,500,000 of the stated death benefit. As of December 31, 2009, the life insurance policies owned by us on the life of our CEO have a total face amount of $7,000,000. The benefit under the 2005 Agreement is not contingent upon continued employment and may be amended at any time by written agreement executed by the CEO and the Company.

As of December 31, 2009, the liability for death benefits under the 1981, 1992 and 2005 Agreements is $3,356,000 ($2,687,000 at December 31, 2008), which is included in current and noncurrent accrued and other liabilities. We accrue for such liabilities when they become probable and discount the liabilities to their present value.

To assist us in funding the benefit agreements discussed above and for other business reasons, we purchased life insurance contracts on various individuals in which we are the beneficiary. As of December 31, 2009, the total face amount of these policies is $20,672,000 of which $2,500,000 of the proceeds is required to be paid under the 2005 Agreement as discussed above. Some of these life insurance policies have cash surrender values that we have borrowed against. The cash surrender values are included in other assets in the amounts of $1,866,000 and $1,504,000, net of borrowings of $2,100,000 and $1,967,000 at December 31, 2009 and 2008, respectively. Increases in cash surrender values of $494,000, $461,000 and $548,000 are netted against the premiums paid for life insurance policies of $842,000, $832,000 and $836,000 in 2009, 2008, and 2007 respectively, and are included in SG&A.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

19. Executive Benefit Agreements and Employee Savings Plans (continued)

We sponsor a savings plan under Section 401(k) of the Internal Revenue Code under which participation is available to substantially all full-time employees. We do not presently contribute to this plan except for EDC and Cherokee Nitrogen Company's ("CNC") union employees and EDN employees, which amounts were not material for each of the three years ended December 31, 2009.

20. Property and Business Interruption Insurance Claims and Recoveries

Cherokee Facility - As a result of damage caused by Hurricane Katrina in August 2005, the natural gas pipeline servicing the chemical production facility located in Cherokee, Alabama (the "Cherokee Facility") suffered damage and the owner of the pipeline declared an event of Force Majeure. This event of Force Majeure caused curtailments and interruption in the delivery of natural gas to the Cherokee Facility through the first quarter of 2006. CNC's insurer was promptly put on notice of a claim and during 2006, CNC filed a business interruption claim relating to this incident. In 2007, we realized insurance recoveries of $3,750,000 relating to this business interruption claim, which were recorded as a reduction to cost of sales.

On February 5, 2009, a small nitric acid plant located at the Cherokee Facility suffered damage due to a fire. The fire was immediately extinguished and there were no injuries. The extent of the damage to the nitric acid plant has been determined; however, the final repair option has not yet been determined. The nitric acid plant that suffered the fire, with a current 182 ton per day capacity, is the smaller of the two nitric acid plants at the Cherokee Facility. The Cherokee Facility continues production with the larger of the nitric acid plants. Our insurance provides for replacement cost coverage relating to property damage with a $1,000,000 property loss deductible. Because our replacement cost coverage for property damages is estimated to exceed our property loss deductible and the net book value of the damaged property, we did not recognize a loss relating to property damage from this fire but we recorded a property insurance claim receivable relating to this event. At December 31, 2009, the balance of the insurance claim receivable relating to this event was $1,175,000.

Bryan Distribution Center - On July 30, 2009, one of our fifteen agricultural distribution centers operated by our Chemical Business was destroyed by fire, resulting in the cessation of operations at this center, which is located in Bryan, Texas ("Bryan Center"). The Bryan Center stored and sold agricultural chemical products, including fertilizer grade ammonium nitrate, potash and certain other fertilizer products. Our Chemical Business is in the process of rebuilding the Bryan Center. Our insurance provides for general liability coverage with a $250,000 loss deductible and for business interruption coverage and for replacement cost coverage relating to property damage with a total $100,000 loss deductible. As of December 31, 2009, a recovery, if any, from our business interruption coverage has not been recognized. Because our replacement cost coverage for property damages is estimated to exceed our property loss deductible and the net book value of the damaged property, we did not recognize a loss relating to property damage from this fire but we recorded an insurance claim receivable relating to this event. During 2009, we received $545,000 from our insurance carrier as a partial payment on our insurance claim, which amount was applied against our insurance claim receivable. At December 31, 2009, the balance of the insurance claim receivable relating to this event was $35,000.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

