VECTOR GROUP LTD
Form 10-Q
November 14, 2006

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For The Quarterly Period Ended September 30, 2006

VECTOR GROUP LTD.
(Exact name of registrant as specified in its charter)

Delaware	**1-5759**	**65-0949535**
(State or other jurisdiction of incorporation or organization)	Commission File Number	(I.R.S. Employer Identification No.)

100 S.E. Second Street
Miami, Florida 33131
305/579-8000
(Address, including zip code and telephone number, including area code, of the principal executive offices)

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, as amended (the Exchange Act), 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.
þ Yes o No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.
o Large accelerated file þ Accelerated filer o Non-accelerated filer

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

At November 13, 2006, Vector Group Ltd. had 56,889,286 shares of common stock outstanding.

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VECTOR GROUP LTD. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Dollars in Thousands, Except Per Share Amounts)
Unaudited

	September 30, 2006	December 31, 2005 Restated[1]
ASSETS:		
Current assets:		
Cash and cash equivalents	$ 143,417	$ 181,059
Investment securities available for sale	24,485	18,507
Accounts receivable trade	8,494	12,714
Inventories	77,158	70,395
Deferred income taxes	27,344	26,179
Assets held for sale	1,437	
Other current assets	2,377	10,245
Total current assets	284,712	319,099
Property, plant and equipment, net	62,192	62,523
Long-term investments, net	32,934	7,828
Investments in non-consolidated real estate businesses	29,287	17,391
Restricted assets	8,528	6,743
Deferred income taxes	51,228	69,988
Intangible asset	107,511	107,511
Other assets	22,594	12,469
Total assets	$ 598,986	$ 603,552
LIABILITIES AND STOCKHOLDERS EQUITY:		
Current liabilities:		
Current portion of notes payable and long-term debt	$ 54,956	$ 9,313
Accounts payable	5,762	15,394
Accrued promotional expenses	14,697	18,317
Accrued taxes payable, net	10,504	32,392
Settlement accruals	34,600	22,505
Deferred income taxes	4,824	3,891
Accrued interest	2,506	5,770
Other accrued liabilities	18,321	20,518
Total current liabilities	146,170	128,100
Notes payable, long-term debt and other obligations, less current portion	103,418	238,242
Fair value of derivatives embedded within convertible debt	96,810	39,371

Non-current employee benefits		20,246		17,235
Deferred income taxes		127,461		145,892
Other liabilities		7,964		5,646
Commitments and contingencies				
Stockholders equity:				
Preferred stock, par value $1.00 per share, authorized 10,000,000 shares				
Common stock, par value $0.10 per share, authorized 100,000,000 shares, issued 59,691,870 and 53,417,525 shares and outstanding 56,887,956 and 49,849,735 shares		5,689		4,985
Additional paid-in capital		154,579		133,325
Unearned compensation				(11,681)
Accumulated deficit		(43,983)		(70,633)
Accumulated other comprehensive loss		(6,940)		(10,610)
Less: 2,803,914 and 3,567,790 shares of common stock in treasury, at cost		(12,428)		(16,320)
Total stockholders equity		96,917		29,066
Total liabilities and stockholders equity	$	598,986	$	603,552

(1) See Notes 1(i) and 2.

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

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VECTOR GROUP LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(Dollars in Thousands, Except Per Share Amounts)
Unaudited

	Three Months Ended		Nine Months Ended	
	Sept. 30, 2006	Sept. 30, 2005 Restated(1)	Sept. 30, 2006	Sept. 30, 2005 Restated(1)
Revenues*	$ 137,665	$ 124,965	$ 368,724	$ 342,251
Expenses:				
Cost of goods sold*	88,329	77,880	230,974	202,780
Operating, selling, administrative and general expenses	23,635	27,109	69,362	76,485
Operating income	25,701	19,976	68,388	62,986
Other income (expenses):				
Interest and dividend income	2,281	1,380	6,383	3,260
Interest expense	(10,779)	(8,141)	(27,795)	(22,363)
Change in fair value of derivatives embedded within convertible debt	(3,464)	1,131	(1,225)	2,258
Loss on extinguishment of debt	(1,306)		(16,166)	
Gain on investments, net	1,433	8	1,386	1,433
Gain from conversion of LTS notes				9,461
Equity in loss on operations of LTS				(299)
Equity income from non-consolidated real estate businesses	2,121	4,184	9,726	6,202
Other, net	81	13	158	69
Income from operations before (benefit) provision for income taxes and minority interests	16,068	18,551	40,855	63,007
Income tax (benefit) expense	(3,550)	7,727	13,934	30,018
Minority interests		(779)		(2,403)
Income from continuing operations	19,618	10,045	26,921	30,586
Discontinued operations:				
Income from discontinued operations, net of minority interests and taxes				82
Gain on disposal of discontinued operations, net of minority interests and taxes				2,952
Income from discontinued operations				3,034

Net income	$	19,618	$	10,045	$	26,921	$	33,620
Per basic common share:								
Income from continuing operations	$	0.33	$	0.22	$	0.47	$	0.67
Income from discontinued operations	$		$		$		$	0.06
Net income applicable to common shares	$	0.33	$	0.22	$	0.47	$	0.73
Per diluted common share:								
Income from continuing operations	$	0.32	$	0.21	$	0.46	$	0.63
Income from discontinued operations	$		$		$		$	0.06
Net income applicable to common shares	$	0.32	$	0.21	$	0.46	$	0.69
Cash distributions declared per share	$	0.38	$	0.36	$	1.14	$	1.09

* Revenues and Cost of goods sold include excise taxes of $48,153, $42,413, $127,956 and $112,856, respectively.

