

FLOWSERVE CORP
Form 10-Q
July 23, 2014

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

FORM 10-Q
(Mark One)

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2014
OR

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM _____ to _____.

Commission File No. 1-13179

FLOWSERVE CORPORATION

(Exact name of registrant as specified in its charter)

New York

(State or other jurisdiction of incorporation or organization)

31-0267900

(I.R.S. Employer Identification No.)

5215 N. O'Connor Blvd., Suite 2300, Irving, Texas

75039

(Address of principal executive offices)

(Zip Code)

(972) 443-6500

(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 ☐ 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 the registrant was required to submit and post such files). ☒ Yes ☐ 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 "accelerated filer," "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☒ (do not check if a smaller reporting company)

Smaller reporting company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ☐

Yes ☐ No ☒

As of July 18, 2014, there were 136,804,037 shares of the issuer's common stock outstanding.

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PART I — FINANCIAL INFORMATION

Item 1. Financial Statements.

FLOWSERVE CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(Amounts in thousands, except per share data)

	Three Months Ended June 30,	
	2014	2013
Sales	\$1,224,378	\$1,239,526
Cost of sales	(794,072)	(817,950)
Gross profit	430,306	421,576
Selling, general and administrative expense	(238,178)	(240,200)
Net earnings from affiliates	2,187	2,145
Operating income	194,315	183,521
Interest expense	(15,027)	(13,125)
Interest income	507	277
Other (expense) income, net	(3,836)	616
Earnings before income taxes	175,959	171,289
Provision for income taxes	(50,794)	(50,395)
Net earnings, including noncontrolling interests	125,165	120,894
Less: Net earnings attributable to noncontrolling interests	(1,652)	(508)
Net earnings attributable to Flowserve Corporation	\$123,513	\$120,386
Net earnings per share attributable to Flowserve Corporation common shareholders:		
Basic	\$0.90	\$0.85
Diluted	0.90	0.84
Cash dividends declared per share	\$0.16	\$0.14

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(Amounts in thousands)

	Three Months Ended June 30,	
	2014	2013
Net earnings, including noncontrolling interests	\$125,165	\$120,894
Other comprehensive income (loss):		
Foreign currency translation adjustments, net of taxes of \$(4,677) and \$17,811, respectively	7,782	(29,425)
Pension and other postretirement effects, net of taxes of \$(819) and \$(1,456), respectively	1,463	2,895
Cash flow hedging activity, net of taxes of \$12 and \$(151), respectively	(65)	234
Other comprehensive income (loss)	9,180	(26,296)
Comprehensive income, including noncontrolling interests	134,345	94,598
Comprehensive income attributable to noncontrolling interests	(1,651)	(349)
Comprehensive income attributable to Flowserve Corporation	\$132,694	\$94,249

See accompanying notes to condensed consolidated financial statements.

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FLOWSERVE CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(Amounts in thousands, except per share data)

	Six Months Ended June 30,	
	2014	2013
Sales	\$2,292,514	\$2,336,122
Cost of sales	(1,485,086)	(1,541,238)
Gross profit	807,428	794,884
Selling, general and administrative expense	(454,405)	(474,708)
Net earnings from affiliates (Note 2)	5,617	33,824
Operating income	358,640	354,000
Interest expense	(30,176)	(25,216)
Interest income	838	551
Other expense, net	(6,741)	(10,412)
Earnings before income taxes	322,561	318,923
Provision for income taxes	(88,809)	(99,128)
Net earnings, including noncontrolling interests	233,752	219,795
Less: Net earnings attributable to noncontrolling interests	(2,505)	(1,619)
Net earnings attributable to Flowserve Corporation	\$231,247	\$218,176
Net earnings per share attributable to Flowserve Corporation common shareholders:		
Basic	\$1.68	\$1.52
Diluted	1.67	1.51
Cash dividends declared per share	\$0.32	\$0.28

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(Amounts in thousands)

	Six Months Ended June 30,	
	2014	2013
Net earnings, including noncontrolling interests	\$233,752	\$219,795
Other comprehensive income (loss):		
Foreign currency translation adjustments, net of taxes of \$(6,451) and \$40,607, respectively	10,733	(67,086)
Pension and other postretirement effects, net of taxes of \$(1,757) and \$(3,053), respectively	4,242	9,627
Cash flow hedging activity, net of taxes of \$(58) and \$(325), respectively	103	475
Other comprehensive income (loss)	15,078	(56,984)
Comprehensive income, including noncontrolling interests	248,830	162,811
Comprehensive income attributable to noncontrolling interests	(2,682)	(1,693)
Comprehensive income attributable to Flowserve Corporation	\$246,148	\$161,118

See accompanying notes to condensed consolidated financial statements.