21. Other Expense, Other Income and Non-Operating Other Income, net

	Year ended December 31, 2009	2008	2007
	(In Thousands)		
Other expense:			
Losses on sales and disposals of property and equipment	$ 378	$ 158	$ 378
Settlements and potential settlements of litigation and potential litigation (1)	75	592	350
Income tax related penalties	35	152	34
Impairments of long-lived assets (2)	-	192	250
Other miscellaneous expense (3)	39	90	174
Total other expense	$ 527	$ 1,184	$ 1,186
Other income:			
Litigation judgment, settlements and potential settlements (4)	$ 50	$ 8,235	$ 3,272
Other miscellaneous income (3)	237	241	223
Total other income	$ 287	$ 8,476	$ 3,495
Non-operating other income, net:			
Interest income	$ 216	$ 1,270	$ 1,291
Miscellaneous income (3)	1	-	73
Miscellaneous expense (3)	(87)	(174)	(100)
Total non-operating other income, net	$ 130	$ 1,096	$ 1,264

(1) For 2008, $325,000 related to settlements recognized associated with various asserted claims, of which $225,000 related to the Climate Control Business. In addition, $267,000 related to various settlements reached, of which $67,000 related to the Chemical Business. During 2007, a settlement was reached relating to alleged damages claimed by a customer of our Climate Control Business.

(2) Based on estimates of the fair values obtained from external sources and estimates made internally based on inquiry and other techniques, we recognized the following impairments:

	Year ended December 31, 2009	2008	2007
	(In Thousands)		
Corporate assets	$ -	$ 192	$ -
Chemical Business assets	-	-	250
	$ -	$ 192	$ 250

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

21. Other Expense, Other Income and Non-Operating Other Income, net (continued)

(3) Amounts represent numerous unrelated transactions, none of which are individually significant requiring separate disclosure.

(4) For 2008, income from litigation judgment and settlements includes approximately $7.6 million, net of attorneys' fees, relating to a litigation judgment involving a subsidiary within our Chemical Business. In June 2008, we received proceeds of approximately $11.2 million for this litigation judgment, which includes interest of approximately $1.4 million and from which we paid attorneys' fees of approximately $3.6 million. The payment of attorneys' fees of 31.67% of our recovery was contingent upon the cash receipt of the litigation judgment. Cash flows relating to this litigation judgment are included in cash flows from continuing operating activities, except for the portion of the judgment associated with the recovery of damages relating to property, plant and equipment and its pro-rata portion of the attorneys' fees. These cash flows are included in cash flows from continuing investing activities. In addition, a settlement was reached for $0.4 million for the recovery of certain environmental-related costs incurred in previous periods relating to property used by Corporate and other business operations. During 2007, our Chemical Business reached a settlement with Dynegy, Inc. and one of its subsidiaries, relating to a previously reported lawsuit. This settlement reflects the net proceeds of approximately $2.7 million received by the Cherokee Facility and the retention by the Cherokee Facility of a disputed accounts payable amount of approximately $0.6 million.

22. Segment Information

Factors Used by Management to Identify the Enterprise's Reportable Segments and Measurement of Segment Income or Loss and Segment Assets

We have two reportable segments: the Climate Control Business and the Chemical Business. Our reportable segments are based on business units that offer similar products and services. The reportable segments are each managed separately because they manufacture and distribute distinct products with different production processes.

We evaluate performance and allocate resources based on operating income or loss. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies.

Description of Each Reportable Segment

Climate Control - The Climate Control Business segment manufactures and sells the following variety of heating, ventilation, and air conditioning ("HVAC") products:

- geothermal and water source heat pumps,
- hydronic fan coils, and
- other HVAC products including large custom air handlers, modular chiller systems and other products and services.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

22. Segment Information (continued)

These HVAC products are primarily for use in commercial and residential new building construction, renovation of existing buildings and replacement of existing systems. Our various facilities located in Oklahoma City comprise substantially all of the Climate Control segment’s operations. Sales to customers of this segment primarily include original equipment manufacturers, contractors and independent sales representatives located throughout the world.

Chemical -The Chemical Business segment manufactures and sells:

- anhydrous ammonia, ammonium nitrate, urea ammonium nitrate, and ammonium nitrate ammonia solution for agricultural applications,
- concentrated, blended and regular nitric acid, mixed nitrating acids, metallurgical and commercial grade anhydrous ammonia, sulfuric acid, and high purity ammonium nitrate for industrial applications, and
- industrial grade ammonium nitrate and solutions for the mining industry.

