

SMITH A O CORP  
Form 10-Q  
August 05, 2014  
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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 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 Number 1-475**

**A. O. Smith Corporation**

**(Exact name of registrant as specified in its charter)**

**Delaware**  
**(State or other jurisdiction of**  
**incorporation or organization)**

**39-0619790**  
**(I.R.S. Employer**  
**Identification No.)**

**11270 West Park Place, Milwaukee, Wisconsin**  
**(Address of principal executive office)**  
**(414) 359-4000**

**53224-9508**  
**(Zip Code)**

**(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

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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 the definitions of large accelerated filer, 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 Act.) ☐ Yes ☒ No

Class A Common Stock Outstanding as of July 31, 2014 13,166,522 shares

Common Stock Outstanding as of July 31, 2014 76,865,850 shares

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**A. O. Smith Corporation**

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## A. O. SMITH CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(dollars in millions, except per share data)

(unaudited)

|                                                        | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |            |
|--------------------------------------------------------|--------------------------------|----------|------------------------------|------------|
|                                                        | 2014                           | 2013     | 2014                         | 2013       |
| Net sales                                              | \$ 595.4                       | \$ 549.1 | \$ 1,147.6                   | \$ 1,058.7 |
| Cost of products sold                                  | 379.2                          | 351.1    | 735.5                        | 681.4      |
| Gross profit                                           | 216.2                          | 198.0    | 412.1                        | 377.3      |
| Selling, general and administrative expenses           | 137.4                          | 131.6    | 268.3                        | 251.6      |
| Restructuring, impairment and settlement expenses, net |                                | 4.2      |                              | 5.9        |
| Interest expense                                       | 1.4                            | 1.6      | 2.8                          | 3.1        |
| Other income                                           | (1.2)                          | (0.7)    | (2.5)                        | (1.7)      |
|                                                        | 78.6                           | 61.3     | 143.5                        | 118.4      |
| Provision for income taxes                             | 21.3                           | 19.2     | 39.5                         | 37.3       |
| Net Earnings                                           | \$ 57.3                        | \$ 42.1  | \$ 104.0                     | \$ 81.1    |
| Net Earnings Per Share of Common Stock                 | \$ 0.63                        | \$ 0.45  | \$ 1.15                      | \$ 0.88    |
| Diluted Net Earnings Per Share of Common Stock         | \$ 0.63                        | \$ 0.45  | \$ 1.14                      | \$ 0.87    |
| Dividends Per Share of Common Stock                    | \$ 0.15                        | \$ 0.12  | \$ 0.30                      | \$ 0.22    |

## A. O. SMITH CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE EARNINGS

(dollars in millions)

(unaudited)

|                                                                                                                                              | Three Months Ended<br>June 30, |         | Six Months Ended<br>June 30, |         |
|----------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------|---------|------------------------------|---------|
|                                                                                                                                              | 2014                           | 2013    | 2014                         | 2013    |
| Net earnings                                                                                                                                 | \$ 57.3                        | \$ 42.1 | \$ 104.0                     | \$ 81.1 |
| Other comprehensive earnings (loss)                                                                                                          |                                |         |                              |         |
| Foreign currency translation adjustments                                                                                                     | 2.7                            | (4.1)   | (7.7)                        | (5.6)   |
| Unrealized net loss on cash flow derivative instruments, less related income tax benefit of \$0.9 and \$0.4 in 2014, \$0.5 and \$0.1 in 2013 | (1.5)                          | (0.9)   | (0.6)                        | (0.2)   |
| Adjustment to pension liability gain, less related income tax provision of \$(2.0) and \$(6.6) in 2014 and \$(0.8) and \$(4.7) in 2013       | 3.2                            | 1.3     | 8.5                          | 7.6     |
| Comprehensive Earnings                                                                                                                       | \$ 61.7                        | \$ 38.4 | \$ 104.2                     | \$ 82.9 |

See accompanying notes to unaudited condensed consolidated financial statements.

