Armstrong Flooring, Inc.
Form 10-Q
November 10, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2016

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File Number 001-37589
ARMSTRONG FLOORING, INC.
(Exact name of Registrant as specified in its charter)

Delaware	47-4303305
(State or other jurisdiction of incorporation or organization)	(I.R.S. employer Identification number)

2500 Columbia Avenue, PO Box 3025, Lancaster, Pennsylvania 17604
(Address of principal executive offices)

(717) 672-9611
(Registrant's telephone number, including area code).

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that registrant was required to submit and post such files.) Yes þ No ¨

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer ¨ Accelerated filer ¨
Non-accelerated filer þ Smaller reporting company ¨

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

The Registrant had 27,827,044 shares of common stock, $0.0001 par value, outstanding at November 4, 2016.

Armstrong Flooring, Inc.

Table of Contents

PART I:
Item 1. Financial Statements

Armstrong Flooring, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations and Comprehensive Income (Loss) (Unaudited)
(Dollars in millions, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net sales	$313.4	$322.6	$921.5	$908.6
Cost of goods sold	245.5	256.9	743.2	735.0
Gross profit	67.9	65.7	178.3	173.6
Selling, general and administrative expenses	53.8	54.1	157.0	150.8
Operating income	14.1	11.6	21.3	22.8
Interest expense	0.6	—	1.3	—
Other expense, net	0.3	2.2	2.1	2.1
Income from continuing operations before income taxes	13.2	9.4	17.9	20.7
Income tax expense	4.9	1.6	8.2	8.0
Income from continuing operations	8.3	7.8	9.7	12.7
Gain on disposal of discontinued operations, net of tax	—	1.1	1.7	43.4
Net income	8.3	8.9	11.4	56.1
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	0.1	(8.7)	(6.6)	(12.2)
Derivatives (loss) gain	(0.3)	1.7	(2.2)	1.4
Postretirement adjustments	1.1	—	2.0	—
Total other comprehensive income (loss)	0.9	(7.0)	(6.8)	(10.8)
Total comprehensive income	$9.2	$1.9	$4.6	$45.3
Basic earnings per share of common stock:				
Basic earnings per share of common stock from continuing operations	$0.30	$0.28	$0.35	$0.46
Basic earnings per share of common stock from discontinued operations	—	0.04	0.06	1.56
Basic earnings per share of common stock	$0.30	$0.32	$0.41	$2.02
Diluted earnings per share of common stock:				
Diluted earnings per share of common stock from continuing operations	$0.29	$0.28	$0.35	$0.46
Diluted earnings per share of common stock from discontinued operations	—	0.04	0.06	1.56
Diluted earnings per share of common stock	$0.29	$0.32	$0.41	$2.02

See accompanying notes to condensed consolidated financial statements.

Armstrong Flooring, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets
(Dollars in millions)

	As of September 30, 2016 (Unaudited)	December 31, 2015
Assets		
Current assets:		
Cash	$32.2	$ —
Accounts and notes receivable, net	90.4	72.2
Inventories, net	250.0	242.8
Deferred income taxes	—	3.0
Prepaid expenses and other current assets	27.7	31.7
Total current assets	400.3	349.7
Property, plant, and equipment, less accumulated depreciation and amortization of $331.7 and $311.1, respectively	440.2	434.5
Intangible assets, net	42.9	42.6
Deferred income taxes	5.2	23.5
Other non-current assets	2.5	13.1
Total assets	$891.1	$ 863.4
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued expenses	$162.9	$ 161.0
Income tax payable	3.2	—
Deferred income taxes	—	0.3
Total current liabilities	166.1	161.3
Long-term debt	10.0	10.0
Postretirement benefit liabilities	74.9	3.3
Pension benefit liabilities	2.1	—
Other long-term liabilities	9.2	12.4
Noncurrent income taxes payable	1.7	56.4
Deferred income taxes	2.6	2.1
Total liabilities	266.6	245.5
Stockholders' equity:		
Common stock with par value $.0001 per share: 100,000,000 shares authorized; 27,813,639 issued and outstanding	—	—
Preferred stock with par value $.0001 per share: 15,000,000 shares authorized; none issued	—	—
Additional paid-in capital	669.5	—
Net Armstrong World Industries ("AWI") investment, prior to Separation	—	615.9
Retained earnings	14.0	—
Accumulated other comprehensive (loss) income	(59.0)	2.0
Total stockholders' equity	624.5	617.9
Total liabilities and stockholders' equity	$891.1	$ 863.4

See accompanying notes to condensed consolidated financial statements.