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FLOWSERVE CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited)

(Amounts in thousands, except par value)

	June 30, 2014	December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 143,569	\$ 363,804
Accounts receivable, net of allowance for doubtful accounts of \$25,422 and \$24,073, respectively	1,157,758	1,155,327
Inventories, net	1,160,181	1,060,670
Deferred taxes	158,276	157,448
Prepaid expenses and other	109,206	110,133
Total current assets	2,728,990	2,847,382
Property, plant and equipment, net of accumulated depreciation of \$866,938 and \$849,863, respectively	696,751	716,289
Goodwill	1,101,869	1,107,551
Deferred taxes	20,711	19,533
Other intangible assets, net	151,959	160,548
Other assets, net	185,830	185,430
Total assets	\$ 4,886,110	\$ 5,036,733
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable	\$ 516,020	\$ 612,092
Accrued liabilities	756,604	861,010
Debt due within one year	65,698	72,678
Deferred taxes	12,394	12,319
Total current liabilities	1,350,716	1,558,099
Long-term debt due after one year	1,123,861	1,127,619
Retirement obligations and other liabilities	472,790	473,894
Shareholders' equity:		
Common shares, \$1.25 par value	220,991	220,991
Shares authorized – 305,000		
Shares issued – 176,793		
Capital in excess of par value	472,329	476,218
Retained earnings	3,172,209	2,985,391
Treasury shares, at cost – 41,036 and 39,630 shares, respectively	(1,737,419)	(1,600,266)
Deferred compensation obligation	10,282	9,522
Accumulated other comprehensive loss	(206,574)	(221,477)
Total Flowserve Corporation shareholders' equity	1,931,818	1,870,379
Noncontrolling interests	6,925	6,742
Total equity	1,938,743	1,877,121
Total liabilities and equity	\$ 4,886,110	\$ 5,036,733

See accompanying notes to condensed consolidated financial statements.

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FLOWSERVE CORPORATION
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(Amounts in thousands)

	Six Months Ended June 30,	
	2014	2013
Cash flows – Operating activities:		
Net earnings, including noncontrolling interests	\$233,752	\$219,795
Adjustments to reconcile net earnings to net cash used by operating activities:		
Depreciation	46,316	43,769
Amortization of intangible and other assets	9,327	7,854
Net (gain) loss on disposition of assets	(167)	) 347
Gain on sale of business	(13,403)) —
Gain on sale of equity investment in affiliate	—	(12,995)
Gain on remeasurement of acquired assets	—	(15,315)
Excess tax benefits from stock-based compensation arrangements	(8,490)	) (8,399)
Stock-based compensation	18,272	16,285
Net earnings from affiliates, net of dividends received	(1,294)	) (2,748)
Change in assets and liabilities:		
Accounts receivable, net	(14,695)	) 5,892
Inventories, net	(115,109)	) (120,671)
Prepaid expenses and other	(8,038)	) (9,991)
Other assets, net	(1,692)	) (2,032)
Accounts payable	(72,649)	) (94,326)
Accrued liabilities and income taxes payable	(86,059)	) (69,784)
Retirement obligations and other liabilities	(5)	) 7,848
Net deferred taxes	2,667	1,645
Net cash flows used by operating activities	(11,267)	) (32,826)
Cash flows – Investing activities:		
Capital expenditures	(53,666)	) (61,159)
Proceeds from disposal of assets	789	336
Payments for acquisition, net of cash acquired	—	(10,143)
Proceeds from sale of business, net of cash divested	46,805	—
Proceeds from equity investments in affiliates	—	46,240
Net cash flows used by investing activities	(6,072)	) (24,726)
Cash flows – Financing activities:		
Excess tax benefits from stock-based compensation arrangements	8,490	8,399
Payments on long-term debt	(20,000)	) (10,000)
Short-term financing, net	—	209,000
Proceeds under other financing arrangements	13,233	9,701
Payments under other financing arrangements	(4,789)	) (9,072)
Repurchases of common shares	(153,068)	) (306,317)
Payments of dividends	(41,382)	) (37,621)
Other	(2,499)	) (73)
Net cash flows used by financing activities	(200,015)) (135,983)
Effect of exchange rate changes on cash	(2,881)) (6,005)

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Net change in cash and cash equivalents	(220,235) (199,540)
Cash and cash equivalents at beginning of period	363,804	304,252	
Cash and cash equivalents at end of period	\$143,569	\$104,712	

See accompanying notes to condensed consolidated financial statements.

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FLOWSERVE CORPORATION

(Unaudited)

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation and Accounting Policies

Basis of Presentation

The accompanying condensed consolidated balance sheet as of June 30, 2014, the related condensed consolidated statements of income and comprehensive income for the three and six months ended June 30, 2014 and 2013, and the condensed consolidated statements of cash flows for the six months ended June 30, 2014 and 2013, of Flowserve Corporation are unaudited. In management's opinion, all adjustments comprising normal recurring adjustments necessary for fair statement of such condensed consolidated financial statements have been made.

