FLOWSERVE CORP
Form 10-Q
November 07, 2018

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

FORM 10-Q
(Mark One)
þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2018
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	31-0267900
(State or other jurisdiction of incorporation or organization)	(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. þ Yes ¨ No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). þ 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 þ Accelerated filer ¨ Non-accelerated filer ¨
Smaller reporting company ¨ Emerging growth company ¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

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

As of November 1, 2018 there were 130,856,957 shares of the issuer’s common stock outstanding.

FLOWSERVE CORPORATION
FORM 10-Q
TABLE OF CONTENTS

Table of Contents

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 September 30,	
	2018	2017
Sales	$952,716	$883,380
Cost of sales	(644,215)	(615,368)
Gross profit	308,501	268,012
Selling, general and administrative expense	(241,878)	(206,001)
(Loss) gain on sale of businesses	(7,727)	9,864
Net earnings from affiliates	3,295	2,918
Operating income	62,191	74,793
Interest expense	(13,826)	(15,043)
Interest income	1,269	1,108
Other (expense) income, net	(5,283)	7,511
Earnings before income taxes	44,351	68,369
Provision for income taxes	(14,912)	(19,628)
Net earnings, including noncontrolling interests	29,439	48,741
Less: Net earnings attributable to noncontrolling interests	(1,234)	(1,136)
Net earnings attributable to Flowserve Corporation	$28,205	$47,605
Net earnings per share attributable to Flowserve Corporation common shareholders:		
Basic	$0.22	$0.36
Diluted	0.21	0.36
Cash dividends declared per share	$0.19	$0.19

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

(Amounts in thousands)	Three Months Ended September 30,	
	2018	2017
Net earnings, including noncontrolling interests	$29,439	$48,741
Other comprehensive (loss) income:		
Foreign currency translation adjustments, net of taxes of $3,246 and $(5,209), respectively	(19,669)	17,674
Pension and other postretirement effects, net of taxes of $(311) and $(557), respectively	2,599	(444)
Cash flow hedging activity	52	12
Other comprehensive (loss) income	(17,018)	17,242
Comprehensive income, including noncontrolling interests	12,421	65,983
Comprehensive income attributable to noncontrolling interests	(1,578)	(1,090)
Comprehensive income attributable to Flowserve Corporation	$10,843	$64,893

See accompanying notes to condensed consolidated financial statements.

Table of Contents

FLOWSERVE CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

(Amounts in thousands, except per share data)	Nine Months Ended September 30,	
	2018	2017
Sales	$2,845,798	$2,626,762
Cost of sales	(1,979,807)	(1,844,303)
Gross profit	865,991	782,459
Selling, general and administrative expense	(711,845)	(680,305)
(Loss) gain on sale of businesses	(7,727)	141,158
Net earnings from affiliates	7,908	9,027
Operating income	154,327	252,339
Interest expense	(43,645)	(44,689)
Interest income	4,237	2,373
Other expense, net	(17,206)	(13,971)
Earnings before income taxes	97,713	196,052
Provision for income taxes	(37,028)	(85,836)
Net earnings, including noncontrolling interests	60,685	110,216
Less: Net earnings attributable to noncontrolling interests	(4,117)	(1,682)
Net earnings attributable to Flowserve Corporation	$56,568	$108,534
Net earnings per share attributable to Flowserve Corporation common shareholders:		
Basic	$0.43	$0.83
Diluted	0.43	0.83
Cash dividends declared per share	$0.57	$0.57

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

(Amounts in thousands)	Nine Months Ended September 30,	
	2018	2017
Net earnings, including noncontrolling interests	$60,685	$110,216
Other comprehensive (loss) income:		
Foreign currency translation adjustments, net of taxes of $8,034 and $(17,380), respectively	(61,217)	85,777
Pension and other postretirement effects, net of taxes of $(898) and $(1,669), respectively	8,106	(1,102)
Cash flow hedging activity, net of taxes of $(34) in 2017	177	96
Other comprehensive (loss) income	(52,934)	84,771
Comprehensive income, including noncontrolling interests	7,751	194,987
Comprehensive income attributable to noncontrolling interests	(5,270)	(2,169)
Comprehensive income attributable to Flowserve Corporation	$2,481	$192,818

See accompanying notes to condensed consolidated financial statements.