2

Armstrong Flooring, Inc. and Subsidiaries
Condensed Consolidated Statements of Stockholders' Equity (Unaudited)
(Dollars in millions)

	Common Stock		Net AWI Investment	Additional Paid-in Capital	Accumulated Other Comprehensive (Loss) Income	Retained Earnings	Total Equity
	Shares	Amount					
December 31, 2015	—	$ —	$ 615.9	$ —	$ 2.0	$ —	$ 617.9
Net (loss) income			(2.6)		—	14.0	11.4
Net transfers from (to) AWI	—	—	102.3	—	(54.2)	—	48.1
Cash distribution paid to AWI	—	—	(50.0)	—	—	—	(50.0)
Reclassification of net parent investment to additional paid-in capital	—	—	(665.6)	665.6	—	—	—
Issuance of common stock at separation	27,738,779	—	—	—	—	—	—
Stock-based employee compensation, net	74,860	—	—	3.9	—	—	3.9
Other comprehensive loss	—	—	—	—	(6.8)	—	(6.8)
September 30, 2016	27,813,639	$ —	$ —	$ 669.5	$ (59.0)	$ 14.0	$ 624.5
December 31, 2014	—	$ —	$ 561.7	$ —	$ 13.7	$ —	$ 575.4
Net income	—	—	56.1	—	—	—	56.1
Net transfers to AWI	—	—	(5.3)	—	—	—	(5.3)
Other comprehensive loss	—	—	—	—	(10.8)	—	(10.8)
September 30, 2015	—	$ —	$ 612.5	$ —	$ 2.9	$ —	$ 615.4

See accompanying notes to condensed consolidated financial statements.

3

Armstrong Flooring, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows (Unaudited)
(Dollars in millions)

	Nine Months Ended September 30,	
	2016	2015
Cash flows from operating activities:		
Net income	$11.4	$56.1
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	34.2	28.3
Deferred income taxes	(4.8)	(45.0)
Stock-based compensation	3.8	—
U.S. pension expense	4.3	—
Other non-cash adjustments, net	1.8	—
Changes in operating assets and liabilities:		
Receivables	(11.1)	(9.5)
Inventories	(7.1)	(12.1)
Accounts payable and accrued expenses	17.1	21.7
Income taxes payable	3.7	6.7
Other assets and liabilities	1.9	(3.3)
Net cash provided by operating activities	55.2	42.9
Cash flows from investing activities:		
Purchases of property, plant and equipment	(28.1)	(33.7)
Other investing activities	0.6	0.3
Net cash used for investing activities	(27.5)	(33.4)
Cash flows from financing activities:		
Proceeds from revolving credit facility	100.0	—
Payments on revolving credit facility	(90.0)	—
Financing costs	(1.4)	—
Payments of long-term debt	(10.0)	—
Distribution paid to AWI	(50.0)	—
Proceeds from exercised stock options	0.2	—
Net transfers from (to) AWI	55.6	(9.5)
Net cash provided (used) by financing activities	4.4	(9.5)
Effect of exchange rate changes on cash and cash equivalents	0.1	—
Net increase in cash and cash equivalents	32.2	—
Cash and cash equivalents at beginning of year	—	—
Cash and cash equivalents at end of period	$32.2	$—
Supplemental Cash Flow Disclosure:		
Amounts in accounts payable for capital expenditures	$3.7	$14.2
Interest paid	$1.2	$—
Income taxes paid, net	$7.5	$—

See accompanying notes to condensed consolidated financial statements.

Armstrong Flooring, Inc. and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements

NOTE 1. BUSINESS AND BASIS OF PRESENTATION

Background

We are a leading global producer of flooring products for use primarily in the construction and renovation of residential, commercial and institutional buildings. We design, manufacture, source and sell resilient and wood flooring products in North America and the Pacific Rim.

On April 1, 2016, Armstrong Flooring, Inc. ("AFI") became an independent company as a result of the separation by Armstrong World Industries ("AWI"), a Pennsylvania corporation, of its Resilient Flooring and Wood Flooring segments from its Building Products ("Ceiling") segment (the "Separation"). The Separation was effected by allocating the assets and liabilities related primarily to the Resilient Flooring and Wood Flooring segments to AFI and then distributing the common stock of AFI to AWI’s shareholders (the "Distribution"). The Separation and Distribution (together, the "Spin-off") resulted in AFI and AWI becoming two independent, publicly traded companies, with AFI owning and operating the Resilient Flooring and Wood Flooring segments and AWI continuing to own and operate a ceilings business. When we refer to "AFI," "the Company," "we," "our," and "us" in this report, we are referring to Armstrong Flooring, Inc., a Delaware corporation, and its consolidated subsidiaries unless the context requires otherwise.

Basis of Presentation

Prior to April 1, 2016, AFI operated as a part of AWI. The financial information for these periods was prepared on a combined basis from AWI’s historical accounting records and is presented herein on a stand-alone basis as if the operations had been conducted independently of AWI. Beginning April 1, 2016, the financial information was prepared on a consolidated basis. The Condensed Consolidated Financial Statements of AFI presented are not indicative of our future performance, and do not necessarily reflect what our historical results of operations, financial position and cash flows would have been if we had operated as a separate, stand-alone entity during all reported periods.

For periods prior to April 1, 2016, AFI was comprised of certain stand-alone legal entities for which discrete financial information was available, as well as portions of legal entities for which discrete financial information was not available ("Shared Entities"). For the Shared Entities for which discrete financial information was not available, such as shared utilities, taxes, and other shared costs, allocation methodologies were applied to allocate amounts to AFI. The Condensed Consolidated Statements of Operations and Comprehensive Income for these periods include all revenues and costs attributable to AFI, including costs for facilities, functions and services used by AFI. The results of operations for those periods also include allocations of costs for administrative functions and services performed on behalf of AFI by centralized staff groups within AWI, AWI’s general corporate expenses and certain pension and other retirement benefit costs for those periods. All of the allocations and estimates in the Condensed Consolidated Financial Statements are based on assumptions that AFI management believes are reasonable. These statements should be read in conjunction with the Combined Financial Statements and Notes for the fiscal year ended December 31, 2015 (the "Combined Financial Statements") in our Information Statement, dated March 24, 2016 (the "Information Statement", filed as Exhibit 99.1 to our Current Report on Form 8-K dated March 24, 2016).