Our primary chemical production facilities are located in El Dorado, Arkansas, Cherokee, Alabama and Baytown, Texas. Sales to customers of this segment primarily include industrial users of acids throughout the United States and parts of Canada; farmers, ranchers, fertilizer dealers and distributors located in the Central and Southeastern United States; and explosive manufacturers in the United States. During 2009, we proceeded to activate a portion of our previously idled Pryor Facility. We plan to produce and sell urea ammonium nitrate and anhydrous ammonia from this facility primarily to one customer pursuant to a purchase and sale agreement.

As of December 31, 2009, our Chemical Business employed 455 persons, with 156 represented by unions under agreements, which will expire in July through November of 2010.

Other - The business operation classified as “Other” primarily sells industrial machinery and related components to machine tool dealers and end users located primarily in North America.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

22. Segment Information (continued)

Segment Financial Information

Information about our continuing operations in different industry segments for each of the three years in the period ended December 31, 2009 is detailed below.

	2009	2008	2007
		(In Thousands)	
Net sales:			
Climate Control:			
Geothermal and water source heat pumps	$ 179,865	$ 190,960	$ 165,115
Hydronic fan coils	46,381	83,472	85,815
Other HVAC products	39,923	36,948	35,435
Total Climate Control	266,169	311,380	286,365
Chemical:			
Agricultural products	104,300	152,802	117,158
Industrial acids and other chemical products	95,997	162,941	95,754
Mining products	57,535	108,374	75,928
Total Chemical	257,832	424,117	288,840
Other	7,837	13,470	11,202
	$ 531,838	$ 748,967	$ 586,407
Gross profit:			
Climate Control	$ 92,409	$ 96,633	$ 83,638
Chemical	42,422	37,991	44,946
Other	2,583	4,256	4,009
	$ 137,414	$ 138,880	$ 132,593
Operating income (loss):			
Climate Control	$ 37,706	$ 38,944	$ 34,194
Chemical	15,122	31,340	35,011
General corporate expenses and other business operations, net (1)	(12,118)	(11,129)	(10,194)
	40,710	59,155	59,011
Interest expense	(6,746)	(11,381)	(12,078)
Gains on extinguishment of debt	1,783	5,529	-
Non-operating income, net:			
Climate Control	8	1	2
Chemical	31	27	109
Corporate and other business operations	91	1,068	1,153
Provisions for income taxes	(15,024)	(18,776)	(2,540)
Equity in earnings of affiliate - Climate Control	996	937	877
Income from continuing operations	$ 21,849	$ 36,560	$ 46,534

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

22. Segment Information (continued)

(1) General corporate expenses and other business operations, net consist of the following:

	2009	2008 (In Thousands)	2007
Gross profit-Other	$ 2,583	$ 4,256	$ 4,009
Selling, general and administrative:			
Personnel costs	(8,083)	(7,937)	(6,879)
Professional fees	(3,687)	(4,759)	(4,299)
Office overhead	(657)	(650)	(646)
Property, franchise and other taxes	(350)	(313)	(314)
Advertising	(258)	(269)	(244)
Shareholders relations	(35)	(74)	(154)
All other	(1,617)	(1,498)	(1,626)
Total selling, general and administrative	(14,687)	(15,500)	(14,162)
Other income	192	766	53
Other expense	(206)	(651)	(94)
Total general corporate expenses and other business operations, net	$ (12,118)	$ (11,129)	$ (10,194)

Information about our property, plant and equipment and total assets by industry segment is detailed below:

	2009	2008 (In Thousands)	2007
Depreciation of property, plant and equipment:			
Climate Control	$ 4,077	$ 3,433	$ 3,195
Chemical	11,291	10,232	8,929
Corporate assets and other	233	165	147
Total depreciation of property, plant and equipment	$ 15,601	$ 13,830	$ 12,271
Additions to property, plant and equipment:			
Climate Control	$ 6,438	$ 12,111	$ 6,778
Chemical	24,627	25,130	9,151
Corporate assets and other	271	457	294
Total additions to property, plant and equipment	$ 31,336	$ 37,698	$ 16,223
Total assets at December 31:			
Climate Control	$ 102,029	$ 117,260	$ 102,737
Chemical	143,800	145,518	121,864
Corporate assets and other	92,804	72,989	82,953
Total assets	$ 338,633	$ 335,767	$ 307,554

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

22. Segment Information (continued)

Net sales by industry segment include net sales to unaffiliated customers as reported in the consolidated financial statements. Net sales classified as “Other” consist of sales of industrial machinery and related components. Intersegment net sales are not significant.