(1) See Notes 1(i) and 2.

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

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VECTOR GROUP LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY
(Dollars in Thousands, Except Per Share Amounts)
Unaudited

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Accumulated Deficit	Unearned Compensation	Treasury Stock	Accumulated Other Comprehensive Loss	Total
Balance, December 31, 2005, restated[1]	49,849,735	$ 4,985	$ 133,325	$ (70,633)	$ (11,681)	$ (16,320)	$ (10,610)	$ 29,066
Net income				26,921				26,921
Forward contract adjustments, net of taxes							227	227
Unrealized gain on investment securities, net of taxes							3,443	3,443
Total other comprehensive income								3,670
Total comprehensive income								30,591
Reclassifications in accordance with SFAS No. 123(R)			(11,681)		11,681			
Effect of stock dividend	2,708,295	271		(271)				
Distributions on common stock			(68,071)					(68,071)
Exercise of options, net of 19,302 shares delivered to pay exercise price	129,926	13	1,587			(371)		1,229
Conversion of debt	4,200,000	420	79,522			4,263		84,205
Beneficial conversion feature associated			16,833					16,833

with issuance of convertible debt, net of taxes								
Amortization of deferred compensation			3,064					3,064
Balance, September 30, 2006	56,887,956	$ 5,689	$ 154,579	$ (43,983)	$	$ (12,428)	$ (6,940)	$ 96,917

(1) See Notes 1(i) and 2.

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

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VECTOR GROUP LTD. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in Thousands, Except Per Share Amounts)
Unaudited

	Nine Months Ended Sept. 30, 2006	Nine Months Ended Sept. 30, 2005 Revised(1)
Net cash provided by operating activities	$ 14,985	$ 28,136
Cash flows from investing activities:		
Proceeds from sale or maturity of investment securities	13,467	3,268
Purchase of investment securities	(12,339)	(500)
Proceeds from sale or liquidation of long-term investments	205	
Purchase of long-term investments	(25,266)	(128)
Investments in non-consolidated real estate businesses	(7,350)	(6,250)
Distributions from non-consolidated real estate businesses		5,500
Increase in restricted assets	(1,777)	(842)
Issuance of LTS common stock		(1,500)
Issuance of LTS notes		(1,750)
Capital expenditures	(8,948)	(5,164)
Proceeds from sale of property, plant and equipment	159	
Discontinued operations		66,912
Net cash (used in) provided by investing activities	(41,849)	59,546
Cash flows from financing activities:		
Proceeds from issuance of notes payable and long-term debt	118,146	44,959
Repayments of notes payable and long-term debt	(67,993)	(3,542)
Borrowings under revolver	390,610	328,086
Repayments on revolver	(380,052)	(319,359)
Distributions on common stock	(67,438)	(50,326)
Issuance of restricted stock		63
Proceeds from exercise of options	1,229	2,778
Deferred financing charges	(5,280)	(2,168)
Discontinued operations		(39,213)
Net cash used in financing activities	(10,778)	(38,722)
Net (decrease) increase in cash and cash equivalents	(37,642)	48,960
Cash and cash equivalents, beginning of period	181,059	110,004
Cash and cash equivalents, end of period	$ 143,417	$ 158,964

(1) See Note 1(a).

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

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VECTOR GROUP LTD.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Presentation:

The consolidated financial statements of Vector Group Ltd. (the Company or Vector) include the accounts of VGR Holding LLC (VGR Holding), Liggett Group LLC (Liggett), Vector Tobacco Inc. (Vector Tobacco), Liggett Vector Brands Inc. (Liggett Vector Brands), New Valley LLC (New Valley) and other less significant subsidiaries. The Company owned all of the limited liability company interests of New Valley at September 30, 2006 and owned 57.7% of the common shares of its corporate predecessor, New Valley Corporation, at September 30, 2005. All significant intercompany balances and transactions have been eliminated.

Liggett is engaged in the manufacture and sale of cigarettes in the United States. Vector Tobacco is engaged in the development and marketing of low nicotine and nicotine-free cigarette products and the development of reduced risk cigarette products. New Valley is engaged in the real estate business and is seeking to acquire additional operating companies and real estate properties.

As discussed in Note 14, New Valley s real estate leasing operations, sold in February 2005, are presented as discontinued operations for the nine months ended September 30, 2005. The 2005 interim condensed consolidated statement of cash flows has been revised to separately disclose the operating, investing and financing portions of the cash flows attributable to discontinued operations. These amounts had previously been reported on a combined basis as a separate caption outside operating, financing and investing activities.