All charges and allocations of cost for facilities, functions and services performed by AWI prior to the Spin-off were deemed paid by AFI to AWI in cash, in the period in which the cost was recorded in the Condensed Consolidated Statements of Operations and Comprehensive Income (Loss). Prior to the Spin-off, transactions between AWI and AFI were accounted for through Net AWI investment.

Prior to the Spin-off, AFI’s portion of current income taxes payable was deemed to have been remitted to AWI in the period the related tax expense was recorded. AFI’s portion of current income taxes receivable was deemed to have been remitted to AFI by AWI in the period to which the receivable applies only to the extent that a refund of such taxes could have been recognized by AFI on a stand-alone basis under the law of the relevant taxing jurisdiction.

5

Armstrong Flooring, Inc. and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements

NOTE 1. BUSINESS AND BASIS OF PRESENTATION (continued)

These Condensed Consolidated Financial Statements are prepared in accordance with generally accepted accounting principles in the United States of America ("U.S. GAAP"). The statements include management estimates and judgments, where appropriate. Management uses estimates to record many items including certain asset values, allowances for bad debts, inventory obsolescence and lower of cost or market charges, warranty reserves, workers compensation, general liability and environmental claims and income taxes. When preparing an estimate, management determines the amount based upon the consideration of relevant information. Management may confer with outside parties, including outside counsel. Actual results may differ from these estimates. In the opinion of management, all adjustments of a normal, recurring nature have been included to provide a fair statement of the results for the reporting periods presented. Operating results for the three and nine months ended September 30, 2016 and 2015 included in this report are unaudited. Quarterly results are not necessarily indicative of annual earnings, primarily due to the different level of sales in each quarter of the year and the possibility of changes in economic conditions between periods.

The accounting policies used in preparing the Condensed Consolidated Financial Statements are the same as those used in preparing the Combined Financial Statements as disclosed in our Information Statement.

All significant intercompany transactions within AFI have been eliminated from the Condensed Consolidated Financial Statements.

The impact of the separation activities on equity is reflected in Net transfers from (to) AWI and Cash distribution paid to AWI on the Condensed Consolidated Statements of Stockholders' Equity. The components on the Condensed Consolidated Statements of Stockholders' Equity and the related cash flow were as follows:

	Nine Months Ended September 30, 2016	
(Dollars in millions)	Condensed Consolidated Statements of Stockholders' Equity	Condensed Consolidated Statements of Cash Flows - Financing Activities
Net transfers from AWI for the three months prior to separation	$53.6	$ 53.6
Net transfers (to) from AWI upon separation	(5.5)	9.0
Other activity concurrent with separation	—	(7.0)
	48.1	55.6
Cash distribution to AWI upon separation	(50.0)	(50.0)
Net transfers (to) from AWI	$(1.9)	$ 5.6

Recently Adopted Accounting Standards

In November 2015, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2015-17, "Balance Sheet Classification of Deferred Taxes." The guidance requires entities with a classified balance sheet to present all deferred tax assets and liabilities as noncurrent. The new guidance may be applied retrospectively or prospectively and is effective for annual reporting periods beginning after December 15, 2016, but early adoption is permitted. We adopted this standard effective April 1, 2016; the balance sheet as of December 31, 2015 was not retrospectively adjusted. Adoption of this standard did not impact our financial condition, results of operations or cash flows.

In March 2016, the FASB issued ASU 2016-09, "Improvements to Employee Share-Based Payment Accounting." The guidance simplifies accounting for share-based payments, most notably by requiring all excess tax benefits and tax deficiencies to be recorded as income tax benefits or expense on the statement of operations and by allowing entities

6

NOTE 1. BUSINESS AND BASIS OF PRESENTATION (continued)
to elect to recognize forfeitures of awards when they occur. The new guidance may be applied retrospectively or prospectively and is effective for annual reporting periods beginning after December 15, 2016, but early adoption is permitted. We adopted this guidance prospectively effective April 1, 2016. We elected to estimate forfeitures based on historical forfeiture activity, when appropriate depending on the number of award recipients. Adoption did not have a material impact on our financial condition, results of operations and cash flows.

Recently Issued Accounting Standards

In May 2014, the FASB issued ASU 2014-09 "Revenue from Contracts with Customers." The guidance requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to a customer. The ASU will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. In August 2015, the FASB issued ASU 2015-14, "Revenue from Contracts with Customers: Deferral of the Effective Date" which defers the effective date for ASU 2014-09 by one year. In March 2016, the FASB issued ASU 2016-08, "Principal versus Agent Considerations (Reporting Gross versus Net)," which clarifies the implementation guidance in ASU 2014-09 relating to principal versus agent considerations. In April 2016, the FASB issued ASU 2016-10, "Identifying Performance Obligations and Licensing," which clarifies guidance related to the impact of goods and services on a performance obligation and timing and pattern of recognition issues related to intellectual property contracts. In May 2016, the FASB issued ASU 2016-12, "Narrow-Scope Improvements and Practical Expedients," which clarify certain narrow provisions of ASU 2014-09. These Accounting Standards Codification (“ASC”) updates are effective for annual reporting periods beginning after December 15, 2017, but early adoption is permitted. We have not selected a transition method and are currently evaluating the impact these ASC updates will have on our financial condition, results of operations and cash flows.