Gross profit by industry segment represents net sales less cost of sales. Gross profit classified as “Other” relates to the sales of industrial machinery and related components.

Our chief operating decision makers use operating income (loss) by industry segment for purposes of making decisions that include resource allocations and performance evaluations. Operating income (loss) by industry segment represents gross profit by industry segment less SG&A incurred by each industry segment plus other income and other expense earned/incurred by each industry segment before general corporate expenses and other business operations, net. General corporate expenses and other business operations, net consist of unallocated portions of gross profit, SG&A, other income and other expense.

Identifiable assets by industry segment are those assets used in the operations of each industry. Corporate assets and other are those principally owned by the parent company or by subsidiaries not involved in the two identified industries.

All net sales and long-lived assets relate to domestic operations for the periods presented.

Net sales to unaffiliated customers include foreign export sales as follows:

Geographic Area	2009	2008	2007
		(In Thousands)	
Canada	$ 20,224	$ 24,749	$ 14,206
Middle East	4,440	4,994	9,523
Mexico, Central and South America	2,154	2,954	2,053
Europe	1,114	2,119	3,069
South and East Asia	1,124	1,645	2,218
Caribbean	443	491	1,119
Other	400	148	129
	$ 29,899	$ 37,100	$ 32,317

Major Customers

Net sales to one customer, Bayer, of our Chemical Business segment represented approximately 7%, 11% and 7% of our total net sales for 2009, 2008 and 2007, respectively. See discussion concerning the Bayer Agreement in Note 15 – Commitments and Contingencies.

Net sales to one customer, Orica, of our Chemical Business segment represented approximately 7%, 11% and 9% of our total net sales for 2009, 2008 and 2007, respectively. See discussion concerning the supply agreement in Note 24 – Subsequent Events.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

22. Segment Information (continued)

Unplanned Maintenance Downtime at the Cherokee Facility in 2008

During the third quarter of 2008, the Cherokee Facility experienced repeated unplanned maintenance downtime, which downtime reduced production and sales by our Chemical Business. As a result, interim repairs were made at the Cherokee Facility during this period. Due to this repeated downtime, the Cherokee Facility lost approximately 20 days of operation that negatively impacted our Chemical Business' operating results in 2008.

23. Related Party Transactions

Golsen Group

In connection with the completion of our March 2007 tender offer for our outstanding shares of our Series 2 Preferred, members of the Golsen Group tendered 26,467 shares of Series 2 Preferred in exchange for our issuance to them of 195,855 shares of our common stock. As a result, we effectively settled approximately $635,000 in dividends in arrears on the shares of Series 2 Preferred tendered. The tender by the Golsen Group was a condition of the Jayhawk Group's agreement to tender shares of Series 2 Preferred in the tender offer as discussed in Note 18.

After the completion of our March 2007 tender offer relating to the Series 2 Preferred, the Golsen Group held 23,083 shares of Series 2 Preferred. Pursuant to our redemption of the remaining outstanding Series 2 Preferred during August 2007, the Golsen Group redeemed 23,083 shares of Series 2 Preferred and received the cash redemption amount of approximately $1,760,000 pursuant to the terms of our redemption of all of our outstanding Series 2 Preferred. The redemption price was $50.00 per share of Series 2 Preferred, plus $26.25 per share in dividends in arrears pro-rata to the date of redemption.

In September 2007, we utilized a portion of the net proceeds of the sale of the 2007 Debentures and working capital to pay approximately $2,250,000 of dividends in arrears on our Series B Preferred and our Series D Preferred, all of the outstanding shares of which are owned by the Golsen Group.

In March 2008, we paid dividends totaling $300,000 on our Series B Preferred and our Series D Preferred, all of the outstanding shares of which are owned by the Golsen Group.

During November 2008, the Golsen Group acquired from an unrelated third party $5,000,000 of the 2007 Debentures.

In January 2009, we paid interest of $137,500 relating to the debentures held by the Golsen Group that was accrued at December 31, 2008.

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LSB Industries, Inc.