Table of Contents

FLOWSERVE CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

(Amounts in thousands, except par value)	September 30, 2018	December 31, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	$ 529,942	$ 703,445
Accounts receivable, net of allowance for doubtful accounts of $54,481 and $59,113, respectively	780,408	856,711
Contract assets, net	261,417	—
Inventories, net	655,652	884,273
Prepaid expenses and other	97,248	114,316
Total current assets	2,324,667	2,558,745
Property, plant and equipment, net of accumulated depreciation of $952,293 and $968,033, respectively	608,739	671,796
Goodwill	1,203,768	1,218,188
Deferred taxes	61,153	51,974
Other intangible assets, net	195,864	210,049
Other assets, net	210,873	199,722
Total assets	$ 4,605,064	$ 4,910,474
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable	$ 400,281	$ 443,113
Accrued liabilities	398,285	724,196
Contract liabilities	174,245	—
Debt due within one year	67,269	75,599
Total current liabilities	1,040,080	1,242,908
Long-term debt due after one year	1,436,746	1,499,658
Retirement obligations and other liabilities	497,511	496,954
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	489,066	488,326
Retained earnings	3,505,051	3,503,947
Treasury shares, at cost – 46,240 and 46,471 shares, respectively	(2,049,535)	(2,059,558)
Deferred compensation obligation	7,025	6,354
Accumulated other comprehensive loss	(559,559)	(505,473)
Total Flowserve Corporation shareholders' equity	1,613,039	1,654,587
Noncontrolling interests	17,688	16,367
Total equity	1,630,727	1,670,954
Total liabilities and equity	$ 4,605,064	$ 4,910,474

See accompanying notes to condensed consolidated financial statements.

Table of Contents

FLOWSERVE CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

(Amounts in thousands)	Nine Months Ended September 30, 2018	2017
Cash flows – Operating activities:		
Net earnings, including noncontrolling interests	$60,685	$110,216
Adjustments to reconcile net earnings to net cash provided (used) by operating activities:		
Depreciation	72,668	75,177
Amortization of intangible and other assets	12,548	12,767
Loss (gain) on disposition of businesses	7,727	(141,158)
Stock-based compensation	14,130	20,291
Foreign currency, asset impairments and other non-cash adjustments	31,678	24,696
Change in assets and liabilities:		
Accounts receivable, net	(9,481)	63,835
Inventories, net	(46,699)	(20,355)
Contract assets, net	(54,822)	—
Prepaid expenses and other assets, net	(16,340)	22,456
Accounts payable	(29,963)	(68,012)
Contract liabilities	3,410	—
Accrued liabilities and income taxes payable	(13,690)	(6,702)
Retirement obligations and other	(1,480)	(18,720)
Net deferred taxes	(4,033)	(2,131)
Net cash flows provided by operating activities	26,338	72,360
Cash flows – Investing activities:		
Capital expenditures	(49,976)	(40,620)
Proceeds from disposal of assets and other	4,062	2,977
(Payments) proceeds from disposition of businesses	(3,663)	208,775
Net cash flows (used) provided by investing activities	(49,577)	171,132
Cash flows – Financing activities:		
Payments on long-term debt	(45,000)	(45,000)
Proceeds under other financing arrangements	2,720	6,234
Payments under other financing arrangements	(9,093)	(12,560)
Payments related to tax withholding for stock-based compensation	(2,972)	(6,287)
Payments of dividends	(74,548)	(74,412)
Other	(4,333)	(4,189)
Net cash flows used by financing activities	(133,226)	(136,214)
Effect of exchange rate changes on cash	(17,038)	27,703
Net change in cash and cash equivalents	(173,503)	134,981
Cash and cash equivalents at beginning of period	703,445	367,162
Cash and cash equivalents at end of period	$529,942	$502,143

See accompanying notes to condensed consolidated financial statements.