In July 2015, the FASB issued ASU 2015-11, "Simplifying the Measurement of Inventory." The guidance requires that inventory that is measured on a first-in, first-out or average cost basis to be measured at lower of cost and net realizable value, as opposed to the lower of cost or market. For inventory that is measured under the last-in, first-out basis or the retail recovery method, there is no change to current measurement requirements. This new guidance must be applied prospectively and is effective for annual reporting periods beginning after December 15, 2016, but early adoption is permitted. We are currently evaluating the impact the adoption of this standard would have on our financial condition, results of operations and cash flows.

In January 2016, the FASB issued ASU 2016-01, "Recognition and Measurement of Financial Assets and Financial Liabilities." The guidance addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. Most notably, this new guidance requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. This new guidance is effective for annual reporting periods beginning after December 15, 2017. We are currently evaluating the impact the adoption of this standard would have on our financial condition, results of operations and cash flows.

In February 2016, the FASB issued ASU 2016-02, "Leases." The guidance amends accounting for leases, most notably by requiring a lessee to recognize the assets and liabilities that arise from a lease agreement. Specifically, this new guidance will require lessees to recognize a liability to make lease payments and a right-of-use asset representing its right to use the underlying asset for the lease term, with limited exceptions. The accounting applied by a lessor is largely unchanged from that applied under existing U.S. GAAP. This new guidance is effective for annual reporting periods beginning after December 15, 2018 and must be adopted under a modified retrospective basis. We are currently evaluating the impact the adoption of this standard would have on our financial condition, results of operations and cash flows.

Armstrong Flooring, Inc. and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements

NOTE 1. BUSINESS AND BASIS OF PRESENTATION (continued)
In June 2016, the FASB issued ASU 2016-13, "Measurement of Credit Losses on Financial Instruments." The guidance requires immediate recognition of estimated credit losses that are expected to occur over the remaining life of many financial assets. This new guidance is effective for annual and interim periods in fiscal years beginning after December 15, 2019, but early adoption is permitted for annual and interim periods in fiscal years beginning after December 15, 2018. We are currently evaluating the impact the adoption of this standard would have on our financial condition, results of operations and cash flows.

In October 2016, the FASB issued ASU 2016-16, "Intra-Entity Transfers of Assets Other Than Inventory." The guidance requires entities to recognize income tax consequences of many intercompany asset transfers other than inventory, at the transaction date. This new guidance is effective for annual and interim periods in fiscal years beginning after December 15, 2017. Early adoption is permitted but only at the beginning of an annual period. We are currently evaluating the impact the adoption of this standard would have on our financial condition, results of operations and cash flows.

NOTE 2. DISCONTINUED OPERATIONS
European Resilient Flooring
On December 4, 2014, AWI's Board of Directors approved the cessation of funding to its DLW subsidiary, which at the time was our European flooring business. As a result, DLW management filed for insolvency in Germany on December 11, 2014.
The DLW insolvency filing in December 2014 resulted in presenting DLW for all historical periods prior to the Separation as a discontinued operation. However, the insolvency filing did not meet the U.S. tax criteria to be considered disposed of until the first quarter of 2015. In determining the U.S. tax impact of the disposition, the liabilities, including an unfunded pension liability of approximately $115.0 million, were considered proceeds. However, pension deductions for tax purposes result only when the benefit payments are made. Accordingly, a deferred tax asset and non-cash income tax benefit of $43.4 million was recorded in the first quarter of 2015 within discontinued operations for the tax benefit of the future pension deductions. AWI is solely responsible for any shortfall, and the beneficiary of any excess, at the closure of the DLW insolvency proceedings. Therefore, DLW is excluded from our balance sheets, results of operations and cash flows after the Spin-off.
The following is a summary of the operating results of DLW, which are reflected in these Condensed Consolidated Financial Statements for periods prior to the Separation.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in millions)	2016	2015	2016	2015
Gain (loss) on disposal of discontinued operations before income tax	$ —	$ 0.5	$(0.1)	$(0.8)
Income tax benefit	—	0.6	1.8	44.2
Gain on disposal of discontinued operations, net of tax	$ —	$ 1.1	$1.7	$43.4

Armstrong Flooring, Inc. and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements

NOTE 3. RELATIONSHIP WITH AWI
Allocation of general corporate and other expenses
These Condensed Consolidated Financial Statements include expense allocations for certain functions provided by AWI, including, but not limited to finance, legal, information technology, and human resources, as well as pension expenses for periods prior to the Spin-off. In 2015, these expenses were allocated on the basis of direct usage when identifiable, with the remainder allocated on the basis of revenue, headcount, or other measures. Beginning in the first quarter of 2016, such expenses were incurred directly by our segments. No expenses were allocated to us after the Separation.
The presentation of these costs allocated to us by AWI in our Condensed Consolidated Statements of Operations and Comprehensive Income is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in millions)	2016	2015	2016	2015
Expense, net:				
Cost of goods sold	$ —	$ 2.6	$ —	$ 7.6
Selling, general and administrative expenses	—	10.2	0.5	24.7
Other expense, net	—	2.3	0.3	2.1
Total	$ —	$ 15.1	$ 0.8	$ 34.4

On April 1, 2016, in connection with the completion of the Separation, we entered into several agreements with AWI that provided for the Separation and allocation between AFI and AWI of the assets, employees, liabilities and obligations of AWI and its subsidiaries attributable to periods prior to, at and after the Separation. These agreements also govern the relationship between AFI and AWI subsequent to the completion of the Separation.