The interim consolidated financial statements of the Company are unaudited and, in the opinion of management, reflect all adjustments necessary (which are normal and recurring) to state fairly the Company s consolidated financial position, results of operations and cash flows. These consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company s amended Annual Report on Form 10-K, as amended, for the year ended December 31, 2005, which will be further amended as discussed in Note 2. The consolidated results of operations for interim periods should not be regarded as necessarily indicative of the results that may be expected for the entire year.

The Company has reclassified $1,678 of equipment deposits made in the fourth quarter of 2005 from Other assets to Restricted assets on its December 31, 2005 consolidated balance sheet to conform to current year presentation. This change in classification did not affect the Company s consolidated statements of operations or cash flows for the three and nine months ended September 30, 2006 and 2005 or its statement of stockholders equity as of September 30, 2006 and December 31, 2005.

VECTOR GROUP LTD.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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(Unaudited)

(b) Estimates and Assumptions:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities and the reported amounts of revenues and expenses. Significant estimates subject to material changes in the near term include restructuring and impairment charges, inventory valuation, deferred tax assets, allowance for doubtful accounts, promotional accruals, sales returns and allowances, actuarial assumptions of pension plans, embedded derivative liability, the tobacco quota buy-out, settlement accruals and litigation and defense costs. Actual results could differ from those estimates.

(c) Share-Based Payments:

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment using the modified prospective method with guidance provided by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure. Under the modified prospective method, the share-based compensation cost recognized beginning January 1, 2006 includes compensation cost for (i) all share-based payments granted prior to, but not vested as of, January 1, 2006, based on the grant date fair value originally estimated in accordance with the provisions of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS No. 123) and (ii) all share-based payments granted subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). Compensation cost is recognized ratably using the straight-line attribution method over the expected vesting period. In addition, pursuant to SFAS No. 123(R), the Company is required to estimate the amount of expected forfeitures when calculating the compensation costs, instead of accounting for forfeitures as incurred, which was the Company s previous method. As of January 1, 2006, the cumulative effect of adopting the estimated forfeiture method was not significant. Prior periods are not restated under this transition method (see Note 10).

(d) Earnings Per Share:

Information concerning the Company s common stock has been adjusted to give effect to the 5% stock dividends paid to Company stockholders on September 29, 2006 and September 29, 2005. The dividend was recorded at par value of $271 in 2006 since the Company had an accumulated deficit. In connection with the 5% stock dividends, the Company increased the number of outstanding stock options by 5% and reduced the exercise prices accordingly. All per share amounts have been presented as if the stock dividends had occurred on January 1, 2005.

In March 2004, the FASB s Emerging Issue Task Force (EITF) reached a final consensus on Issue No. 03-6, Participating Securities and the Two-Class Method under FASB Statement 128 , which established standards regarding the computation of earnings per share (EPS) by companies that have issued securities other than common stock that contractually entitle the holder to participate in dividends and earnings of the company. Earnings available to common stockholders for the period are reduced by the contingent interest associated with the Company s convertible notes issued in 2004, 2005 and 2006. The convertible debt issued by the Company in 2004, 2005 and 2006, which are a participating security due to the contingent interest feature, had no impact on EPS for the nine months ended September 30, 2006 and 2005, as the dividends on the common stock into which the debt is convertible increased

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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interest expense and reduced earnings available to common stockholders so there were no unallocated earnings under EITF Issue No. 03-6.

As discussed in Note 10, the Company has stock option awards which provide for common stock dividend equivalents at the same rate as paid on the common stock with respect to the shares underlying the unexercised portion of the options. These outstanding options represent participating securities under EITF Issue No. 03-6. Because the Company accounted for the dividend equivalent rights on these options as additional compensation cost in accordance with APB Opinion No. 25, these participating securities had no impact on the calculation of basic EPS in periods ending prior to January 1, 2006. Effective with the adoption of SFAS No. 123(R) on January 1, 2006, the Company recognizes payments of the dividend equivalent rights ($1,578 and $4,734 for the three and nine months ended September 30, 2006, respectively) on these options as reductions in additional paid-in capital on the Company s consolidated balance sheet. As a result, in its calculation of basic EPS for the three and nine months ended September 30, 2006, the Company has adjusted its net income for the effect of these participating securities as follows:

	Three Months Ended Sept. 30, 2006	Nine Months Ended Sept. 30, 2006
Net income	$ 19,618	$ 26,921
Income attributable to participating securities	(1,330)	(1,871)
Net income available to common stockholders	$ 18,288	$ 25,050

Basic EPS is computed by dividing net income available to common stockholders by the weighted-average number of shares outstanding, which includes vested restricted stock. Diluted EPS includes the dilutive effect of stock options and unvested restricted stock grants. Basic and diluted EPS were calculated using the following shares for the three and nine months ended September 30, 2006 and 2005:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Weighted-average shares for basic EPS	56,207,561	46,300,534	53,533,407	46,188,907
Plus incremental shares related to stock options and unvested restricted stock grants	1,390,841	2,551,052	1,449,170	2,224,312
Weighted-average shares for diluted EPS	57,598,402	48,851,586	54,982,577	48,413,219

The following stock options, non-vested restricted stock and shares issuable upon the conversion of convertible debt were outstanding during the three and nine months ended September 30, 2005 and the three and nine months ended September 30, 2006 but were not included in the computation of diluted EPS because the exercise prices of the options and the per share expense associated with the restricted stock were greater than the average market price of the common shares during the respective periods, and the impact of common shares issuable under the convertible debt were anti-dilutive to EPS.