Table of Contents

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 September 30, 2018, the related condensed consolidated statements of income and comprehensive income for the three and nine months ended September 30, 2018 and 2017 and the condensed consolidated statements of cash flows for the nine months ended September 30, 2018 and 2017 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. Where applicable, prior period information has been updated to conform to current year presentation.
The accompanying condensed consolidated financial statements and notes in this Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2018 ("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 audited consolidated financial statements presented in our Annual Report on Form 10-K for the year ended December 31, 2017 ("2017 Annual Report").
Argentina Highly Inflationary - Effective July 1, 2018, Argentina was designated as hyperinflationary, and as a result, we began using the U.S. dollar as our functional currency in Argentina. Our Argentinian subsidiary's sales for the three and nine months ended September 30, 2018 and total assets at September 30, 2018 represented approximately 1% of our consolidated sales and total assets.
Accounting Developments
Pronouncements Implemented
In May 2014, the FASB issued Accounting Standards Update ("ASU") No. 2014-09, "Revenue from Contracts with Customers (Topic 606)" (the "New Revenue Standard" or "ASC 606"), which supersedes most of the revenue recognition requirements in "Revenue Recognition (Topic 605)" ("Topic 605"). On January 1, 2018, we adopted the New Revenue Standard using the modified retrospective method for transition, applying the guidance to those contracts which were not completed as of that date. According to our method of transition we adjusted for the cumulative effect of the changes made to our condensed consolidated balance sheet and recorded a cumulative effect adjustment to increase retained earnings by approximately $20 million, mostly associated with the increase in percentage of completion ("POC") method revenue, as a result of initially applying the standard. We have modified our accounting policies and practices, business processes, systems and controls to support compliance with the standard requirements. Revenue recognition and related financial information for this Quarterly Report are based on the requirements of ASC 606. Accordingly, periods prior to January 1, 2018 are presented in accordance with Topic 605. Refer to Note 2 of this Quarterly Report for a discussion on our adoption of the New Revenue Standard.
In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities." The ASU requires entities to measure equity investments that do not result in consolidation and are not accounted for under the equity method at fair value with changes in fair value recognized in net income. The ASU also requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. The requirement to disclose the method(s) and significant assumptions used to estimate the fair value for financial instruments measured at amortized cost on the balance sheet has been eliminated by this ASU. In February 2018, the FASB issued ASU No. 2018-03, "Technical Corrections and Improvements to Financial Instruments-Overall (Subtopic 825-10)" to clarify certain aspects of ASU No. 2016-01. Our adoption of ASU No. 2016-01 and ASU No. 2018-03 effective January 1, 2018 did not have an impact on our consolidated financial condition and results of operations.
In August 2016, the FASB issued ASU No. 2016-15, “Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments - A consensus of the FASB Emerging Issues Task Force.” The update was issued

with the objective of reducing the existing diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows under Topic 230 and other topics. Our adoption of ASU No. 2016-15 effective January 1, 2018 did not have a material impact on our consolidated statement of cash flows.

In October 2016, the FASB issued ASU No. 2016-16, "Income Taxes (Topic 740) Intra-Entity Transfers of Assets Other Than Inventory." The ASU guidance requires the recognition of the income tax consequences of an intercompany asset transfer, other than transfers of inventory, when the transfer occurs. For intercompany transfers of inventory, the income tax effects will continue