These agreements include a Transition Services Agreement, a Tax Matters Agreement, an Employee Matters Agreement, a Trademark License Agreement, a Transition Trademark Agreement and a Campus Lease Agreement.

Under the Transition Services Agreement, AFI and AWI will provide various services to each other, including information technology, accounts payable, payroll, and other financial functions and administrative services.

The Tax Matters Agreement generally governs AFI's and AWI's respective rights, responsibilities and obligations after the separation and distribution with respect to tax liabilities and benefits, tax attributes, the preparation and filing of tax returns, the control of audits and other tax proceedings, and other matters regarding taxes for any tax period ending on or before the distribution date, as well as tax periods beginning after the distribution date. In addition, the Tax Matters Agreement provides that AFI is liable for taxes incurred by AWI that may arise if AFI takes, or fails to take, certain actions that may result in the Separation, the Distribution or certain related transactions failing to qualify as tax-free for U.S. federal income tax purposes. AWI received an opinion from its tax counsel that the Separation qualified as a tax-free transaction for AWI and its shareholders.

The Employee Matters Agreement governs certain compensation and employee benefit obligations with respect to the current and former employees and non-employee directors of AFI and AWI. Pursuant to this agreement and in connection with the Distribution, AWI transferred assets and liabilities from defined benefit pension and postretirement plans (the “Shared Plans”) sponsored by AWI to AFI that relate to active AFI employees and certain former AFI employees to mirror plans established by AFI.

Armstrong Flooring, Inc. and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements

NOTE 3. RELATIONSHIP WITH AWI (continued)
Pursuant to the Trademark License Agreement, AWI provided AFI with a perpetual, royalty-free license to use the “Armstrong” trade name and logo.

Pursuant to the Transition Trademark License agreement, AFI provided AWI with a five-year royalty-free license to utilize the “Inspiring Great Spaces” tagline, logo and related color scheme.

Under the Campus Lease Agreement, AFI leased certain portions of AWI’s campus for use as AFI's corporate headquarters. The Campus Lease Agreement provides for an initial term of five years from April 1, 2016. Minimum rent expense is expected to be $1.4 million for the remaining three months of 2016, $5.6 million per annum for the years 2017 - 2020, and $1.4 million in 2021, notwithstanding any renewals or additional charges.

NOTE 4. INCOME TAXES

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in millions)	2016	2015	2016	2015
Income from continuing operations before income taxes	$13.2	$9.4	$17.9	$20.7
Income tax expense	4.9	1.6	8.2	8.0
Effective tax rate	37.1 %	17.0 %	45.8 %	38.6 %

The effective tax rates for the third quarter, as well as the first nine months of 2016, were higher versus the comparable 2015 periods primarily due to AFI operating as a part of AWI prior to April 1, 2016 and the geographic distribution of earnings.
Upon audit, taxing authorities may challenge all or part of an uncertain income tax position. While AFI has no history of tax audits on a stand-alone basis, AWI was routinely audited by U.S. federal, state and local, and non-U.S. taxing authorities. Accordingly, AFI regularly assesses the outcome of potential examinations in each of the taxing jurisdictions when determining the adequacy of the amount of unrecognized tax benefit recorded. We do not expect to record any material changes during 2016 to AFI's unrecognized tax benefits as of December 31, 2015.
As of September 30, 2016, we consider foreign unremitted earnings to be permanently reinvested.

Armstrong Flooring, Inc. and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements

NOTE 5. EARNINGS PER SHARE OF COMMON STOCK

The table below shows a reconciliation of the numerator and denominator for basic and diluted earnings per share calculations for the periods indicated.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in millions)	2016	2015	2016	2015
Numerator				
Income from continuing operations	$ 8.3	$ 7.8	$ 9.7	$ 12.7
Gain on disposal of discontinued operations, net tax	—	1.1	1.7	43.4
Net income	$ 8.3	$ 8.9	$ 11.4	$ 56.1
Denominator				
Weighted average number of common shares outstanding	27,792,041	27,738,779	27,755,439	27,738,779
Weighted average number of vested shares not yet issued	116,120	—	79,171	—
Weighted average number of common shares outstanding - Basic	27,908,161	27,738,779	27,834,610	27,738,779
Dilutive stock-based compensation awards outstanding	441,655	—	282,862	—
Weighted average number of common shares outstanding - Diluted	28,349,816	27,738,779	28,117,472	27,738,779

On April 1, 2016, AWI distributed 27,738,779 shares of AFI's common stock to AWI’s shareholders. Basic and diluted earnings per common share for the three and nine months ended September 30, 2015 were calculated using the shares distributed on April 1, 2016.