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Number of stock options	603,129	490,902	509,328	592,023
Weighted-average exercise price	$20.28	$30.11	$21.06	$27.47
Weighted-average shares of non- vested restricted stock	635,236	17,120	651,746	5,769
Weighted-average expense per share	$18.73	$18.62	$18.72	$18.62
Weighted-average number of shares issuable upon conversion of debt	12,560,900	12,442,446	12,491,732	11,189,838
Weighted-average conversion price	$18.95	$20.09	$18.99	$20.39

(e) Comprehensive Income:

Other comprehensive income is a component of stockholders equity and includes such items as the unrealized gains and losses on investment securities available for sale, forward foreign contracts and minimum pension liability adjustments. Total comprehensive income for the three and nine months ended September 30, 2006 and

2005 is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005 Restated	2006	2005 Restated
Net income	$ 19,618	$ 10,045	$ 26,921	$ 33,620
Forward contract adjustments, net of income taxes	(50)	(121)	227	(543)
Net unrealized gains on investment securities available for sale:				
Change in net unrealized gains, net of income taxes	553	6	4,293	736
Net unrealized gains reclassified into net income, net of income taxes	(878)	(6)	(850)	(925)
Change in unrealized gains, net of income taxes	(325)		3,443	(189)
Total comprehensive income	$ 19,243	$ 9,924	$ 30,591	$ 32,888

The components of accumulated other comprehensive loss were as follows as of September 30, 2006 and December 31, 2005:

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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	September 30, 2006	December 31, 2005
Net unrealized gains on investment securities available for sale	$ 4,071	$ 628
Forward contracts adjustment	(372)	(599)
Additional pension liability	(10,639)	(10,639)
Accumulated other comprehensive loss	$ (6,940)	$ (10,610)

(f) Financial Instruments:

As required by SFAS No. 133, derivatives embedded within the Company s convertible debt are recognized on the Company s balance sheet and are stated at estimated fair value as determined by a third party at each reporting period. Changes in the fair value of the embedded derivatives are reflected within the Company s consolidated statements of operations as Change in fair value of derivatives embedded within convertible debt.

The Company uses forward foreign exchange contracts to mitigate its exposure to changes in exchange rates relating to purchases of equipment from third parties. The primary currency to which the Company is exposed is the Euro. A substantial portion of the Company s foreign exchange contracts is effective as hedges. The fair value of forward foreign exchange contracts designated as hedges is reported in other current assets or current liabilities and the change in fair value of the contracts during the period is recorded in other comprehensive income. The fair value of the forward foreign exchange contracts at September 30, 2006 was a liability of approximately $9.

(g) Revenue Recognition:

Revenues from sales are recognized upon the shipment of finished goods when title and risk of loss have passed to the customer, there is persuasive evidence of an arrangement, the sale price is determinable and collectibility is reasonably assured. The Company provides an allowance for expected sales returns, net of any related inventory cost recoveries and recoverable excise taxes. Certain sales incentives, including buydowns, are classified as reductions of net sales in accordance with EITF Issue No. 01-9, Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products) . In accordance with EITF Issue No. 06-3, How Sales Taxes Should be Presented in the Income Statement (Gross versus Net) , the Company s accounting policy is to include federal excise taxes in revenues and cost of goods sold. Such revenues totaled $48,153 and $127,956 for the three and nine months ended September 30, 2006 and $42,413 and $112,856 for the three and nine months ended September 30, 2005, respectively. Since the Company s primary line of business is tobacco, the Company s financial position and its results of operations and cash flows have been and could continue to be materially adversely affected by significant unit sales volume declines, litigation and defense costs, increased tobacco costs or reductions in the selling price of cigarettes in the near term.

(h) Contingencies:

The Company records Liggett s product liability legal expenses and other litigation costs as operating, selling, general and administrative expenses as those costs are incurred. As

VECTOR GROUP LTD.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in Thousands, Except Per Share Amounts) (Continued)
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discussed in Note 8, legal proceedings covering a wide range of matters are pending or threatened in various jurisdictions against Liggett.

The Company records provisions in the consolidated financial statements for pending litigation when it determines that an unfavorable outcome is probable and the amount of the loss can be reasonably estimated. Except as discussed in Note 8, (i) management has not concluded that it is probable that a loss has been incurred in any of the pending smoking-related litigation; (ii) management is unable to make a meaningful estimate of the amount or range of loss that could result from an unfavorable outcome of pending smoking-related litigation; and (iii) accordingly, management has not provided any amounts in the consolidated financial statements for unfavorable outcomes, if any. Litigation is subject to many uncertainties, and it is possible that the Company s consolidated financial position, results of operations or cash flows could be materially adversely affected by an unfavorable outcome in any such smoking-related litigation.