Table of Contents

to be deferred until the inventory has been sold to a third party. Our adoption of ASU No. 2016-16 effective January 1, 2018 did not have a material impact on our consolidated financial condition and results of operations.
In November 2016, the FASB issued ASU No. 2016-18, "Statement of Cash Flows (Topic 230): Restricted Cash." The amendments in this ASU require that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. Our adoption of ASU No. 2016-18 effective January 1, 2018 did not have a material impact on our consolidated statement of cash flows.
In January 2017, the FASB issued ASU No. 2017-01, "Business Combinations (Topic 805): "Clarifying the Definition of a Business." The ASU clarifies the definition of a business and provides guidance on evaluating as to whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The definition clarification as outlined in this ASU affects many areas of accounting including acquisitions, disposals, goodwill, and consolidation. Our adoption of ASU No. 2017-01 effective January 1, 2018 did not have a material impact on our consolidated financial condition and results of operations.
In February 2017, the FASB issued ASU No. 2017-05, "Other Income - Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets." The FASB issued this ASU to clarify the scope of subtopic 610-20, which the FASB had failed to define in its issuance of ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)." We adopted ASU No. 2017-05 effective January 1, 2018, concurrently with ASU No. 2014-09. Our adoption of ASU No. 2017-05 effective January 1, 2018 did not have a material impact on our consolidated financial condition and results of operations.
In March 2017, the FASB issued ASU No. 2017-07, "Compensation-Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost." The ASU requires entities to disaggregate the current service cost component from the other components of net benefit cost and present it with other current compensation costs for related employees in the income statement and present the other components of net benefit cost elsewhere in the income statement and outside of operating income. Entities are required to retrospectively apply the requirement for a separate presentation in the income statement of service costs and other components of net benefit cost. We adopted the income statement presentation aspects of this new guidance on a retrospective basis. The following is a reconciliation of the effect of the reclassification of the net post-retirement benefit cost from cost of sales ("COS") and selling, general and administrative expenses ("SG&A") to other expense, net in our condensed consolidated statement of income for the three and nine months ended September 30, 2017:

(Amounts in thousands)	As Previously Reported	Adjustments(1)	As Reported
Three Months Ended September 30, 2017			
Cost of sales	$(615,848)	$ 480	$(615,368)
Gross profit	267,532	480	268,012
Selling, general and administrative expense	(206,295)	294	(206,001)
Operating income	74,019	774	74,793
Other income, net	8,285	(774)	7,511
Nine Months Ended September 30, 2017			
Cost of sales	$(1,845,796)	$ 1,493	$(1,844,303)
Gross profit	780,966	1,493	782,459
Selling, general and administrative expense	(681,181)	876	(680,305)
Operating income	249,970	2,369	252,339
Other expense, net	(11,602)	(2,369)	(13,971)

(1) We elected the practical expedient that allows us to use the amounts disclosed in prior comparative periods' pension and postretirement plan footnotes as the basis for the retrospective application of the new income statement presentation requirements. See Note 11 of this Quarterly Report for additional information on the components of the net periodic cost for retirement and postretirement benefits plans.

In May 2017, the FASB issued ASU No. 2017-09, "Compensation-Stock Compensation (Topic 718): Scope of Modification Accounting." The ASU provides guidance on the types of changes to the terms or conditions of share-based payment awards, to which an entity would be required to apply modification accounting. The ASU is applied prospectively to awards modified on or

Table of Contents

after the effective date. Our adoption of ASU No. 2017-09 effective January 1, 2018 did not have an impact on our consolidated financial condition and results of operations.

Pronouncements Not Yet Implemented

In February 2016, the FASB issued ASU No. 2016-02, “Leases (Topic 842)”. The ASU requires that organizations that lease assets recognize assets and liabilities on the balance sheet for the rights and obligations created by those leases. The ASU will affect the presentation of lease related expenses on the income statement and statement of cash flows and will increase the required disclosures related to leases. This ASU is effective for annual periods beginning after December 15, 2018, including interim periods within those fiscal years with early adoption permitted. We are currently evaluating the impact of ASU No. 2016-02 and all related ASU's on our consolidated financial condition and results of operations. We have formed a project team and are in the process of assessing critical components of this new guidance and the potential impact that the guidance will have on our financial position, results of operations and cash flows. This evaluation process includes a review of our leasing contracts and a completeness assessment over our lease population. We are implementing a software tool and are concurrently identifying changes to our business processes, systems and controls to support adoption of the new standard. Based on the preliminary work completed and our initial qualitative evaluation, we believe a key change upon adoption of the standard will be the balance sheet recognition of leased assets and liabilities. Also, based on the same qualitative evaluation, we believe that any changes in income statement recognition will not be material.