Diluted earnings per share is calculated using net income available to common stockholders divided by the diluted weighted average number of common shares outstanding during each period determined using the treasury stock method.

Performance-based employee compensation awards are considered potentially dilutive in the initial period in which the performance conditions are met. Performance awards representing 913,172 and 612,584 shares of restricted stock units for the three and nine months ended September 30, 2016, respectively, were excluded from the computation of diluted earnings per share as the performance conditions have not yet been met. Options to purchase zero and 130,451 shares of common stock for the three and nine months ended September 30, 2016, respectively, were excluded from the computation of diluted earnings per share calculated under the treasury stock method.

11

Armstrong Flooring, Inc. and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements

NOTE 6. ACCOUNTS AND NOTES RECEIVABLE
The following table presents accounts and note receivables, net of allowances:

(Dollars in millions)	As of September 30, 2016	December 31, 2015
Customer receivables	$97.7	$ 85.1
Miscellaneous receivables	9.5	4.9
Less: allowance for product warranties, discounts, and losses	(16.8)	(17.8)
Accounts and notes receivable, net	$90.4	$ 72.2

Generally, we sell our products to select, pre-approved customers whose businesses are affected by changes in economic and market conditions. We consider these factors and the financial condition of each customer when establishing our allowance for losses from doubtful accounts.
Allowance for product warranties represents expected reimbursements for cost associated with warranty repairs, the majority of which is provided to our independent distributors through a credit against accounts receivable from the distributor to AFI.

The following table summarizes the activity for the allowance for product warranties:

(Dollars in millions)	Nine Months Ended September 30, 2016	2015
Allowance for product warranties balance at beginning of period	$(7.3)	$(7.7)
Reductions for payments	8.0	7.8
Current year warranty accruals	(8.2)	(7.6)
Allowance for product warranties balance at end of period	$(7.5)	$(7.5)

NOTE 7. INVENTORIES
The following table presents details related to our inventories, net:

(Dollars in millions)	As of September 30, 2016	December 31, 2015
Finished goods	$149.5	$ 127.8
Goods in process	19.7	21.0
Raw materials and supplies	96.6	106.2
Less: LIFO and other reserves	(15.8)	(12.2)
Total inventories, net	$250.0	$ 242.8

Armstrong Flooring, Inc. and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements

NOTE 8. INTANGIBLE ASSETS

The following table details amounts related to our intangible assets:

		As of			
		September 30, 2016		December 31, 2015	
(Dollars in millions)	Estimated Useful Life	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortizing intangible assets					
Land use rights	Various	$5.3	$ 0.7	$ 5.4	$ 0.6
Developed technology	15 years	5.5	1.3	4.9	1.1
Other	Various	0.2	0.2	0.2	0.2
Total		11.0	$ 2.2	10.5	$ 1.9
Non-amortizing intangible assets					
Trademarks and brand names	Indefinite	34.1		34.0	
Total intangible assets		$45.1		$ 44.5	

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in millions)	2016	2015	2016	2015
Amortization expense	$0.1	$0.1	$0.3	$0.4

NOTE 9. ACCOUNTS PAYABLE AND ACCRUED EXPENSES

The following table details amounts related to our accounts payable and accrued expenses:

	As of	
(Dollars in millions)	September 30, 2016	December 31, 2015
Payables, trade and other	$120.3	$ 117.7
Employment costs	25.7	24.9
Other payables	16.9	18.4
Accounts payable and accrued expenses	$162.9	$ 161.0

NOTE 10. DEBT

On April 1, 2016, AFI entered into a $225.0 million asset-based revolving credit facility with a five-year maturity (“ABL Facility”). Concurrent with the closing of the ABL Facility, AFI borrowed $100.0 million and used $50.0 million of the proceeds to fund a cash distribution to AWI. Financing and other related costs incurred in connection with the ABL Facility of $1.4 million are reflected in Other non-current assets in the Condensed Consolidated Balance Sheets and are amortized over the term of the ABL Facility. As of September 30, 2016, the debt outstanding under the ABL Facility was $10.0 million and outstanding letters of credit were $1.8 million.

Due to its stated five-year maturity, this obligation is presented as a long-term obligation in our Condensed Consolidated Balance Sheets. However, AFI may repay this obligation at any time, without penalty.

NOTE 10. DEBT (continued)

Obligations under the ABL Facility are secured by qualifying accounts receivable, inventories, and select machinery and equipment of AFI's wholly owned domestic subsidiaries. The ABL Facility includes a $50.0 million sublimit for the issuance of standby letters of credit. Borrowings under the ABL Facility bear interest at a rate equal to an adjusted base rate or the London Interbank Offered Rate ("LIBOR") plus an applicable margin, which varies according to average excess credit availability and was 1.50% at September 30, 2016. We are required to pay a commitment fee, payable quarterly in arrears, on the average daily unused amount of the ABL Facility, which varies according to utilization and is currently 0.375%. Outstanding letters of credit issued under the ABL Facility are subject to fees which are due quarterly in arrears based on an adjusted base rate.