The accompanying condensed consolidated financial statements and notes in this Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2014 ("Quarterly Report") are presented as permitted by Regulation S-X and do not contain certain information included in our annual financial statements and notes thereto. Accordingly, the accompanying condensed consolidated financial information should be read in conjunction with the consolidated financial statements presented in our audited Annual Report on Form 10-K for the year ended December 31, 2013 ("2013 Annual Report").

As discussed in Note 15 to our consolidated financial statements included in our 2013 Annual Report, on May 23, 2013, our certificate of incorporation was amended to increase the number of authorized shares of common stock from 120.0 million to 305.0 million and enable a three-for-one stock split approved by the Board of Directors on February 7, 2013 in the form of a 200% common stock dividend. The record date for the stock split was June 7, 2013, and additional shares were distributed on June 21, 2013. Shareholders' equity and all share data, including treasury shares and stock-based compensation award shares, and per share data presented herein have been retrospectively adjusted to reflect the impact of the increase in authorized shares and the stock split, as appropriate.

Venezuela – Our operations in Venezuela generally consist of a service center that performs service and repair activities. In addition, certain of our operations in other countries sell equipment and parts that are typically denominated in United States ("U.S.") dollars directly to Venezuelan customers. Our Venezuelan subsidiary's sales for the three and six months ended June 30, 2014 and total assets at June 30, 2014 represented less than 1% of consolidated sales and total assets for the same periods. Effective February 13, 2013, the Venezuelan government devalued its currency (bolivar) from 4.3 to 6.3 bolivars to the U.S. dollar. As a result of the devaluation, we recognized a loss of \$4.0 million in the first quarter of 2013. The loss was reported in other expense, net in our condensed consolidated statements of income and resulted in no tax benefit.

In the first quarter of 2014, the Venezuelan government expanded the use of periodic auctions for U.S. dollars conducted under the Complementary System of Foreign Currency Administration ("SICAD I"). At June 30, 2014 the SICAD I exchange rate was 10.8 bolivars to the U.S. dollar, compared with the official exchange rate of 6.3 bolivars to the U.S. dollar ("Official"). In addition, the Venezuelan government created a third currency exchange mechanism ("SICAD II") that is currently being interpreted to be available to all entities for all transactions at an exchange rate that is significantly less favorable than the Official exchange rate or the SICAD I exchange rate.

As of June 30, 2014, we believe the Official exchange rate continues to be the most appropriate rate to remeasure the U.S. dollar value of the assets, liabilities and results of operations of our Venezuelan subsidiary. We are continuing to assess and monitor the ongoing impact of the recent changes in the Venezuelan foreign exchange market on our Venezuelan operations and imports into the market, including our Venezuelan subsidiary's ability to remit cash for dividends and other payments at the Official exchange rate, as well as further actions of the Venezuelan government and economic conditions that may adversely impact our future consolidated financial condition or results of operations. For reference, if we were to remeasure our bolivar-denominated net monetary assets as of June 30, 2014 utilizing the SICAD I or SICAD II exchange rate, it is estimated that the resulting loss would have been

approximately \$4 million or \$8 million, respectively.

Accounting Policies

Significant accounting policies, for which no significant changes have occurred in the six months ended June 30, 2014, are detailed in Note 1 to our consolidated financial statements included in our 2013 Annual Report.

Accounting Developments

Pronouncements Implemented

In February 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2013-04, "Liabilities (Topic 405) - Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date," which requires a reporting entity that is jointly and severally liable to

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measure the obligation as the sum of the amount the entity has agreed with co-obligors to pay and any additional amount it expects to pay on behalf of one or more co-obligors. The scope of this ASU excludes obligations addressed by existing guidance. The ASU shall be applied retrospectively for arrangements existing at the beginning of the year of adoption. Our adoption of ASU No. 2013-04 effective January 1, 2014 did not have an impact on our consolidated financial condition and results of operations.

In April 2013, the FASB issued ASU No. 2013-07, "Presentation of Financial Statements (Topic 205) - Liquidation Basis of Accounting," which requires an entity to prepare its financial statements using the liquidation basis of accounting when liquidation is imminent. Liquidation is imminent when the likelihood is remote that the entity will return from liquidation and either (a) a plan for liquidation is approved by the person or persons with the authority to make such a plan effective and the likelihood is remote that the execution of the plan will be blocked by other parties or (b) a plan for liquidation is being imposed by other forces (for example, involuntary bankruptcy). The ASU shall be applied prospectively from the day that liquidation becomes imminent. Our adoption of ASU No. 2013-07 effective January 1, 2014 did not have an impact on our consolidated financial condition and results of operations.

In July 2013, the FASB issued ASU No. 2013-11, "Income Taxes (Topic 740) - Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists," which provides guidance on the presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The ASU shall be applied prospectively to all unrecognized tax benefits that exist at the effective date. The adoption of ASU No. 2013-11 effective January 1, 2014 did not have an impact on our consolidated financial condition and results of operations.