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments-Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments." The ASU requires, among other things, the use of a new current expected credit loss ("CECL") model in order to determine our allowances for doubtful accounts with respect to accounts receivable and contract assets. The CECL model requires that we estimate our lifetime expected credit loss with respect to our receivables and contract assets and record allowances that, when deducted from the balance of the receivables, represent the net amounts expected to be collected. We will also be required to disclose information about how we developed the allowances, including changes in the factors that influenced our estimate of expected credit losses and the reasons for those changes. The amendments of the ASU are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. We are currently evaluating the impact of ASU No. 2016-13 on our consolidated financial condition and results of operations.

In January 2017, the FASB issued ASU No. 2017-04, "Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment." The amendments in this ASU allow companies to apply a one-step quantitative test and record the amount of goodwill impairment as the excess of a reporting unit’s carrying amount over its fair value, not to exceed the total amount of goodwill allocated to the reporting unit. The amendments of the ASU are effective for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. We are currently evaluating the impact of ASU No. 2017-04 on our consolidated financial condition and results of operations.

On July 13, 2017, the FASB issued ASU No. 2017-11, “Earnings Per Share (Topic 260); Distinguishing Liabilities from Equity (Topic 480); Derivatives and Hedging (Topic 815): (Part I) Accounting for Certain Financial Instruments with Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatory Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatory Redeemable Noncontrolling Interests with a Scope Exception.” The ASU amends guidance in FASB Accounting Standards Codification ("ASC") 260, Earnings Per Share, FASB ASC 480, Distinguishing Liabilities from Equity, and FASB ASC 815, Derivatives and Hedging. The amendments in Part I of this ASU change the classification analysis of certain equity-linked financial instruments (or embedded features) with down round features. The amendments in Part II of the ASU re-characterize the indefinite deferral of certain provisions of Topic 480 that now are presented as pending content in the codification, to a scope exception. The amendments in this ASU must be applied to annual reporting periods beginning after December 15, 2018. Early adoption is permitted. We are currently evaluating the impact of ASU No. 2017-11 on our consolidated financial condition and results of operations.

On August 28, 2017, the FASB issued ASU No. 2017-12, "Derivatives and Hedging (Topic 815): Targeted improvements of Accounting for Hedging Activities." The purpose of this ASU is to better align a company’s risk management activities and financial reporting for hedging relationships. Additionally, the ASU simplifies the hedge accounting requirements and improve the disclosures of hedging arrangements. The amendments in this ASU must be applied to annual reporting periods beginning after December 15, 2019. Early adoption is permitted. We are currently evaluating the impact of ASU No. 2017-12 on our consolidated financial condition and results of operations.

In February 2018, the FASB issued ASU No. 2018-02, "Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Comprehensive Income (“AOCI”)." The ASU and its amendments were issued as a result of the enactment of the U.S. Tax Cuts and Jobs Act of 2017. The amendments of this ASU address the available options to reclassify stranded tax effects within AOCI to retained earnings in each period in which the effect of the change (or portion thereof) is recorded. Additionally, the ASU outlines the disclosure requirements for releasing income tax effects from

Table of Contents

AOCI. The ASU is effective for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years. Early adoption is permitted. The ASU should be applied either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act is recognized. We are currently evaluating the impact of ASU No. 2018-02 on our consolidated financial condition and results of operations.

In July 2018, the FASB issued ASU No. 2018-07, "Compensation - Stock Compensation (Topic 718) - Improvements to Non-employee Share-based Payment Accounting." The amendments of this ASU apply to all share-based payment transactions to non-employees, in which a grantor acquires goods or services to be used or consumed in a grantor’s own operations, accounted under ASC 505-50, Equity-Based Payments to Non-Employees. Under the amendments of ASU 2018-07, most of the guidance on compensation to nonemployees would be aligned with the requirements for shared based payments granted to employees, Topic 718. The ASU is effective for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years. Early adoption is permitted. We are currently evaluating the impact of ASU No. 2018-07 on our consolidated financial condition and results of operations.

In August 2018, the FASB issued ASU No. 2018-13, "Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement." The amendments of the ASU modify the disclosure requirements for fair value measurements by removing, modifying, or adding certain disclosure information requirements for assets and liabilities measured at fair value in the statement of financial position or disclosed in the notes to financial statements. The ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019, with early adoption permitted for the removed disclosures and delayed adoption until fiscal year 2020 permitted for the new disclosures. The removed and modified disclosures will be adopted on a retrospective basis and the new disclosures will be adopted on a prospective basis. We are currently evaluating the impact of ASU No. 2018-13 on our consolidated financial condition and results of operations.