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## A. O. SMITH CORPORATION

## CONDENSED CONSOLIDATED BALANCE SHEETS

(dollars in millions, except share data)

|                                    | (unaudited)       |                   |
|------------------------------------|-------------------|-------------------|
|                                    | June 30, 2014     | December 31, 2013 |
| <b>Assets</b>                      |                   |                   |
| <b>Current Assets</b>              |                   |                   |
| Cash and cash equivalents          | \$ 393.7          | \$ 380.7          |
| Marketable securities              | 102.9             | 105.3             |
| Receivables                        | 457.0             | 458.7             |
| Inventories                        | 206.8             | 193.4             |
| Deferred income taxes              | 40.6              | 40.1              |
| Other current assets               | 32.9              | 27.4              |
| <b>Total Current Assets</b>        | <b>1,233.9</b>    | <b>1,205.6</b>    |
| Property, plant and equipment      | 789.1             | 758.7             |
| Less accumulated depreciation      | 372.6             | 367.4             |
| Net property, plant and equipment  | 416.5             | 391.3             |
| Goodwill                           | 433.3             | 433.5             |
| Other intangibles                  | 317.6             | 324.8             |
| Other assets                       | 29.4              | 36.3              |
| <b>Total Assets</b>                | <b>\$ 2,430.7</b> | <b>\$ 2,391.5</b> |
| <b>Liabilities</b>                 |                   |                   |
| <b>Current Liabilities</b>         |                   |                   |
| Trade payables                     | \$ 356.9          | \$ 387.1          |
| Accrued payroll and benefits       | 52.4              | 61.7              |
| Accrued liabilities                | 80.5              | 81.2              |
| Product warranties                 | 46.0              | 46.7              |
| Long-term debt due within one year | 14.2              | 14.2              |
| <b>Total Current Liabilities</b>   | <b>550.0</b>      | <b>590.9</b>      |
| Long-term debt                     | 236.2             | 177.7             |

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|                                                                                                     |                   |                   |
|-----------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Pension liabilities                                                                                 | 109.8             | 110.7             |
| Other liabilities                                                                                   | 178.0             | 183.5             |
| <b>Total Liabilities</b>                                                                            | <b>1,074.0</b>    | <b>1,062.8</b>    |
| <b>Stockholders' Equity</b>                                                                         |                   |                   |
| Class A Common Stock, \$5 par value: authorized 14,000,000 shares; issued 13,231,930 and 13,232,412 | 66.2              | 66.4              |
| Common Stock, \$1 par value: authorized 120,000,000 shares; issued 82,121,866 and 82,065,280        | 82.1              | 82.1              |
| Capital in excess of par value                                                                      | 597.2             | 589.7             |
| Retained earnings                                                                                   | 1,058.8           | 982.2             |
| Accumulated other comprehensive loss                                                                | (258.9)           | (259.1)           |
| Treasury stock at cost                                                                              | (188.7)           | (132.6)           |
| <b>Total Stockholders' Equity</b>                                                                   | <b>1,356.7</b>    | <b>1,328.7</b>    |
| <b>Total Liabilities and Stockholders' Equity</b>                                                   | <b>\$ 2,430.7</b> | <b>\$ 2,391.5</b> |

See accompanying notes to unaudited condensed consolidated financial statements.

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## A. O. SMITH CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(dollars in millions)