Notes to Consolidated Financial Statements (continued)

23. Related Party Transactions (continued)

In March 2009, we paid dividends totaling $300,000 on our Series B Preferred and our Series D Preferred, all of the outstanding shares of which are owned by the Golsen Group.

During 2009, we incurred interest expense of $275,000 relating to the debentures held by the Golsen Group, of which $137,500 remains accrued at December 31, 2009.

Quail Creek Bank

Bernard Ille, a member of our board of directors, is a director of Quail Creek Bank, N.A. (the “Bank”). The Bank was a lender to one of our subsidiaries. During 2007, the subsidiary made interest and principal payments on outstanding debt owed to the Bank in the respective amount of $.1 million and $3.3 million in 2007 (none in 2009 or 2008). The debt accrued interest at an annual interest rate of 8.25%. The loan was secured by certain of the subsidiary’s property, plant and equipment. This loan was paid in full in June 2007 utilizing a portion of the net proceeds of our sale of the 2007 Debentures.

24. Subsequent Events (Unaudited)

During February 2010, EDC signed an extension of EDC’s anhydrous ammonia purchase agreement with Koch Nitrogen International Sarl (“Koch”). Under the extension, Koch agrees to supply certain of EDC’s requirements of anhydrous ammonia through December 31, 2012.

During February 2010, EDC entered into a cost-plus supply agreement with Orica International Pte Ltd. (“Orica International”) to supply Orica International with 250,000 tons per year of industrial grade ammonium nitrate through December 2014. This new agreement, which became effective January 1, 2010, replaced EDC’s previous agreement to supply 210,000 tons per year of industrial grade ammonium nitrate to Orica USA, Inc.

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LSB Industries, Inc.

Supplementary Financial Data

Quarterly Financial Data (Unaudited)

(In Thousands, Except Per Share Amounts)

	Three months ended			
	March 31	June 30	September 30	December 31
2009				
Net sales	$ 150,197	$ 138,563	$ 127,778	$ 115,300
Gross profit (1)	$ 40,728	$ 37,827	$ 30,653	$ 28,206
Income from continuing operations (1) (2)	$ 11,745	$ 8,743	$ 1,103	$ 258
Net income (loss) from discontinued operations	(2)	(13)	(30)	(220)
Net income	$ 11,743	$ 8,730	$ 1,073	$ 38
Net income applicable to common stock	$ 11,437	$ 8,730	$ 1,073	$ 38
Income per common share:				
Basic:				
Income from continuing operations	$ .54	$ .41	$ .05	$ .01
Income (loss) from discontinued operations, net	-	-	-	(.01)
Net income	$ .54	$ .41	$ .05	$ -
Diluted:				
Income from continuing operations	$ .51	$ .38	$ .05	$ .01
Income (loss) from discontinued operations, net	-	-	-	(.01)
Net income	$ .51	$ .38	$ .05	$ -
2008				
Net sales	$ 160,455	$ 198,052	$ 210,920	$ 179,540
Gross profit (1)	$ 37,757	$ 43,741	$ 31,169	$ 26,213
Income from continuing operations (1) (2)	$ 10,907	$ 17,924	$ 4,157	$ 3,572
Net income (loss) from discontinued operations	-	(17)	4	-
Net income	$ 10,907	$ 17,907	$ 4,161	$ 3,572
Net income applicable to common stock	$ 10,601	$ 17,907	$ 4,161	$ 3,572
Income per common share:				
Basic:	$ .50	$ .85	$ .20	$ .17
Diluted:	$ .46	$ .75	$ .18	$ .16

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LSB Industries, Inc.

Supplementary Financial Data

Quarterly Financial Data (Unaudited) (continued)

(1) The following items increased (decreased) gross profit and income from continuing operations:

	Three months ended			
	March 31	June 30	September 30	December 31
	(In Thousands)			
Changes in unrealized gains (losses) relating to commodities contracts still held at period end:				
2009	$ (1,498)	$ 30	$ 385	$ 138
2008	$ 53	$ 808	$ (5,391)	$ (3,576)
Turnaround costs:				
2009	$ (120)	$ (484)	$ (2,078)	$ (731)
2008	$ (247)	$ (366)	$ (881)	$ (4,461)
Precious metals, net of recoveries:				
2009	$ 486	$ (1,543)	$ (841)	$ (1,403)
2008	$ (2,460)	$ (1,102)	$ (1,304)	$ (1,462)
Changes in inventory reserves:				
2009	$ 3,032	$ (8)	$ 162	$ (782)
2008	$ (169)	$ (15)	$ (216)	$ (3,424)
Unplanned maintenance downtime - Cherokee Facility:				
2008	$ -	$ -	$ (5,100)	$ -

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LSB Industries, Inc.