In August 2018, the FASB issued ASU No. 2018-14, "Compensation-Retirement Benefits-Defined Benefit Plans-General (Subtopic 715-20): Disclosure Framework-Changes to the Disclosure Requirements for Defined Benefit Plans." The ASU amends the disclosure requirements by adding, clarifying, or removing certain disclosures for sponsor defined benefit pension or other postretirement plans. The amendments are effective for fiscal years ending after December 15, 2020 and the amendments should be applied retrospectively to all periods presented. We are currently evaluating the impact of ASU No. 2018-14 on our consolidated financial condition and results of operations.

In August 2018, the FASB issued ASU No. 2018-15, "Intangibles-Goodwill and Other-Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract." The ASU addresses how entities should account for costs associated with implementing a cloud computing arrangement that is considered a service contract. Per the amendments of the ASU, implementation costs incurred in a cloud computing arrangement that is a service contract should be accounted for in the same manner as implementation costs incurred to develop or obtain software for internal use as prescribed by guidance in ASC350-40. The ASU requires that implementation costs incurred in a cloud computing arrangement be capitalized rather than expensed. Further, the ASU specifies the method for the amortization of costs incurred during implementation, and the manner in which the unamortized portion of these capitalized implementation costs should be evaluated for impairment. The ASU also provides guidance on how to present such implementation costs in the financial statements and also creates additional disclosure requirements. The amendments are effective for fiscal years beginning after December 15, 2019, including interim periods. Early adoption of the ASU requirements is permitted, including adoption in any interim period. The amendments in this ASU should be applied either retrospectively or prospectively to all implementation costs incurred after the date of adoption. We are currently evaluating the impact of ASU No. 2018-15 on our consolidated financial condition and results of operations.

2. Revenue Recognition

We enter into contracts with customers typically having multiple commitments of goods and services including any combination of designing, developing, manufacturing, modifying, installing and commissioning of flow management equipment and providing services and parts related to the performance of such products. We evaluate the commitments in our contracts with customers to determine if the commitments are both capable of being distinct and distinct in the context of the contract in order to identify performance obligations.

We recognize revenue when (or as) we satisfy a performance obligation by transferring control of the performance obligation to a customer. Control of a performance obligation may transfer to the customer either over time or at a point in time depending on an evaluation of the specific facts and circumstances for each contract, including the terms and conditions of the contract as agreed with the customer, as well as the nature of the products or services to be provided. Our larger contracts are typically completed within a one to three-year period, while many other contracts, such as “short cycle” contracts, have a shorter timeframe for revenue recognition.

Table of Contents

Control transfers over time when the customer is able to direct the use of and obtain substantially all of the benefits of our work as we perform. This typically occurs when products have no alternative use and we have a right to payment for performance completed to date, including a reasonable profit margin. Our contracts often include cancellation provisions that require the customer to reimburse us for costs incurred up to the date of cancellation, and some contracts also provide for reimbursement of profit upon cancellation in addition to costs incurred to date.

Our primary method for recognizing revenue over time is the POC method. We measure progress towards completion by applying an input measure based on costs incurred to date relative to total estimated costs at completion (i.e., the cost-to-cost method). This method provides a reasonable depiction of the transfer of control of products and services to customers as it ensures our efforts towards satisfying a performance obligation, as reflected by costs incurred, are included in the measure of progress used for recognition of revenue. Costs generally include direct labor, direct material and manufacturing overhead. Costs that do not contribute towards control transfer are generally immaterial, but are excluded from the measure of progress in the event they are significant.