(unaudited)

|                                                                                           | Six Months Ended<br>June 30, |         |
|-------------------------------------------------------------------------------------------|------------------------------|---------|
|                                                                                           | 2014                         | 2013    |
| <b>Operating Activities</b>                                                               |                              |         |
| Net earnings                                                                              | \$ 104.0                     | \$ 81.1 |
| Adjustments to reconcile net earnings to cash provided by (used in) operating activities: |                              |         |
| Depreciation and amortization                                                             | 29.6                         | 28.0    |
| Pension expense                                                                           | 13.2                         | 14.0    |
| Loss on disposal of assets                                                                | 0.4                          | 0.2     |
| Net changes in operating assets and liabilities, net of acquisitions:                     |                              |         |
| Current assets and liabilities                                                            | (55.1)                       | (13.8)  |
| Noncurrent assets and liabilities                                                         | (1.2)                        | (3.1)   |
| <b>Cash Provided by Operating Activities - continuing operations</b>                      | 90.9                         | 106.4   |
| <b>Cash Used in Operating Activities - discontinued operations</b>                        | (1.1)                        | (1.4)   |
| <b>Cash Provided by Operating Activities</b>                                              | 89.8                         | 105.0   |
| <b>Investing Activities</b>                                                               |                              |         |
| Capital expenditures                                                                      | (50.8)                       | (38.2)  |
| Acquisition of business                                                                   |                              | (4.0)   |
| Investments in marketable securities                                                      | (110.3)                      | (59.3)  |
| Net proceeds from sale of securities                                                      | 110.4                        | 157.7   |
| <b>Cash (Used in) Provided by Investing Activities</b>                                    | (50.7)                       | 56.2    |
| <b>Financing Activities</b>                                                               |                              |         |
| Long-term debt incurred (retired)                                                         | 58.5                         | (34.4)  |
| Common stock repurchases                                                                  | (60.8)                       | (14.0)  |
| Net proceeds from stock option activity                                                   | 3.6                          | 6.9     |
| Dividends paid                                                                            | (27.4)                       | (20.5)  |
| <b>Cash Used in Financing Activities</b>                                                  | (26.1)                       | (62.0)  |

|                                                  |                 |                 |
|--------------------------------------------------|-----------------|-----------------|
| Net increase in cash and cash equivalents        | 13.0            | 99.2            |
| Cash and cash equivalents - beginning of period  | 380.7           | 266.9           |
| <b>Cash and Cash Equivalents - End of Period</b> | <b>\$ 393.7</b> | <b>\$ 366.1</b> |

See accompanying notes to unaudited condensed consolidated financial statements.

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**PART I - FINANCIAL INFORMATION**

**ITEM 1 - FINANCIAL STATEMENTS**

**A. O. SMITH CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**June 30, 2014**

**(unaudited)**

**1. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2014 are not necessarily indicative of the results expected for the full year. It is suggested that the accompanying condensed consolidated financial statements be read in conjunction with the audited consolidated financial statements and the notes thereto included in the company's latest Annual Report on Form 10-K filed with the SEC on February 20, 2014.

On April 15, 2013, the company's stockholders approved a proposal to increase the company's authorized shares of Common Stock and the company's board of directors declared a two-for-one stock split of the company's Class A Common Stock and Common Stock (including treasury shares) in the form of a 100 percent stock dividend to stockholders of record on April 30, 2013 and payable on May 15, 2013. All references in the financial statements and footnotes to the number of shares outstanding, price per share, per share amounts and stock based compensation data have been recast to reflect the split for all periods presented.

*Recent Accounting Pronouncements*

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Codification (ASC) 606-10, *Revenue from Contracts with Customers* (issued under Accounting Standards Update No. 2014-09).

ASC 606-10 will replace all existing revenue recognition guidance when effective. ASC 606-10 is effective for the year beginning January 1, 2017. The standard allows for either full retrospective adoption or modified retrospective adoption. The company is in the process of determining whether the adoption of ASC 606-10 will have an impact on the company's consolidated financial condition, results of operations or cash flows.

**2. Acquisition**

On February 14, 2013, the company acquired 100 percent of the shares of MiM Isitma Sogutma Havalandirma ve Aritma Sistemleri San. Tic. A.S. (MiM), a privately-held Turkish water treatment company. The addition of MiM expanded the company's product offerings and gave the company access to Eastern Europe and Black Sea region water treatment markets. MiM is included in the Rest of World segment.