Supplementary Financial Data

Quarterly Financial Data (Unaudited) (continued)

(2) The following items increased (decreased) income from continuing operations:

	Three months ended			
	March 31	June 30	September 30	December 31
	(In Thousands)			
Expenses associated with the Pryor Facility:				
2009	$ (1,996)	$ (3,217)	$ (7,058)	$ (4,965)
2008	$ (421)	$ (498)	$ (425)	$ (1,047)
Gain (loss) on extinguishment of debt:				
2009	$ 1,322	$ 421	$ 53	$ (13)
2008	$ -	$ -	$ -	$ 5,529
Judgment, settlements and potential settlements of litigation and potential litigation:				
2009	$ 50	$ (75)	$ -	$ -
2008	$ 350	$ 7,518	$ -	$ (225)
Benefit (provision) for income taxes:				
2009 (A)	$ (7,349)	$ (5,451)	$ (1,310)	$ (914)
2008 (B)	$ (6,720)	$ (10,709)	$ (2,388)	$ 1,041

(A) For the three months ended December 31, 2009, the provision for income taxes includes the impact of additional provisions totaling $538,000 relating to the adjustments necessary to reconcile the 2008 state income tax returns to the 2008 estimated tax provision.

(B) During the three months ended December 31, 2008, we performed a detailed analysis of all our deferred tax assets and liabilities and determined that our deferred tax assets were understated by approximately $1,827,000. As a part of our analysis, we reviewed the realizability of these deferred tax assets and determined that a valuation allowance of approximately $268,000 was required. Accordingly, the addition of the deferred tax assets and the associated valuation allowance resulted in a tax benefit of $1,559,000 in our income taxes for the three months ended December 31, 2008. In addition, the net effect of these adjustments increased basic and diluted net income per share by $0.07 and $0.06, respectively, for the year ended December 31, 2008.

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LSB Industries, Inc.

Schedule I - Condensed Financial Information of Registrant

Condensed Balance Sheets

The following condensed financial statements in this Schedule I are of the parent company only, LSB Industries, Inc.

	December 31, 2009	December 31, 2008
	(In Thousands)	
Assets		
Current assets:		
Cash and cash equivalents	$ 23,071	$ 25,720
Accounts receivable, net	12	46
Supplies, prepaid items and other	93	85
Due from subsidiaries	17,544	32,235
Notes receivable from a subsidiary	10,000	31,400
Total current assets	50,720	89,486
Property, plant and equipment, net	258	186
Investments in and due from subsidiaries	146,402	100,179
Other assets, net	2,017	2,468
	$ 199,397	$ 192,319
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 257	$ 432
Accrued and other liabilities	1,186	3,816
Redeemable, noncumulative, convertible preferred stock	48	52
Current portion of long-term debt	8	9
Total current liabilities	1,499	4,309
Long-term debt	29,400	40,500
Due to subsidiaries	2,558	2,558
Noncurrent accrued and other liabilities	4,492	3,947
Stockholders' equity:		
Preferred stock	3,000	3,000
Common stock	2,537	2,496
Capital in excess of par value	129,941	127,337
Retained earnings	41,082	19,804
	176,560	152,637
Less treasury stock	15,112	11,632
Total stockholders' equity	161,448	141,005
	$ 199,397	$ 192,319

See accompanying notes.

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LSB Industries, Inc.

Schedule I - Condensed Financial Information of Registrant

Condensed Statements of Income

	Year ended December 31, 2009	2008	2007
		(In Thousands)	
Fees under service, tax sharing and management agreements with subsidiaries	$ 3,531	$ 3,501	$ 2,801
Selling, general and administrative expense	5,321	6,108	5,361
Litigation judgment	-	(7,560)	-
Gain on sale of precious metals	-	-	(4,259)
Other expense (income), net	82	65	(402)
Operating income (loss)	(1,872)	4,888	2,101
Interest expense	3,513	5,988	5,142
Gains on extinguishment of debt	(1,783)	(5,529)	-
Interest and other non-operating income, net	(2,328)	(3,342)	(3,309)
Income (loss) from continuing operations	(1,274)	7,771	268
Equity in earnings of subsidiaries	23,123	28,789	46,266
Net income (loss) from discontinued operations	(265)	(13)	348
Net income	$ 21,584	$ 36,547	$ 46,882

See accompanying notes.