(i) New Accounting Pronouncements:

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3 . SFAS No. 154 changes the requirements for the accounting for, and reporting of, a change in accounting principle. The provisions of SFAS No. 154 require, unless impracticable, retrospective application to prior periods financial statements of (i) all voluntary changes in accounting principles and (ii) changes required by a new accounting pronouncement, if a specific transition is not provided. SFAS No. 154 also requires that a change in depreciation, amortization, or depletion method for long-lived, non-financial assets be accounted for as a change in accounting estimate, which requires prospective application of the new method. SFAS No. 154 is effective for all accounting changes made in fiscal years beginning after December 15, 2005. The current period impact of the application of SFAS No. 154 is discussed below in connection with the application of EITF Issue No. 05-8, Income Tax Effects of Issuing Convertible Debt with a Beneficial Conversion Feature .

In March 2005, the FASB issued Interpretation No. 47, Accounting for Conditional Asset Retirement Obligations an Interpretation of SFAS Statement No. 143 (FIN 47). FIN 47 clarifies the timing of liability recognition for legal obligations associated with the retirement of a tangible long-lived asset when the timing and/or method of settlement are conditional on a future event. FIN 47 is effective for fiscal years ending after December 15, 2005. The application of FIN 47 did not have a material impact on the Company s consolidated financial position, results of operations or cash flows.

In September 2005, the EITF reached a consensus on Issue No. 04-13, Inventory Exchanges . EITF Issue No. 04-13 required two or more inventory transactions with the same party to be considered a single nonmonetary transaction subject to APB Opinion No. 29, Accounting for Nonmonetary Transactions , if the transactions were entered into in contemplation of one another. EITF Issue No. 04-13 is effective for the Company for new arrangements entered into after April 2, 2006. The adoption of EITF Issue No. 04-13 did not have a material impact on the Company s financial position, results of operations or cash flows.

Effective January 1, 2006, the Company adopted EITF Issue No. 05-8, Income Tax Effects of Issuing Convertible Debt with a Beneficial Conversion Feature. In Issue No. 05-8, the EITF concluded that the issuance of convertible debt with a beneficial conversion feature creates a temporary difference on which deferred taxes should be provided. The consensus is required to be applied in fiscal periods beginning after December 15, 2005, by retroactive restatement of

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prior financial statements retroactive to the issuance of the convertible debt. The adoption of EITF Issue No. 05-8 reduced income tax expense by $267 and $585 for the three and nine months ended September 30, 2006, respectively. The retrospective application of EITF Issue No. 05-8 reduced income tax expense by $114 and $309 for the three and nine months ended September 30, 2005, respectively. A reconciliation of the net impact of the application of EITF Issue No. 05-8 at December 31, 2005 on the Company s consolidated balance sheet is as follows:

	Long-Term Deferred Income Taxes	Additional Paid-in Capital	Accumulated Deficit	Stockholders Equity
December 31, 2005, as restated, prior to adoption of EITF 05-8	$ 137,381	$ 141,184	$ (69,981)	$ 37,577
Application of EITF 05-8:				
Establishment of deferred tax liability	7,859	(7,859)		(7,859)
Increase to income tax benefit for the year ended December 31, 2004	(27)		27	27
Decrease to income tax expense for the year ended December 31, 2005	(406)		406	406
Decrease to extraordinary item, unallocated goodwill	1,085		(1,085)	(1,085)
Revised balance, as restated, December 31, 2005	$ 145,892	$ 133,325	$ (70,633)	$ 29,066

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Instruments . SFAS No. 155 amends SFAS Nos. 133 and 140 and relates to the financial reporting of certain hybrid financial instruments. SFAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of fiscal years commencing after September 15, 2006. The Company has not completed its assessment of the impact of this standard on its consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (an interpretation of FASB Statement No. 109) , which is effective for fiscal years beginning after December 15, 2006 with earlier adoption encouraged. This interpretation was issued to clarify the accounting for uncertainty in income taxes recognized in the financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company has not completed its assessment of the impact of this standard on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements , which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS No. 157 clarifies that fair value should be based on assumptions

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that market participants would use when pricing an asset or liability and establishes a fair value hierarchy of three levels that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data. SFAS No. 157 requires fair value measurements to be separately disclosed by level within the fair value hierarchy. The provisions of SFAS No. 157 will become effective for the Company beginning January 1, 2008. Generally, the provisions of this statement are to be applied prospectively. Certain situations, however, require retrospective application as of the beginning of the year of adoption through the recognition of a cumulative effect of accounting change. Such retrospective application is required for financial instruments, including derivatives and certain hybrid instruments with limitations on initial gains or losses under EITF Issue No. 02-3, Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities . The Company has not completed its assessment of the impact of this standard on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans. SFAS No. 158 requires an employer to recognize the overfunded or underfunded status of their benefit plans as an asset or liability in its balance sheet and to recognize changes in that funded status in the year in which the changes occur as a component of other comprehensive income. The funded status is measured as the difference between the fair value of the plan s assets and its benefit obligation. In addition, SFAS No. 158 requires an employer to measure benefit plan assets and obligations that determine the funded status of a plan as of the end of its fiscal year. The Company presently measures the funded status of its plans at September 30 and the new measurement date requirements become effective for the Company for the year ended December 31, 2008. The prospective requirement to recognize the funded status of a benefit plan and to provide the required disclosures will become effective for the Company on December 31, 2006. The adoption of SFAS No. 158 will have no impact on the Company s results of operations or cash flows. Based on the funded status of the Company s pension and postretirement benefit plans as reported in its December 31, 2005 Annual Report on Form 10-K, the adoption of SFAS No. 158 will result in a $1,398 reduction of Non-current employee benefits, which is included in other liabilities, a $534 reduction of Deferred income taxes, which is included in other assets, and an $864 decrease to Accumulated Other Comprehensive Loss, which is included in stockholders equity. The ultimate impact is contingent on plan asset returns and the assumptions that will be used to measure the funded status of each of the Company s pension and postretirement benefit plans as of December 31, 2006.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year s financial statements are materially misstated. The provisions of SAB 108 are required to be applied beginning December 31, 2006. The Company does not expect the adoption of SAB 108 to impact its consolidated financial statements.