In April 2014, the FASB issued ASU No. 2014-08, "Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360) - Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity," which provides guidance on the requirements for reporting discontinued operations. A discontinued operation may include a component of an entity or a group of components of an entity, or a business or nonprofit activity. A disposal of a component of an entity or a group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results when the component of an entity or group of components of an entity meets the criteria to be classified as held for sale, is disposed of by sale, or is disposed of other than by sale (e.g., by abandonment or in a distribution to owners in a spinoff). This ASU also introduces new disclosure requirements for discontinued operations. The ASU shall be applied prospectively to (a) all disposals (or classifications as held for sale) of components of an entity and (b) businesses or nonprofit activities that, on acquisition, are classified as held for sale that occur after the effective date. We early adopted this ASU effective January 1, 2014 and it did not have an impact on our consolidated financial condition and results of operations.

Pronouncements Not Yet Implemented

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)" which supersedes the revenue recognition requirements in "Revenue Recognition (Topic 605)." The standard is principle-based and provides a five-step model to determine when and how revenue is recognized. The core principle is that a company should recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. There are also expanded disclosure requirements in this ASU. For public entities ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period and allows for either full retrospective adoption or modified retrospective adoption. We are currently evaluating the impact of ASU No. 2014-09 on our consolidated financial condition and results of operations.

In June 2014, the FASB issued ASU No. 2014-11 "Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures." This ASU changes the accounting for repurchase-to-maturity transactions and linked repurchase financings so that such transactions will now be accounted for as secured

borrowings. This accounting change is effective for the first interim or annual period beginning after December 15, 2014 and early adoption is not permitted. There are also new disclosure requirements in this ASU. The adoption of ASU No. 2014-11 will not have a material impact on our consolidated financial condition and results of operations. In June 2014, the FASB issued ASU No. 2014-12 "Compensation-Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period." This ASU was issued to address share-based payment awards with a performance target affecting vesting that could be achieved after the employee's requisite service period. This ASU is effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. This ASU may be applied either (a) prospectively to all awards granted or modified after the effective date or (b) retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter. The adoption of ASU No. 2014-12 will not have a material impact on our consolidated financial condition and results of operations.

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2. Disposition, Acquisition and Exit of Joint Venture

Effective March 31, 2014, we sold our Flow Control Division's ("FCD") Naval OY ("Naval") business to a Finnish valve manufacturer. The sale included Naval's manufacturing facility located in Laitila, Finland and a service and support center located in St. Petersburg, Russia. The cash proceeds for the sale totaled \$46.8 million, net of cash divested, and resulted in a \$13.4 million pre-tax gain recorded in selling, general and administrative expense in the condensed consolidated statements of income. Net sales related to the Naval business totaled \$8.2 million in the first quarter of 2014.

As discussed in Note 2 to our consolidated financial statements included in our 2013 Annual Report, effective December 10, 2013, we acquired for inclusion in Industrial Product Division ("IPD"), 100% of Innovative Mag-Drive, LLC ("Innomag"), a privately-owned, U.S.-based company specializing in advanced sealless magnetic drive centrifugal pumps for the chemical and general industries, in an asset purchase up to \$78.7 million in cash. Of the total purchase price, \$66.7 million was paid at closing and \$0.8 million represented a subsequent working capital adjustment. The remaining \$11.2 million of the total purchase price is contingent upon Innomag achieving certain performance metrics during the two- and five-year periods following the acquisition, and to the extent achieved, is expected to be paid in cash within four months of the performance measurement dates. We initially recorded a liability of \$7.5 million as an estimate of the acquisition date fair value of the contingent consideration, which is based on the weighted probability of achievement of the performance metrics as of the date of the acquisition. No pro forma financial information has been presented due to immateriality.

As discussed in Note 2 to our consolidated financial statements included in our 2013 Annual Report, effective March 28, 2013, we and our joint venture partner agreed to exit our joint venture, Audco India, Limited ("AIL"), which manufactures integrated industrial valves in India. To effect the exit, in two separate transactions, FCD acquired 100% ownership of AIL's plug valve manufacturing business in an asset purchase for cash of \$10.1 million and sold its 50% equity interest in AIL to the joint venture partner for \$46.2 million in cash. We remeasured to fair value our previously held equity interest in the purchased net assets of the plug valve manufacturing business resulting in net assets acquired of approximately \$25 million and a pre-tax gain of \$15.3 million. The sale of our equity interest in AIL resulted in a pre-tax gain of \$13.0 million. In the first quarter of 2013, both of the above gains were recorded in net earnings from affiliates in the condensed consolidated statements of income. No pro forma information has been provided due to immateriality. Prior to these transactions, our 50% interest in AIL was recorded using the equity method of accounting.