Under the terms of the ABL Facility, we are required to maintain a fixed charge coverage ratio of at least 1.0. As of September 30, 2016, availability under the ABL Facility exceeded the required threshold and, as a result, this covenant was not applicable. In addition, the ABL Facility contains customary negative covenants, including those that restrict our ability to allow certain liens to attach to assets, make certain acquisitions and investments, incur certain additional indebtedness, make certain fundamental changes to our structure, make certain dispositions, change the nature of our business, and enter into certain other transactions or agreements.

As of December 31, 2015, outstanding long-term debt of $10.0 million consisted of a tax-exempt industrial development bond, the repayment of which in the first quarter of 2016 is reflected within Net transfers from (to) AWI on the Condensed Consolidated Statements of Stockholders' Equity.

NOTE 11. DERIVATIVE FINANCIAL INSTRUMENTS

We are exposed to market risk from changes in foreign exchange rates that could impact our results of operations, cash flows and financial condition. We enter into derivative contracts, including contracts to hedge our foreign currency exchange rate exposures. Exposure to individual counterparties is controlled and derivative financial instruments are entered into with a diversified group of major financial institutions. Forward swap contracts are entered into for periods consistent with underlying exposure and do not constitute positions independent of those exposures. At inception, hedges designated as hedging instruments are formally documented as either (1) a hedge of a forecasted transaction or "cash flow" hedge, or (2) a hedge of the fair value of a recognized liability or asset or "fair value" hedge. Derivatives are formally assessed both at inception and at least quarterly thereafter, to ensure that derivatives used in hedging transactions are highly effective in offsetting changes in either the fair value or cash flows of the hedged item. If it is determined that a derivative ceases to be a highly effective hedge, or if the anticipated transaction is no longer probable of occurring, hedge accounting is discontinued, and any future mark-to-market adjustments are recognized in earnings. Derivative financial instruments are used as risk management tools and not for speculative trading purposes.

Counterparty Risk

We only enter into derivative transactions with established counterparties having a credit rating of BBB or better. Counterparty credit default swap levels and credit ratings are monitored on a regular basis. All of our derivative transactions with counterparties are governed by master International Swap and Derivatives Association agreements ("ISDAs") with netting arrangements. These agreements can limit exposure in situations where gain and loss positions are outstanding with a single counterparty. We neither post nor receive cash collateral with any counterparty for our derivative transactions. These ISDAs do not have any credit contingent features; however, a default under our ABL Facility would trigger a default under these agreements. Exposure to individual counterparties is controlled, and thus the risk of counterparty default is negligible.

Armstrong Flooring, Inc. and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements

NOTE 11. DERIVATIVE FINANCIAL INSTRUMENTS (continued)
Currency Rate Risk – Sales and Purchases
We manufacture and sell our products in a number of countries and, as a result, we are exposed to movements in foreign currency exchange rates. To a large extent, our global manufacturing and sales provide a natural hedge of foreign currency exchange rate movement, as foreign currency expenses generally offset foreign currency revenues. We manage our cash flow exposures on a net basis and use derivatives to hedge the majority of our unmatched foreign currency cash inflows and outflows. Before considering the impacts of any hedging, our major foreign currency exposures as of September 30, 2016, based on operating profits by currency, are from the Canadian Dollar, the Chinese Renminbi and the Euro.
We use foreign currency forward exchange contracts to reduce our exposure to the risk that the eventual net cash inflows and outflows resulting from the sale of products to foreign customers and purchases from foreign suppliers will be adversely affected by changes in exchange rates. These derivative instruments are used for forecasted transactions and are classified as cash flow hedges. These cash flow hedges are executed quarterly, generally up to 15 months forward. Gains and losses on these instruments are recorded in Other comprehensive income (loss), to the extent effective, until the underlying transaction is recognized in earnings. The mark-to-market gains or losses on ineffective portions of hedges are recognized in Selling, general and administrative expense. The earnings impact of the ineffective portion of these hedges was not material for the three and nine months ended September 30, 2016 and 2015.
Currency Rate Risk - Intercompany Loans and Dividends
We may use foreign currency forward exchange contracts to hedge exposures created by cross-currency intercompany loans and dividends. The translation adjustments related to these loans are recoded in Other expense, net. The offsetting gains and losses on the related derivative contracts are also recorded in Other expense, net. These contracts are decreased or increased as repayments are made or additional intercompany loans are extended or adjusted for intercompany dividend activity as necessary. The notional amount of these hedges was $22.3 million at September 30, 2016. We did not have any open hedges related to intercompany loans and dividends as of December 31, 2015.
Financial Statement Impacts
The following tables present amounts related to our derivatives designated as hedging instruments as of September 30, 2016 and December 31, 2015. Our derivative assets and derivative liabilities not designated as hedging instruments were immaterial at September 30, 2016 and December 31, 2015.
The following foreign exchange contracts outstanding are presented gross as we have not netted derivative assets with derivative liabilities:

	As of September 30, 2016			
(Dollars in millions)	Derivative Assets		Derivative Liabilities	
Balance Sheet Location	Fair Value	Notional	Fair Value	Notional
Prepaid expenses and other current assets	$0.2	$ 5.5	$ —	$ —
Accounts payable and accrued expenses	—	—	0.2	30.1