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LSB Industries, Inc.

Schedule I - Condensed Financial Information of Registrant

Condensed Statements of Cash Flows

	Year ended December 31, 2009	2008	2007
		(In Thousands)	
Net cash flows provided (used) by operating activities	$ (4,899)	$ 1,140	$ 5,953
Cash flows from investing activities:			
Capital expenditures	(99)	(71)	(71)
Proceeds from litigation judgment associated with property, plant and equipment of a subsidiary	-	5,948	-
Payment of legal costs relating to litigation judgment associated with property, plant and equipment of a subsidiary	-	(1,884)	-
Proceeds from sales of property and equipment	-	-	2
Notes receivable from a subsidiary	-	-	(29,886)
Payments received on notes receivable from a subsidiary	21,400	4,886	-
Payment of senior unsecured notes of a subsidiary		-	6,950
Other assets	(283)	(274)	(147)
Net cash provided (used) by investing activities	21,018	8,605	(23,152)
Cash flows from financing activities:			
Acquisition of 5.5% convertible debentures	(8,938)	(13,207)	-
Payments on other long-term debt	(1)	(6)	(4)
Payments of debt issuance costs	-	-	(209)
Proceeds from 5.5% convertible debentures, net of fees	-	-	56,985
Net change in due to/from subsidiaries	(7,738)	(3,972)	(4,832)
Purchase of treasury stock	(3,200)	(4,821)	-
Proceeds from exercise of stock options	609	846	1,522
Proceeds from exercise of warrant	-	-	393
Excess income tax benefit associated with stock-based compensation	806	2,390	1,740
Dividends paid on preferred stocks	(306)	(306)	(2,934)
Acquisition of non-redeemable preferred stock	-	-	(1,292)
Net cash provided (used) by financing activities	(18,768)	(19,076)	51,369
Net increase (decrease) in cash	(2,649)	(9,331)	34,170
Cash and cash equivalents at the beginning of year	25,720	35,051	881
Cash and cash equivalents at the end of year	$ 23,071	$ 25,720	$ 35,051

See accompanying notes.

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LSB Industries, Inc.

Schedule I - Condensed Financial Information of Registrant

Notes to Condensed Financial Statements

1. Basis of Presentation - The accompanying condensed financial statements of the parent company include the accounts of LSB Industries, Inc. (the “Company”) only. The Company’s investments in subsidiaries are stated at cost plus equity in undistributed earnings (losses) of subsidiaries since date of acquisition. These condensed financial statements should be read in conjunction with the Company’s consolidated financial statements.

2. Debt Issuance Costs - During 2009, we acquired a portion of the 2007 Debentures. As a result, approximately $379,000 of the unamortized debt issuance costs associated with the 2007 Debentures acquired was charged against the gain on extinguishment of debt in 2009.

During 2008, we acquired a portion of the 2007 Debentures. As a result, approximately $764,000 of the unamortized debt issuance costs associated with the 2007 Debentures acquired was charged against the gain on extinguishment of debt in 2008.

During 2007, we incurred debt issuance costs of $3,224,000 relating to the 2007 Debentures. In addition, the remaining portion of the 2006 Debentures was converted into our common stock. As a result of the conversions, approximately $266,000 of the remaining debt issuance costs, net of amortization, associated with the 2006 Debentures were charged against capital in excess of par value in 2007.

3. Commitments and Contingencies - The Company has guaranteed the payment of principal and interest under the terms of various debt agreements of its subsidiaries. Subsidiaries’ long-term debt outstanding at December 31, 2009, which is guaranteed by the Company, is as follows (in thousands):

Secured Term Loan due 2012	$ 50,000
Other, most of which is collateralized by machinery, equipment and real estate	16,541
	$ 66,541

In addition, the Company has guaranteed approximately $34.1 million of our subsidiaries’ credit terms with vendors (primarily relating to purchases of natural gas) and approximately $22.9 million of our subsidiaries’ insurance bonds.

See Notes 13 and 15 of the notes to the Company’s consolidated financial statements for discussion of the long-term debt and commitments and contingencies.