3. Stock-Based Compensation Plans

We maintain the Flowserve Corporation Equity and Incentive Compensation Plan (the "2010 Plan"), which is a shareholder-approved plan authorizing the issuance of up to 8,700,000 shares of our common stock in the form of restricted shares, restricted share units and performance-based units (collectively referred to as "Restricted Shares"), incentive stock options, non-statutory stock options, stock appreciation rights and bonus stock. Of the 8,700,000 shares of common stock authorized under the 2010 Plan, 5,059,754 were available for issuance as of June 30, 2014. The Flowserve Corporation 2004 Stock Compensation Plan expired on June 22, 2014, with 827,835 shares unissued. No stock options have been granted since 2006.

Restricted Shares – Awards of Restricted Shares are valued at the closing market price of our common stock on the date of grant. The unearned compensation is amortized to compensation expense over the vesting period of the restricted shares. We had unearned compensation of \$45.2 million and \$31.5 million at June 30, 2014 and December 31, 2013, respectively, which is expected to be recognized over a weighted-average period of approximately one year. These amounts will be recognized into net earnings in prospective periods as the awards vest. The total fair value of Restricted Shares vested during the three months ended June 30, 2014 and 2013 was \$1.5 million and \$1.6 million, respectively. The total fair value of Restricted Shares vested during the six months ended June 30, 2014 and 2013 was \$34.4 million and \$34.8 million, respectively.

We recorded stock-based compensation expense of \$5.5 million (\$8.4 million pre-tax) and \$5.4 million (\$8.2 million pre-tax) for the three months ended June 30, 2014 and 2013, respectively. We recorded stock-based compensation expense of \$12.0 million (\$18.3 million pre-tax) and \$10.7 million (\$16.3 million pre-tax) for the six months ended June 30, 2014 and 2013, respectively.

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The following table summarizes information regarding Restricted Shares:

	Six Months Ended June 30, 2014	
	Shares	Weighted Average Grant-Date Fair Value
Number of unvested shares:		
Outstanding - January 1, 2014	2,020,678	\$44.68
Granted	486,484	72.30
Vested	(778,643)	) 44.24
Canceled	(71,977)	) 50.93
Outstanding - June 30, 2014	1,656,542	\$52.72

Unvested Restricted Shares outstanding as of June 30, 2014, includes approximately 829,000 units with performance-based vesting provisions. Performance-based units are issuable in common stock and vest upon the achievement of pre-defined performance targets, primarily based on our average annual return on net assets over a three-year period as compared with the same measure for a defined peer group for the same period. Most units were granted in three annual grants since January 1, 2012 and have a vesting percentage between 0% and 200% depending on the achievement of the specific performance targets. Compensation expense is recognized ratably over a cliff-vesting period of 36 months, based on the fair market value of our common stock on the date of grant, as adjusted for anticipated forfeitures. During the performance period, earned and unearned compensation expense is adjusted based on changes in the expected achievement of the performance targets. Vesting provisions range from 0 to approximately 1,610,000 shares based on performance targets. As of June 30, 2014, we estimate vesting of approximately 1,018,000 shares based on expected achievement of performance targets.

4. Derivative Instruments and Hedges

Our risk management and foreign currency derivatives and hedging policy specifies the conditions under which we may enter into derivative contracts. See Notes 1 and 6 to our consolidated financial statements included in our 2013 Annual Report and Note 7 of this Quarterly Report for additional information on our derivatives. We enter into foreign exchange forward and swap contracts to hedge our cash flow risks associated with transactions denominated in currencies other than the local currency of the operation engaging in the transaction. All designated foreign exchange hedging instruments are highly effective.

Foreign exchange contracts designated as hedging instruments had a notional value of \$56.3 million and \$6.2 million, at June 30, 2014 and December 31, 2013, respectively. The fair values of assets and liabilities and any changes in those fair values related to designated foreign exchange contracts are immaterial for the periods presented below.

Foreign exchange contracts with third parties not designated as hedging instruments had a notional value of \$576.7 million and \$610.7 million, at June 30, 2014 and December 31, 2013, respectively. At June 30, 2014, the length of foreign exchange contracts currently in place ranged from one day to 21 months.

Also as part of our risk management program, we enter into interest rate swap agreements to hedge exposure to floating interest rates on certain portions of our debt. At June 30, 2014 and December 31, 2013, we had \$40.0 million and \$140.0 million, respectively, of notional amount in outstanding interest rate swaps with third parties. All interest rate swaps are highly effective. At June 30, 2014, the maximum remaining length of any interest rate swap contract in place was approximately 12 months.

We are exposed to risk from credit-related losses resulting from nonperformance by counterparties to our financial instruments. We perform credit evaluations of our counterparties under foreign exchange contracts and interest rate swap agreements and expect all counterparties to meet their obligations. We have not experienced credit losses from our counterparties.