2. RESTATEMENT OF FINANCIAL RESULTS

On November 9, 2006, the Company determined that it would restate its financial statements for each of the years ended December 31, 2004 and 2005, and selected financial data for each of the years 2004 and 2005 appearing in Item 6 of its Annual Report on Form 10-K, as amended, for the year ended December 31, 2005, as well as its interim financial statements for the quarters ended March 31, 2005 and 2006, June 30, 2005 and 2006, and September 30, 2005. The restatement will correct an error in the computation of the amortization of the debt discount created by the embedded derivative and the beneficial conversion feature associated with the Company s 5% variable interest senior convertible notes due 2011. The restatement adjustments affected the Company s previously reported interest expense, the related income tax effect, and extraordinary items, as well as the Company s previously reported deferred financing costs, long-term debt, additional paid-in-capital and accumulated deficit balances. The effects of the restatement are reflected in the Company s consolidated financial statements and accompanying notes included herein. See Note 16

Restated Financial Information. See also Notes 1, 2, 7, 10, 11 and 13 to the consolidated financial statements. All periods presented are unaudited.

The aggregate net effect of the restatement was to increase stockholders equity by $4,781 as of June 30, 2006, $4,142 as of March 31, 2006, $3,422 as of December 31, 2005 and $336 as of December 31, 2004. The restatement also increased net income for the three months ended March 31, 2006 and 2005 by $720 ($0.01 per diluted common share) and $731 ($0.01 per diluted common share), respectively, and decreased net loss for the three months ended June 30, 2006 by $639 ($0.01 per diluted common share) and increased net income for the three months ended June 30, 2005 by $1,071 ($0.02 per diluted common share). In addition, the restatement adjustments increased net income for the six months ended June 30, 2006 and 2005 by $1,359 ($0.03 per diluted common share) and $1,802 ($0.04 per diluted common share), respectively. The restatement increased net income for the three months ended September 30, 2005 by $810 ($0.02 per diluted common share) and increased net income for the nine months ended September 30, 2005 by $2,612 ($0.05 per diluted common share). Further, the restatement increased net income by $3,291 ($0.08 per diluted common share) and $336 ($0.01 per diluted common share) for the years ended December 31, 2005 and 2004, respectively.

The restatement adjustments will correct the previous amortization method used in calculating the amortization of the debt discount created by the embedded derivative and beneficial conversion feature associated with the Company s 5% variable interest senior convertible notes due 2011. The Company previously amortized the debt discount on its 5% variable interest senior convertible notes due 2011 using an erroneous amortization method that did not result in a consistent yield on the convertible debt over its term.

The revised financial statements and selected financial data for the periods referenced above will be included, as applicable, in an amended Annual Report on Form 10-K, as amended, for the year ended December 31, 2005, and in amended Quarterly Reports on Form 10-Q for the quarters ended March 31, 2006 and June 30, 2006. The revised interim financial statements for the quarter ended September 30, 2005 have been included within this Quarterly Report on Form 10-Q for the quarter ended September 30, 2006. The Company expects to file the amended documents as promptly as practicable. Until the Company files the amended filings, its previously published financial statements relating to these periods and not covered in this Form 10-Q should not be relied upon.

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3. RESTRUCTURING

The components of the combined pre-tax restructuring charges relating to the 2004 Liggett Vector Brands restructurings for the nine months ended September 30, 2006 are as follows:

	Employee Severance and Benefits	Contract Termination/ Exit Costs	Total
Balance, December 31, 2005	$ 713	$ 1,403	$ 2,116
Utilized	(514)	(420)	(934)
Balance, September 30, 2006	$ 199	$ 983	$ 1,182

4. INVESTMENT SECURITIES AVAILABLE FOR SALE

Investment securities classified as available for sale are carried at fair value, with net unrealized gains or losses included as a component of stockholders equity, net of taxes and minority interests. For the three and nine months ended September 30, 2006 and 2005, net realized gains were $1,433, $8, $1,386 and $1,433 respectively.

The components of investment securities available for sale and the associated gross unrealized gains and losses, before income tax effect, at September 30, 2006 are as follows:

	Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value
Marketable equity securities	$ 10,106	$ 7,847	$ 935	$ 17,018
Marketable debt securities	7,517	7	57	7,467
	$ 17,623	$ 7,854	$ 992	$ 24,485

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Marketable equity securities available for sale as of September 30, 2006 include New Valley s 11,111,111 shares of Ladenburg Thalmann Financial Services Inc., which were carried at $11,667 (see Note 12).