The company paid an aggregate cash purchase price of \$4.0 million, net of cash received of \$1.9 million. In addition the company assumed debt of \$1.7 million and recorded contingent consideration of \$1.1 million, the fair value of the contingent payment due to the former owners of MiM if certain targets are met for growth in sales, gross profits and operating profits through 2017.

**Table of Contents****2. Acquisition (continued)**

The fair value of the purchase price resulted in an allocation to acquired intangible assets totaling \$4.3 million of which \$2.4 million has been assigned to customer lists which are being amortized over ten years.

MiM's results of operations have been included in the company's financial statements from February 14, 2013, the date of acquisition. Revenues and pre-tax results associated with MiM included in results of operations for the three and six months ended June 30, 2013 are not material to the company's net sales or pre-tax earnings.

**3. Restructuring, Impairment and Settlement Expenses - Net**

In the first quarter of 2013, the company announced a move of manufacturing operations from its Fergus, Ontario facility to other North American facilities. During the three months ended June 30, 2013, the company recognized \$4.2 million of pre-tax restructuring and impairment expenses, comprised of \$2.6 million of severance costs and \$1.6 million of inventory obsolescence expenses, as well as a corresponding \$1.1 million tax benefit related to the charge. For the six months ended June 30, 2013, the company recognized \$16.9 million of pre-tax restructuring and impairment expenses, comprised of \$7.8 million of severance costs, \$1.6 million of inventory obsolescence expenses and impairment charges related to long-lived assets totaling \$7.5 million, as well as a corresponding \$4.3 million tax benefit related to the charge. The majority of the consolidation of operations occurred in the second quarter of 2013.

In the first quarter of 2013, the company entered into a settlement agreement with a former supplier of a North American subsidiary regarding previous overcharges and warranty costs. The terms of the settlement agreement resulted in an \$11.0 million cash payment to the company, a pre-tax gain of \$11.0 million and a related \$4.3 million income tax expense.

The following table presents an analysis of the company's restructuring and impairment reserves:

(dollars in millions)

|                              | Inventory<br>Obsolescence |       | Severance Costs |       | Equipment<br>Relocation<br>Costs | Total  |
|------------------------------|---------------------------|-------|-----------------|-------|----------------------------------|--------|
| Balance at December 31, 2013 | \$                        | 1.7   | \$              | 1.5   | \$ 0.4                           | \$ 3.6 |
| Cash payments/disposals      |                           | (0.4) |                 | (0.5) | (0.2)                            | (1.1)  |
| Balance at March 31, 2014    | \$                        | 1.3   | \$              | 1.0   | \$ 0.2                           | \$ 2.5 |
| Reserve adjustments          |                           | (0.4) |                 | 0.4   |                                  |        |
| Cash payments/disposals      |                           | (0.4) |                 | (0.2) | (0.2)                            | (0.8)  |
| Balance at June 30, 2014     | \$                        | 0.5   | \$              | 1.2   | \$                               | \$ 1.7 |

**Table of Contents****4. Inventories**

The following table presents the components of the company's inventory balances:

| (dollars in millions) |               |                   |
|-----------------------|---------------|-------------------|
|                       | June 30, 2014 | December 31, 2013 |
| Finished products     | \$ 102.7      | \$ 88.8           |
| Work in process       | 13.7          | 12.3              |
| Raw materials         | 111.7         | 113.6             |
|                       | 228.1         | 214.7             |
| LIFO reserve          | (21.3)        | (21.3)            |
|                       | \$ 206.8      | \$ 193.4          |

**5. Long-Term Debt**

The company has a \$400 million multi-currency revolving credit agreement with eight banks, which expires on December 12, 2017. The facility has an accordion provision which allows it to be increased up to \$500 million if certain conditions (including lender approval) are satisfied. Borrowings under bank credit lines and commercial paper borrowings are supported by the \$400 million revolving credit agreement. As a result of the long-term nature of this facility, the company's commercial paper and credit line borrowings are classified as long-term debt at June 30, 2014.