4. Preferred Stock and Stockholders’ Equity - At December 31, 2009 and 2008, a subsidiary of the Company owns 2,451,527 shares of the Company’s common stock, which shares have been considered as issued and outstanding in the accompanying Condensed Balance Sheets included in this Schedule I - Condensed Financial Information of Registrant. See Notes 3, 12, 17 and 18 of notes to the Company’s consolidated financial statements for discussion of matters relating to the Company’s preferred stock and other stockholders’ equity matters.

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LSB Industries, Inc.

Schedule I - Condensed Financial Information of Registrant

Notes to Condensed Financial Statements (continued)

5. Litigation Judgment - See Note 21 of the notes to the Company's consolidated financial statements for the discussion of the income from a litigation judgment in 2008.

6. Precious Metals - The Company had owned a specified quantity of precious metals used in the production process at one of its subsidiaries. Precious metals are carried at cost, with cost being determined using a FIFO basis. During 2007, the Company sold metals the subsidiary had accumulated in excess of their production requirements. As a result, the Company recognized gains of $4,259,000 for 2007 (none in 2009 and 2008) from the sale of these precious metals. These gains included an intercompany profit of $2,248,000, which are eliminated in the accompanying condensed statement of income through equity in earnings of subsidiaries. The intercompany profit resulted from differences in the FIFO cost basis of these metals in relation to the consolidated FIFO cost basis.

7. Gains on Extinguishment of Debt - During 2009 and 2008, we acquired $11.1 million and $19.5 million, respectively, aggregate principal amount of the 2007 Debentures for approximately $8.9 million and $13.2 million, respectively, with each purchase being negotiated. As a result, we recognized a gain on extinguishment of debt of approximately $1.8 million and $5.5 million, respectively, after writing off the unamortized debt issuance costs associated with the 2007 Debentures acquired.

8. Interest Income - During 2007, the Company earned interest of $685,000 relating to $6,950,000 of senior unsecured notes due 2007 (the "Notes") of one of its subsidiaries, ThermaClime, which amount was being held as an investment. During 2007, ThermaClime repaid the Notes. In 2006, the Company entered into a $6,400,000 term loan due 2009 with ThermaClime. During 2009, 2008, and 2007, the Company earned interest of $698,000, $699,000 and $698,000, respectively, relating to this term loan. During 2009, ThermaClime repaid this term loan. During 2007, the Company entered into two demand notes totaling $29,886,000 with ThermaClime of which $15,000,000 and $4,886,000 was repaid in 2009 and 2008, respectively. During 2009, 2008, and 2007, the Company earned interest of $1,394,000, $1,671,000 and $801,000, respectively, relating to these demand notes. In addition, the Company has invested a portion of its cash (including a portion of the net proceeds of the 2007 Debentures) in highly liquid investments. During 2009, 2008, and 2007, the Company earned interest of $11,000, $651,000 and $752,000, respectively, relating to these investments.

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LSB Industries, Inc.

Schedule II - Valuation and Qualifying Accounts

Years ended December 31, 2009, 2008, and 2007

(In Thousands)

Description	Balance at Beginning of Year	Additions-Charges to (Recoveries) Costs and Expenses	Deductions-Write-offs/ Costs Incurred	Balance at End of Year
Accounts receivable - allowance for doubtful accounts (1):				
2009	$ 729	$ 90	$ 143	$ 676
2008	$ 1,308	$ 371	$ 950	$ 729
2007	$ 2,269	$ 858	$ 1,819	$ 1,308
Inventory-reserve for slow-moving items (1):				
2009	$ 514	$ 745	$ 61	$ 1,198
2008	$ 460	$ 210	$ 156	$ 514
2007	$ 829	$ 29	$ 398	$ 460
Notes receivable - allowance for doubtful accounts (1):				
2009	$ 970	$ -	$ -	$ 970
2008	$ 970	$ -	$ -	$ 970
2007	$ 970	$ -	$ -	$ 970
Deferred tax assets - valuation (1):				
2009	$ 268	$ 90	$ -	$ 358
2008	$ -	$ 268	$ -	$ 268
2007	$ 18,932	$ (18,932)	$ -	$ -

(1) Deducted in the consolidated balance sheet from the related assets to which the reserve applies.

Other valuation and qualifying accounts are detailed in our notes to consolidated financial statements.