The fair value of foreign exchange contracts not designated as hedging instruments are summarized below:

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(Amounts in thousands)	June 30, 2014	December 31, 2013
Current derivative assets	\$3,136	\$5,215
Noncurrent derivative assets	37	729
Current derivative liabilities	2,266	2,207
Noncurrent derivative liabilities	—	113

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The fair value of interest rate swaps and foreign exchange contracts designated as hedging instruments are summarized below:

	June 30, 2014	December 31, 2013
(Amounts in thousands)		
Current derivative assets	\$149	\$146
Noncurrent derivative assets	3	—
Current derivative liabilities	424	409
Noncurrent derivative liabilities	10	37

Current and noncurrent derivative assets are reported in our condensed consolidated balance sheets in prepaid expenses and other and other assets, net, respectively. Current and noncurrent derivative liabilities are reported in our condensed consolidated balance sheets in accrued liabilities and retirement obligations and other liabilities, respectively.

The impact of net changes in the fair values of foreign exchange contracts are summarized below:

	Three Months Ended June 30,		Six Months Ended June 30,	
(Amounts in thousands)	2014	2013	2014	2013
Gain (loss) recognized in income	\$1,421	\$(4,534)	\$(123)	\$(7,531)

Gains and losses recognized in our condensed consolidated statements of income for foreign exchange contracts are classified as other (expense) income, net.

The impact of net changes in the fair values of interest rate swaps in cash flow hedging relationships are summarized in Note 15.

5. Debt

Debt, including capital lease obligations, consisted of:

	June 30, 2014	December 31, 2013
(Amounts in thousands, except percentages)		
4.00% Senior Notes due November 15, 2023, net of unamortized discount	\$298,673	\$298,615
3.50% Senior Notes due September 15, 2022 net of unamortized discount	498,373	498,289
Term Loan Facility, interest rate of 1.48% at June 30, 2014 and 1.50% at December 31, 2013	350,000	370,000
Capital lease obligations and other borrowings	42,513	33,393
Debt and capital lease obligations	1,189,559	1,200,297
Less amounts due within one year	65,698	72,678
Total debt due after one year	\$1,123,861	\$1,127,619

Senior Notes

As discussed in Note 10 to our consolidated financial statements included in our 2013 Annual Report, on November 1, 2013 we completed the public offering of \$300.0 million in aggregate principal amount of senior notes due November 15, 2023 ("2023 Senior Notes"). On September 11, 2012, we completed the public offering of \$500.0 million in aggregate principal amount of senior notes due September 15, 2022 ("2022 Senior Notes").

Senior Credit Facility

As discussed in Note 10 to our consolidated financial statements included in our 2013 Annual Report, on October 4, 2013 we amended our existing credit agreement that provided for a \$400.0 million term loan ("Term Loan Facility") and a revolving credit facility ("Revolving Credit Facility" and, together with the Term Loan Facility, the "Senior Credit Facility") with a maturity date of October 4, 2018. As of June 30, 2014 and December 31, 2013, we had no amounts outstanding under the Revolving Credit Facility. We had outstanding letters of credit of \$80.0 million and \$106.1

million at June 30, 2014 and December 31, 2013, respectively, which reduced our borrowing capacity to \$920.0 million and \$893.9 million, respectively. Our obligations under the Senior Credit Facility are guaranteed by certain of our 100% owned domestic subsidiaries. Such guarantees are released if we achieve certain credit ratings. We had not achieved these ratings as of June 30, 2014. Our compliance with applicable financial covenants under the Senior Credit Facility is tested quarterly, and we complied with all covenants at June 30, 2014.

We may prepay loans under our Senior Credit Facility in whole or in part, without premium or penalty, at any time. A commitment fee, which is payable quarterly on the daily unused portions of the Senior Credit Facility, was 0.175% (per annum) during the period ended June 30, 2014. During the six months ended June 30, 2014, we made scheduled repayments of \$20.0 million under our Term Loan Facility. We have scheduled repayments of \$10.0 million due in each of the next four quarters on our Senior Credit Facility. Our Senior Credit Facility bears a floating rate of interest, and we have \$40.0 million of notional amount of interest rate swaps at June 30, 2014 to hedge exposure to floating interest rates.

European Letter of Credit Facility

Due to the increased capacity and the removal of the performance letters of credit sublimit of the amended Revolving Credit Facility, we elected not to renew our 364-day unsecured, committed €125.0 million European Letter of Credit Facility ("European LOC Facility"), which expired in October 2013; however, the existing letters of credit remain outstanding and are still bound by the facility's covenants. We were in compliance with all covenants under our European LOC Facility as of June 30, 2014.

We had outstanding letters of credit drawn on the European LOC Facility of €12.3 million (\$16.8 million) and €69.6 million (\$95.4 million) as of June 30, 2014 and December 31, 2013, respectively.

6. Supplemental Guarantor Financial Information

Our Senior Notes are fully and unconditionally and jointly and severally guaranteed by certain of our 100% owned domestic subsidiaries. The following condensed consolidating financial statements present the financial position, results of operations and cash flows of Flowserve Corporation (referred to as "Parent" for the purpose of this note only) on a Parent-only (Issuer) basis, the combined guarantor subsidiaries on a guarantor-only basis, the combined non-guarantor subsidiaries on a non-guarantor-only basis and elimination adjustments necessary to arrive at the information for the Parent, guarantor subsidiaries and non-guarantor subsidiaries on a condensed consolidated basis. Investments in subsidiaries have been accounted for using the equity method for this presentation.