Historically, revenue recognized under the POC method has been 5% to 10% of our consolidated sales. Under the New Revenue Standard, we have experienced an increase in the amount of revenue recognized over time. This increase is primarily due to the application of the new "transfer of control" model for revenue recognition. Under this model, revenue for performance obligations subject to contractual transfer of control during the manufacturing process are recognized over time. This includes contracts with cancellation provisions that require reimbursement for costs incurred plus a reasonable margin and for which the performance obligation has no alternative use. Revenue from products and services transferred to customers over time accounted for approximately 21% and 5% of total revenue for the three month periods ended September 30, 2018 and 2017, respectively, and 22% and 4% of total revenue for the nine month periods ended September 30, 2018 and 2017, respectively.

If control does not transfer over time, then control transfers at a point in time. We recognize revenue at a point in time at the level of each performance obligation based on the evaluation of certain indicators of control transfer, such as title transfer, risk of loss transfer, customer acceptance and physical possession. Revenue from products and services transferred to customers at a point in time accounted for approximately 79% and 95% of total revenue for the three month periods ended September 30, 2018 and 2017, respectively, and 78% and 96% of total revenue for the nine month periods ended September 30, 2018 and 2017, respectively.

A contract modification, or "change order," occurs when the existing enforceable rights and obligations of a contract change, such as a change in the scope, price or terms and conditions. We account for a change order as a new accounting contract when the change order is limited to adding new, distinct products and services that are priced in an amount consistent with standalone selling price. Other change orders are accounted for as a modification of the existing accounting contract. When a change order occurs for a contract having in-process over time performance obligations, the effect of the change order on the transaction price and the measure of progress for the performance obligations to which it relates is recognized as an adjustment to revenue (either as an increase in or a reduction of revenue) on a cumulative catch-up basis.

Freight charges billed to customers are included in sales and the related shipping costs are included in cost of sales in our consolidated statements of income. If shipping activities are performed after a customer obtains control of a product, we apply a policy election to account for shipping as an activity to fulfill the promise to transfer the product to the customer.

We apply a policy election to exclude transaction taxes collected from customers from sales when the tax is both imposed on and concurrent with a specific revenue-producing transaction.

In certain instances, we provide guaranteed completion dates under the terms of our contracts. Failure to meet contractual delivery dates can result in late delivery penalties or liquidated damages. In the event that the transaction price of such a contract is probable of experiencing a significant reversal due to a penalty, we constrain a portion of the transaction price. This reduction to the transaction price could potentially cause estimated total contract costs to exceed the transaction price, in which case we record a provision for the estimated loss in the period the loss is first projected. In circumstances where the transaction price still exceeds total projected costs, the estimated penalty generally reduces profitability of the contract at the time of subsequent revenue recognition.

Our incremental costs to obtain a contract are limited to sales commissions. We apply the practical expedient to expense commissions as incurred for contracts having a duration of one year or less. Sales commissions related to contracts with a duration of greater than one year are immaterial to our financial statements and are also expensed as incurred.

We have not identified any material costs to fulfill a contract that qualify for capitalization under ASC 340-40.

Performance Obligations

A performance obligation is a promise in a contract to transfer a distinct good or service to the customer, and is the unit of account for recognition of revenue. Many of our contracts have multiple performance obligations as the promise to transfer the individual goods or services, or certain groups of goods and services, is separately identifiable from other promises in the contract.

Table of Contents

We allocate the transaction price of each contract to the performance obligations on the basis of standalone selling price and recognize revenue when, or as, control of each performance obligation transfers to the customer. For standard products, we identify the standalone selling price based on directly observable information. For customized or unique products and services, we apply the cost plus margin approach to estimate the standalone selling price. Under this method, we forecast our expected costs of satisfying a performance obligation and then add an appropriate standalone market margin for that distinct good or service.

We have elected to use the practical expedient to not adjust the transaction price of a contract for the effects of a significant financing component if, at the inception of the contract, we expect that the period between when we transfer a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

A material product warranty exists when a customer has specifically requested or negotiated a warranty period that is significantly longer than our standard warranty period (i.e., a "service-type warranty") and where the warranty obligation is material in the context of the contract. It is not common for our contracts to contain material product warranties. However, when such a warranty exists, we account for it as a separate performance obligation. We estimate the standalone selling price of the warranty obligation utilizing a cost plus margin approach and allocate a portion of the transaction price to the warranty performance obligation on the basis of estimated standalone selling price. We recognize revenue for warranty performance obligations over time on a straight line basis over the extended warranty period.