**6. Product Warranties**

The company offers warranties on the sales of certain of its products and records an accrual for the estimated future claims. The following table presents the company's warranty liability activity.

| (dollars in millions) |          |          |
|-----------------------|----------|----------|
|                       | 2014     | 2013     |
| Balance at January 1, | \$ 136.6 | \$ 129.6 |
| Expense               | 16.6     | 15.0     |
| Claims settled        | (17.3)   | (15.7)   |
| Balance at March 31,  | \$ 135.9 | \$ 128.9 |
| Expense               | 15.7     | 16.7     |
| Claims settled        | (15.2)   | (15.8)   |
| Balance at June 30,   | \$ 136.4 | \$ 129.8 |



**Table of Contents****7. Earnings Per Share of Common Stock**

The numerator for the calculation of basic and diluted earnings per share is net earnings. The following table sets forth the computation of basic and diluted weighted-average shares used in the earnings per share calculations:

|                                                                     | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|---------------------------------------------------------------------|--------------------------------|------------|------------------------------|------------|
|                                                                     | 2014                           | 2013       | 2014                         | 2013       |
| Denominator for basic earnings per share<br>weighted average shares | 90,509,155                     | 92,655,557 | 90,868,025                   | 92,603,598 |
| Effect of dilutive stock options and share units                    | 647,158                        | 576,351    | 690,957                      | 605,088    |
| Denominator for diluted earnings per share                          | 91,156,313                     | 93,231,908 | 91,558,982                   | 93,208,686 |

**8. Stock Based Compensation**

The company adopted the A. O. Smith Combined Incentive Compensation Plan (the plan) effective January 1, 2007. Stockholders reapproved the plan on April 16, 2012. The plan is a continuation of the A. O. Smith Combined Executive Incentive Compensation Plan which was originally approved by stockholders in 2002. The number of shares available for granting of options, restricted stock or share units under the plan at June 30, 2014 was 2,317,722. Upon stock option exercise or share unit vesting, shares are issued from treasury stock.

Total stock based compensation cost recognized in the three months ended June 30, 2014 and 2013 was \$2.0 million and \$2.4 million, respectively. Total stock based compensation cost recognized in the six months ended June 30, 2014 and 2013 was \$7.8 million and \$6.4 million, respectively.

*Stock Options*

The stock options granted in the six months ended June 30, 2014 and 2013 have three year pro-rata vesting from the date of grant. Stock options are issued at exercise prices equal to the fair value of Common Stock on the date of grant. For active employees, all options granted in 2014 and 2013 expire ten years after date of grant. Options are expensed ratably over the three-year vesting period; however included in the stock option expense for the three and six months ended June 30, 2014 and 2013 is expense associated with the accelerated vesting of stock option awards for certain employees who either are retirement eligible or become retirement eligible during the vesting period. Stock based compensation cost attributable to stock options in the three months ended June 30, 2014 and 2013 was \$0.9 million and \$1.1 million, respectively. Stock based compensation expense attributable to stock options in the six months ended June 30, 2014 and 2013 was \$3.7 million and \$2.9 million, respectively.

**Table of Contents****8. Stock Based Compensation (continued)**

Changes in option awards, all of which relate to Common Stock, were as follows for the six months ended June 30, 2014:

|                                | Weighted-Average<br>Per Share<br>Exercise Price | Six Months<br>Ended<br>June 30, 2014 | Average<br>Remaining<br>Contractual<br>Life | Aggregate<br>Intrinsic<br>Value<br>(dollars<br>in<br>millions) |
|--------------------------------|-------------------------------------------------|--------------------------------------|---------------------------------------------|----------------------------------------------------------------|
| Outstanding at January 1, 2014 | \$ 22.37                                        | 1,440,623                            |                                             |                                                                |
| Granted                        | 46.49                                           | 297,900                              |                                             |                                                                |
| Exercised                      | 13.99                                           | (91,269)                             |                                             |                                                                |
| Outstanding at June 30, 2014   | 27.19                                           | 1,647,254                            | 8 years                                     | \$ 31.8                                                        |
| Exercisable at June 30, 2014   | \$ 19.94                                        | 992,670                              | 7 years                                     | \$ 27.7                                                        |