FLOWSERVE CORPORATION

CONDENSED CONSOLIDATING STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

	Three Months Ended June 30, 2014				
	Parent (Issuer)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Total
(Amounts in thousands)					
Sales	\$—	\$474,960	\$ 831,814	\$(82,396)	\$1,224,378
Cost of sales	—	(305,643)	(570,825)	82,396	(794,072)
Gross profit	—	169,317	260,989	—	430,306
Selling, general and administrative expense	(447)	(119,378)	(118,353)	—	(238,178)
Net earnings from affiliates	—	(25)	2,212	—	2,187
Net earnings from consolidated subsidiaries, net of tax	130,035	106,025	—	(236,060)	—
Operating income	129,588	155,939	144,848	(236,060)	194,315
Interest expense, net	(8,924)	(2,768)	(2,828)	—	(14,520)
Other expense, net	—	(3,112)	(724)	—	(3,836)
Earnings before income taxes	120,664	150,059	141,296	(236,060)	175,959
Provision for income taxes	2,849	(20,024)	(33,619)	—	(50,794)
Net earnings, including noncontrolling interests	123,513	130,035	107,677	(236,060)	125,165

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Less: Net earnings attributable to noncontrolling interests	—	—	(1,652)	—	(1,652)
Net earnings attributable to Flowserve Corporation	\$123,513	\$130,035	\$ 106,025	\$(236,060)	\$123,513
Comprehensive income attributable to Flowserve Corporation	\$132,694	\$139,131	\$ 112,495	\$(251,626)	\$132,694

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	Three Months Ended June 30, 2013				
	Parent (Issuer)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Total
(Amounts in thousands)					
Sales	\$—	\$492,643	\$ 842,124	\$(95,241)	\$1,239,526
Cost of sales	—	(321,255)	(591,936)	95,241	(817,950)
Gross profit	—	171,388	250,188	—	421,576
Selling, general and administrative expense	(1,724)	(69,928)	(168,548)	—	(240,200)
Net earnings from affiliates	—	176	1,969	—	2,145
Net earnings from consolidated subsidiaries, net of tax	126,771	65,156	—	(191,927)	—
Operating income	125,047	166,792	83,609	(191,927)	183,521
Interest expense, net	(7,233)	(2,981)	(2,634)	—	(12,848)
Other (expense) income, net	—	(1,708)	2,324	—	616
Earnings before income taxes	117,814	162,103	83,299	(191,927)	171,289
Provision for income taxes	2,572	(35,332)	(17,635)	—	(50,395)
Net earnings, including noncontrolling interests	120,386	126,771	65,664	(191,927)	120,894
Less: Net earnings attributable to noncontrolling interests	—	—	(508)	—	(508)
Net earnings attributable to Flowserve Corporation	\$120,386	\$126,771	\$ 65,156	\$(191,927)	\$120,386
Comprehensive income attributable to Flowserve Corporation	\$94,249	\$95,295	\$ 31,795	\$(127,090)	\$94,249

	Six Months Ended June 30, 2014				
	Parent (Issuer)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Total
(Amounts in thousands)					
Sales	\$—	\$917,467	\$ 1,533,886	\$(158,839)	\$2,292,514
Cost of sales	—	(587,856)	(1,056,069)	158,839	(1,485,086)
Gross profit	—	329,611	477,817	—	807,428
Selling, general and administrative expense	(896)	(170,550)	(282,959)	—	(454,405)
Net earnings from affiliates	—	362	5,255	—	5,617
Net earnings from consolidated subsidiaries, net of tax	244,494	145,207	—	(389,701)	—
Operating income	243,598	304,630	200,113	(389,701)	358,640
Interest expense, net	(18,057)	(5,447)	(5,834)	—	(29,338)
Other income (expense), net	2	(4,977)	(1,766)	—	(6,741)
Earnings before income taxes	225,543	294,206	192,513	(389,701)	322,561
Provision for income taxes	5,704	(49,712)	(44,801)	—	(88,809)
Net earnings, including noncontrolling interests	231,247	244,494	147,712	(389,701)	233,752
Less: Net earnings attributable to noncontrolling interests	—	—	(2,505)	—	(2,505)

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Net earnings attributable to Flowserve Corporation	\$231,247	\$244,494	\$ 145,207	\$(389,701)	\$231,247
Comprehensive income attributable to Flowserve Corporation	\$246,148	\$259,185	\$ 158,823	\$(418,008)	\$246,148