A material right option is a benefit provided to a customer in a current contract, such as an option to receive future products or services for free or at a significant discount, that is incremental to benefits widely available to similar customers that do not enter into a specific contract. It is not common for our contracts to contain material right options. However, when a material right option exists, it is accounted for as a separate performance obligation and a portion of the transaction price is allocated to the performance obligation based on the estimated standalone selling price of the option. Revenue is recognized when (or as) the customer exercises the right to acquire future products and/or services.

On September 30, 2018, the aggregate transaction price allocated to unsatisfied (or partially unsatisfied) performance obligations was approximately $1,354 million. We estimate recognition of approximately $658 million of this amount as revenue in the remainder of 2018 and an additional $696 million in 2019 and thereafter.

Revenue recognized for performance obligations satisfied (or partially satisfied) in prior periods for the three and nine months ended September 30, 2018 was not material.

Table of Contents

ASC 606 Adoption Impact

We applied ASC 606 only to contracts that were not substantially complete as of January 1, 2018 and reflected the aggregate impact of all contract modifications ("change orders") that occurred before the beginning of the earliest period presented when accounting for modified contracts at transition. The following table presents the cumulative effect of the changes made to our condensed consolidated balance sheet as of January 1, 2018 related to the adoption of the New Revenue Standard:

(Amounts in thousands)	December 31, 2017	Adjustments due to adoption of New Revenue Standard	January 1, 2018
Accounts receivable, net of allowance for doubtful accounts(1)	856,711	(49,247)	807,464
Contract assets, net(2)	—	219,361	219,361
Inventories, net(3)	884,273	(238,573)	645,700
Prepaid expenses and other	114,316	(4,457)	109,859
Total current assets	2,558,745	(72,916)	2,485,829
Deferred taxes	51,974	(2,706)	49,268
Other assets, net	199,722	2,004	201,726
Total assets	4,910,474	(73,618)	4,836,856
Accounts payable	443,113	11,784	454,897
Accrued liabilities(4)	724,196	(290,445)	433,751
Contract liabilities(5)	—	178,515	178,515
Total current liabilities	1,242,908	(100,146)	1,142,762
Retirement obligations and other liabilities	496,954	6,568	503,522
Retained earnings	3,503,947	19,642	3,523,589
Total equity	1,670,954	19,960	1,690,914
Total liabilities and equity	4,910,474	(73,618)	4,836,856

(1) Adjusted for contract assets accounted for under delivery based methods, previously reported in receivables, net.
(2) Represents our right of payment in advance of our contractual right to bill the customer.
(3) Adjusted for contract assets accounted under the over time method, previously reported in inventories, net.
(4) Adjusted for deferred revenue previously reported in accrued liabilities and reclassified to contract assets and contract liabilities.
(5) Represents contractual billings in excess of revenue recognized at the contract level, previously reported in accrued liabilities.

Table of Contents

The modified retrospective approach requires a dual reporting presentation to be disclosed in the year of adoption. The dual reporting requirement outlines the impact amount by which a financial statement line is affected in the current reporting period by the adoption of the New Revenue Standard as compared with the previous standard in effect before the adoption.

The following tables present the dual reporting requirements:

(Amounts in thousands, except percentages)	Three Months Ended September 30, 2018		
	Balances without Adoption of New Revenue Standard	Effect of Change	As Reported
Sales	$929,037	$23,679	$952,716
Cost of sales	(635,505)	(8,710)	(644,215)
Gross profit	293,532	14,969	308,501
Gross profit margin	31.6 %		32.4 %
Selling, general and administrative expense	(241,877)	(1)	(241,878)
Loss on sale of business	(7,727)	—	(7,727)
Net earnings from affiliates	3,295	—	3,295
Operating income	47,223	14,968	62,191
Operating income as a percent of sales	5.1 %		6.5 %
Interest expense	(13,826)	—	(13,826)
Interest income	1,269	—	1,269
Other expense, net	(5,494)	211	(5,283)
Earnings before income taxes	29,172	15,179	44,351