	As of December 31, 2015			
(Dollars in millions)	Derivative Assets		Derivative Liabilities	
Balance Sheet Location	Fair Value	Notional	Fair Value	Notional
Prepaid expenses and other current assets	$3.2	$ 29.7	$ —	$ —
Accounts payable and accrued expenses	—	—	0.3	5.2

15

Armstrong Flooring, Inc. and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements

NOTE 11. DERIVATIVE FINANCIAL INSTRUMENTS (continued)
The following tables summarize the amount of (loss) gain recognized in Accumulated Other Comprehensive (Loss) Income ("AOCI") and the amounts reclassified from AOCI for the effective portion of foreign exchange contracts:

	Recognized in AOCI			
	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in millions)	2016	2015	2016	2015
Cost of goods sold	$(0.1)	$0.6	$(0.4)	$0.1
Net sales	(0.1)	2.5	(1.1)	4.3
Total	$(0.2)	$3.1	$(1.5)	$4.4

	Reclassified from AOCI			
	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in millions)	2016	2015	2016	2015
Cost of goods sold	$—	$(0.1)	$(0.2)	$(0.6)
Net sales	0.2	1.3	1.6	3.4
Total	$0.2	$1.2	$1.4	$2.8

As of September 30, 2016, the amount of existing losses in AOCI expected to be recognized in earnings over the next twelve months is $0.1 million.

The amount of pre-tax loss recognized in earnings for derivative instruments not designated as hedging instruments was $0.2 million for the three and nine months ended September 30, 2016. There were no gains or losses from derivative instruments not designated as hedging instruments for the three and nine months ended September 30, 2015.

NOTE 12. FINANCIAL INSTRUMENTS
The estimated fair values of our financial instruments are as follows:

	As of September 30, 2016		December 31, 2015	
(Dollars in millions)	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
Total debt	$(10.0)	$ (10.0)	$(10.0)	$ (10.0)
Foreign currency contracts, net	—	—	2.9	2.9

Total debt at September 30, 2016 consisted of the outstanding borrowings under the ABL Facility. Borrowings under the ABL Facility are at variable market interest rates (Level 2 inputs) and accordingly, the carrying amount approximates fair value. Total debt at December 31, 2015 consisted of a $10.0 million variable rate tax-exempt industrial development bond.

The fair values of our net foreign currency contracts were estimated from market quotes, which are considered to be Level 1 inputs.

We do not have any assets or liabilities that are valued using Level 3 unobservable inputs.

Armstrong Flooring, Inc. and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements

NOTE 13. SEVERANCE EXPENSE

In the third quarter of 2016, we recorded $1.7 million of severance expense in Selling, general and administrative expenses related to the reorganization of certain administrative functions. This expense includes amounts related to the elimination of six positions, including the Chief Operating Officer position. Severance expense of $1.0 million and $0.7 million was recorded in our Resilient Flooring and Wood Flooring segments, respectively.

NOTE 14. PENSION AND OTHER POSTRETIREMENT BENEFIT PROGRAMS

For periods prior to April 1, 2016, certain of our North American employees participated in defined benefit pension and postretirement plans (the “Shared Plans”) sponsored by AWI. In addition, prior to April 1, 2016, certain of our U.S. employees participated in a postretirement medical benefit plan sponsored by us (the “AFI Postretirement Plan”). The related net benefit plan obligations of the Shared Plans were not included in our Condensed Consolidated Balance Sheets as we did not sponsor the Shared Plans and had no rights or obligations related to the Shared Plans’ assets or liabilities. Our Condensed Consolidated Statements of Operations and Comprehensive Income (Loss) include Shared Plan expenses for our active and retired employees as well as an allocation of Shared Plan expenses associated with corporate personnel. The Shared Plan expenses presented in our Condensed Consolidated Financial Statements represent the allocation of plan costs to AFI and do not represent cash payments to AWI or to the Shared Plans.

Effective April 1, 2016, upon separation from AWI, AFI created defined benefit pension and postretirement plans which provide North American employees and retirees who previously participated in the Shared Plans the same defined benefit pension and postretirement benefits that had been previously been provided by AWI. As a result of the Separation, and based on a preliminary analysis provided by our actuaries, AFI assumed defined benefit pension plan assets of approximately $350 million, defined benefit pension benefit obligations of approximately $385 million, defined benefit postretirement benefit obligations of approximately $83 million and accumulated other comprehensive income of approximately $102 million. AFI also retained the AFI Postretirement Plan described above. During the third quarter of 2016, final actuarial analysis determined that AFI will assume $380.9 million of defined benefit plan assets. Actuarial assumptions used for the AFI plans are the same as those used by AWI for the Shared Plans.

Armstrong Flooring, Inc. and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements

NOTE 14. PENSION AND OTHER POSTRETIREMENT BENEFIT PROGRAMS (continued)
The following table summarizes our pension and postretirement expense (income).

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in millions)	2016	2015	2016	2015
AFI Plans:				
Defined benefit pension, U.S.				
Service cost	$ 1.4	$ —	$ 2.9	$ —
Interest cost	3.9	—	7.8	—
Expected return on plan assets	(5.8)	—	(11.6)	—
Amortization of prior service cost	0.1	—	0.2	—
Amortization of net actuarial loss	2.6	—		