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	Six Months Ended June 30, 2013				Consolidated Total
	Parent (Issuer)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	
(Amounts in thousands)					
Sales	\$—	\$940,221	\$ 1,573,510	\$(177,609)	\$2,336,122
Cost of sales	—	(610,220)	(1,108,627)	177,609	(1,541,238)
Gross profit	—	330,001	464,883	—	794,884
Selling, general and administrative expense	(2,063)	(162,716)	(309,929)	—	(474,708)
Net earnings from affiliates	—	400	33,424	—	33,824
Net earnings from consolidated subsidiaries, net of tax	229,328	125,433	—	(354,761)	—
Operating income	227,265	293,118	188,378	(354,761)	354,000
Interest expense, net	(13,733)	(5,760)	(5,172)	—	(24,665)
Other expense, net	—	(3,382)	(7,030)	—	(10,412)
Earnings before income taxes	213,532	283,976	176,176	(354,761)	318,923
Provision for income taxes	4,644	(54,648)	(49,124)	—	(99,128)
Net earnings, including noncontrolling interests	218,176	229,328	127,052	(354,761)	219,795
Less: Net earnings attributable to noncontrolling interests	—	—	(1,619)	—	(1,619)
Net earnings attributable to Flowserve Corporation	\$218,176	\$229,328	\$ 125,433	\$(354,761)	\$218,176
Comprehensive income attributable to Flowserve Corporation	\$161,118	\$264,467	\$ 159,285	\$(423,752)	\$161,118

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FLOWSERVE CORPORATION

CONDENSED CONSOLIDATING BALANCE SHEETS

	June 30, 2014				
	Parent (Issuer)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Total
(Amounts in thousands)					
ASSETS					
Current assets:					
Cash and cash equivalents	\$ 909	\$ —	\$ 142,660	\$ —	\$ 143,569
Accounts receivable, net	—	255,706	902,052	—	1,157,758
Intercompany receivables	4,180	130,587	322,601	(457,368)	—
Inventories, net	—	398,760	761,421	—	1,160,181
Other current assets, net	626	141,468	125,388	—	267,482
Total current assets	5,715	926,521	2,254,122	(457,368)	2,728,990
Property, plant and equipment, net	—	221,421	475,330	—	696,751
Goodwill	—	709,239	392,630	—	1,101,869
Intercompany receivables	432,500	11,376	56,542	(500,418)	—
Investment in consolidated subsidiaries	2,646,529	1,997,900	—	(4,644,429)	—
Other assets, net	13,831	199,680	144,989	—	358,500
Total assets	\$ 3,098,575	\$ 4,066,137	\$ 3,323,613	\$ (5,602,215)	\$ 4,886,110
LIABILITIES AND EQUITY					
Current liabilities:					
Accounts payable	\$ —	\$ 139,773	\$ 376,247	\$ —	\$ 516,020
Intercompany payables	103	326,678	130,587	(457,368)	—
Accrued liabilities	11,772	248,091	496,741	—	756,604
Debt due within one year	40,000	—	25,698	—	65,698
Deferred taxes	—	—	12,394	—	12,394
Total current liabilities	51,875	714,542	1,041,667	(457,368)	1,350,716
Long-term debt due after one year	1,107,046	—	16,815	—	1,123,861
Intercompany payables	1,144	487,898	11,376	(500,418)	—
Retirement obligations and other liabilities	6,692	217,168	248,930	—	472,790
Total liabilities	1,166,757	1,419,608	1,318,788	(957,786)	2,947,367
Total Flowserve Corporation shareholders' equity	1,931,818	2,646,529	1,997,900	(4,644,429)	1,931,818
Noncontrolling interests	—	—	6,925	—	6,925
Total equity	1,931,818	2,646,529	2,004,825	(4,644,429)	1,938,743
Total liabilities and equity	\$ 3,098,575	\$ 4,066,137	\$ 3,323,613	\$ (5,602,215)	\$ 4,886,110

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	December 31, 2013				
	Parent (Issuer)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Total
(Amounts in thousands)					
ASSETS					
Current assets:					
Cash and cash equivalents	\$29,086	\$—	\$ 334,718	\$—	\$363,804
Accounts receivable, net	—	263,594	891,733	—	1,155,327
Intercompany receivables	—	155,422	74,089	(229,511)	—
Inventories, net	—	371,172	689,498	—	1,060,670
Other current assets, net	1,879	144,551	121,151	—	267,581
Total current assets	30,965	934,739	2,111,189	(229,511)	2,847,382
Property, plant and equipment, net	—	220,072	496,217	—	716,289
Goodwill	—	715,722	391,829	—	1,107,551
Intercompany receivables	432,500	9,520	186,789	(628,809)	—
Investment in consolidated subsidiaries	2,579,701	1,850,998	—	(4,430,699)	—
Other assets, net	15,486	211,755	138,270	—	365,511
Total assets	\$3,058,652	\$3,942,806	\$ 3,324,294	\$(5,289,019)	\$5,036,733
LIABILITIES AND EQUITY					
Current liabilities:					
Accounts payable	\$—	\$163,254	\$ 448,838	\$—	\$612,092
Intercompany payables	81	74,008	155,422	(229,511)	—
Accrued liabilities	12,874	293,012	555,124	—	—