The Company s marketable debt securities have a weighted average maturity of 1.65 years at September 30, 2006 and mature from October 2006 to March 2010.

5. INVENTORIES

Inventories consist of:

	September 30, 2006	December 31, 2005
Leaf tobacco	$ 33,937	$ 35,312
Other raw materials	3,214	3,157
Work-in-process	1,076	1,685
Finished goods	42,797	34,653
Inventories at cost	81,024	74,807
LIFO adjustments	(3,866)	(4,412)
	$ 77,158	$ 70,395

The Company has a leaf inventory management program whereby, among other things, it is committed to purchase certain quantities of leaf tobacco. The purchase commitments are for quantities not in excess of anticipated requirements and are at prices, including carrying costs, established at the date of the commitment. At September 30, 2006, Liggett had leaf tobacco purchase commitments of approximately $10,742. There were no leaf tobacco purchase commitments at Vector Tobacco at that date.

Included in the above table was approximately $1,041 at September 30, 2006 and $1,208 at December 31, 2005 of leaf inventory associated with Vector Tobacco s QUEST product, which is carried at its estimated net realizable value.

LIFO inventories represent approximately 95% of total inventories at September 30, 2006 and 92% of total inventories at December 31, 2005.

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6. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consist of:

	September 30, 2006	December 31, 2005
Land and improvements	$ 1,418	$ 1,418
Buildings	13,732	13,718
Machinery and equipment	97,299	98,037
Leasehold improvements	3,226	2,724
Construction-in-progress	7,136	2,960
	122,811	118,857
Less accumulated depreciation	(60,619)	(56,334)
	$ 62,192	$ 62,523

Depreciation and amortization expense on property, plant and equipment for the three and nine months ended September 30, 2006 was $2,486 and $7,477, respectively. Depreciation and amortization expense on property, plant and equipment for the three and nine months ended September 30, 2005 was $2,737 and $8,281, respectively. Future machinery and equipment purchase commitments at Liggett were $1,107 at September 30, 2006.

During the second quarter of 2006, Liggett Vector Brands recognized an impairment charge of $324 associated with its decision to dispose of an asset to an unrelated third party. As a result, the Company has classified this asset with a net book value at September 30, 2006 of $1,325 within Assets held for sale in its consolidated balance sheet at September 30, 2006.

The Company has also included equipment with a net book value of $112, which was owned and held for sale by Liggett at September 30, 2006, within Assets held for sale in its consolidated balance sheet at September 30, 2006.

In February 2005, New Valley completed the sale of its two office buildings in Princeton, New Jersey for $71,500. (Refer to Notes 12 and 14). The Company recorded a gain of $2,952, net of minority interests and income taxes, in the first quarter of 2005 in connection with the sale.

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7. NOTES PAYABLE, LONG-TERM DEBT AND OTHER OBLIGATIONS

Notes payable, long-term debt and other obligations consist of:

	September 30, 2006	December 31, 2005 (Restated)
Vector:		
3.875% Variable Interest Senior Convertible Debentures due 2026, net of unamortized net discount of $83,862*	$ 26,138	$
5% Variable Interest Senior Convertible Notes due 2011, net of unamortized net discount of $55,261 and $58,655*	56,603	53,209
6.25% Convertible Subordinated Notes due 2008		132,492
Liggett:		
Revolving credit facility	10,558	
Term loan under credit facility	3,095	3,482
Equipment loans	14,200	9,828
Vector Tobacco:		
Notes payable Medallion acquisition due 2007	35,000	35,000
V.T. Aviation:		
Note payable	7,681	8,300
VGR Aviation:		
Note payable	4,719	4,867
Other	380	377
Total notes payable, long-term debt and other obligations	158,374	247,555
Less:		
Current maturities	(54,956)	(9,313)
Amount due after one year	$ 103,418	$ 238,242

* The fair value of the derivatives embedded within the 3.875% Variable Interest

Senior Convertible Debentures ($58,313 at September 30, 2006) and the 5% Variable Interest Senior Convertible Notes ($38,497 at September 30, 2006 and $39,371 at December 31, 2005) is separately classified as a derivative liability in the consolidated balance sheets.

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Variable Interest Senior Convertible Debt Vector:

Vector has issued two series of variable interest senior convertible debt. Both series of debt pay interest on a quarterly basis at a stated rate plus an additional amount of interest on each payment date. The additional amount is based on the amount of cash dividends paid during the prior three-month period ending on the record date for such interest payment multiplied by the total number of shares of its common stock into which the debt will be convertible on such record date (the Additional Interest).

The Company has filed a registration statement with respect to the resale of both series of its variable interest senior debt and the common stock issuable upon conversion of the debt.

3.875% Variable Interest Senior Convertible Debentures due 2026:

In July 2006, the Company sold $110,000 of its 3.875% variable interest senior convertible debentures due 2026 in a private offering to qualified institutional buyers in accordance with Rule 144A under the Securities Act of 1933. The Company used the net proceeds of the offering to redeem its remaining 6.25% convertible subordinated notes due 2008 and for general corporate purposes.

The debentures pay interest on a quarterly basis at a rate of 3.875% per annum plus Additional Interest (the Debenture Total Interest). Notwithstanding the foregoing, however, the interest payable on each interest payment date shall be the higher of (i) the Debenture Total Interest and (ii) 5.75% per annum. The debentures are convertible into the Company s common stock at the holder s option. The conversion price, which was $20.48 per share at September 30, 2006, is subject to adjustment for various events, including the issuance of stock dividends.

The debentures will mature on June 15, 2026. The Company must redeem 10% of the total aggregate principal amount of the debentures outstanding on June 15, 2011. In addition to such redemption amount, the Company will also redeem on June 15, 2011 and at the end of each interest accrual period thereafter an additional amount, if any, of the debentures necessary to prevent the debentures from being treated as an Applicable High Yield Discount Obligation under the Internal Revenue Code. The holders of the debentures will have the option on June 15, 2012, June 15, 2016 and June 15, 2021 to require the Company to repurchase some or all of their remaining debentures. The redemption price for such redemptions will equal 100% of the principal amount of the debentures plus accrued interest. If a fundamental change (as defined in the Indenture) occurs, the Company will be required to offer to repurchase the debentures at 100% of their principal amount, plus accrued interest and, under certain circumstances, a make-whole premium .

5% Variable Interest Senior Convertible Notes Due November 2011:

In November 2004, the Company sold $65,500 of its 5% variable interest senior convertible notes due November 15, 2011 in a private offering to qualified institutional investors in accordance with Rule 144A under the Securities Act of 1933. The buyers of the notes had the right, for a 120-day period ending March 18, 2005, to purchase up to an additional $16,375 of the notes. At December 31, 2004, buyers had exercised their rights to purchase an additional $1,405 of the notes, and the remaining $14,959 principal amount of notes were purchased during the first quarter of 2005. In April 2005, Vector issued an additional $30,000 principal amount of 5% variable interest senior convertible notes due November 15, 2011 in a separate private offering to qualified institutional investors in accordance with Rule 144A. These notes, which were issued under a new indenture at a net price of 103.5%, were on the same terms as the $81,864 principal amount of notes previously issued in connection with the November 2004 placement.

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The notes pay interest on a quarterly basis at a rate of 5% per annum plus Additional Interest (the Notes Total Interest). Notwithstanding the foregoing, however, during the period prior to November 15, 2006, the interest payable on each interest payment date is the higher of (i) the Notes Total Interest and (ii) 6.75% per year. The notes are convertible into the Company s common stock at the holder s option. The conversion price, which was $17.60 at September 30, 2006, is subject to adjustment for various events, including the issuance of stock dividends.

The notes will mature on November 15, 2011. The Company must redeem 12.5% of the total aggregate principal amount of the notes outstanding on November 15, 2009. In addition to such redemption amount, the Company will also redeem on November 15, 2009 and at the end of each interest accrual period thereafter an additional amount, if any, of the notes necessary to prevent the notes from being treated as an Applicable High Yield Discount Obligation under the Internal Revenue Code. The holders of the notes will have the option on November 15, 2009 to require the Company to repurchase some or all of their remaining notes. The redemption price for such redemptions will equal 100% of the principal amount of the notes plus accrued interest. If a fundamental change (as defined in the indenture) occurs, the Company will be required to offer to repurchase the notes at 100% of their principal amount, plus accrued interest and, under certain circumstances, a make-whole premium .

Embedded Derivatives on the Variable Interest Senior Convertible Debt:

The portion of the Debenture Total Interest and the Notes Total Interest which is computed by reference to the cash dividends paid on the Company s common stock is considered an embedded derivative within the convertible debt, which the Company is required to separately value. Pursuant to SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities , as amended by SFAS No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities , the Company has bifurcated these embedded derivatives and, based on a valuation by a third party, estimated the fair value of the embedded derivative liability. The resulting discount created by allocating a portion of the issuance proceeds to the embedded derivative is then amortized to interest expense over the term of the debt using the effective interest method. Changes to the fair value of these embedded derivatives are reflected quarterly in the Company s consolidated statements of operations as Change in fair value of derivatives embedded within convertible debt. The value of the embedded derivative is contingent on changes in interest rates of debt instruments maturing over the duration of the convertible debt as well as projections of future cash and stock dividends over the term of the debt.

The estimated initial fair values of the embedded derivatives associated with the 3.875% convertible debentures and the 5% convertible notes were $56,214 and $42,042, respectively.

A summary of non-cash interest expense associated with the embedded derivative liability for the three and nine months ended September 30, 2006 and 2005 is as follows:

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005 Restated	2006	2005 Restated
3.875% convertible debentures	$ 515	$	$ 515	$
5% convertible notes	763	611	2,173	1,640
	$ 1,278	$ 611	$ 2,688	$ 1,640

A summary of non-cash changes in fair value of derivatives embedded within convertible debt is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
3.875% convertible debentures	$ 2,099	$	$ 2,099	$
5% convertible notes	1,365	(1,131)	(874)	(2,258)
	$ 3,464	$ (1,131)	$ 1,225	$ (2,258)