The weighted-average fair value per option at the date of grant during the six months ended June 30, 2014 and 2013 using the Black-Scholes option-pricing model was \$16.55 and \$12.45, respectively. Assumptions were as follows:

|                         | Six Months Ended June 30, |       |
|-------------------------|---------------------------|-------|
|                         | 2014                      | 2013  |
| Expected life (years)   | 6.0                       | 6.1   |
| Risk-free interest rate | 2.7%                      | 2.0%  |
| Dividend yield          | 1.1%                      | 1.1%  |
| Expected volatility     | 36.6%                     | 38.4% |

The expected life is based on historical exercise behavior and the projected exercise of unexercised stock options. The risk free interest rate is based on the U.S. Treasury yield curve in effect on the date of grant for the expected life of the option. The actual dividend yield is based on the actual annual dividends divided by the grant date market value of the company's common stock. The expected volatility is based on the historical volatility of the company's common stock.

***Restricted Stock and Share Units***

Participants may also be awarded shares of restricted stock or share units under the plan. The company granted 110,310 and 141,700 share units under the plan in the six months ended June 30, 2014 and 2013, respectively. The share units were valued at \$5.1 million and \$4.9 million at the dates of issuance in 2014 and 2013, respectively, based on the company's stock price at the dates of grant. The company's share units are recognized as compensation expense ratably over the three-year vesting period; however included in share unit expense in the three and six months ended

June 30, 2014 and 2013 is expense associated with accelerated vesting of share unit awards for certain employees who either are retirement eligible or will become retirement eligible during the vesting period. Share based compensation expense attributable to share units of \$1.1 million and \$1.3 million was recognized in the three months ended June 30, 2014 and 2013, respectively. Share based compensation expense attributable to share units of \$4.1 million and \$3.5 million was recognized in the six months ended June 30, 2014 and 2013, respectively.

**Table of Contents****8. Stock Based Compensation (continued)**

A summary of share unit activity under the plan is as follows:

|                                        | Number of Units | Weighted-Average<br>Grant Date Value |
|----------------------------------------|-----------------|--------------------------------------|
| Issued and unvested at January 1, 2014 | 446,036         | \$ 26.14                             |
| Granted                                | 110,310         | 46.48                                |
| Vested                                 | (144,476)       | 21.63                                |
| Issued and unvested at June 30, 2014   | 441,870         | \$ 33.23                             |

**9. Pensions**

The following table presents the components of the company's net pension expense:

(dollars in millions)

|                                    | Three Months Ended<br>June 30, |        | Six Months Ended<br>June 30, |         |
|------------------------------------|--------------------------------|--------|------------------------------|---------|
|                                    | 2014                           | 2013   | 2014                         | 2013    |
| Service cost                       | \$ 1.8                         | \$ 2.2 | \$ 3.9                       | \$ 4.5  |
| Interest cost                      | 11.4                           | 9.9    | 22.4                         | 19.7    |
| Expected return on plan assets     | (15.2)                         | (15.4) | (30.2)                       | (30.8)  |
| Amortization of unrecognized loss  | 8.8                            | 10.6   | 17.6                         | 21.0    |
| Amortization of prior service cost | (0.2)                          | (0.2)  | (0.5)                        | (0.4)   |
| Defined benefit plan expense       | \$ 6.6                         | \$ 7.1 | \$ 13.2                      | \$ 14.0 |

The company did not make a contribution to its U.S. pension plan in 2013 and is not required to make a contribution in 2014.

**10. Operations by Segment**

The company is comprised of two reporting segments: North America and Rest of World. Both segments manufacture and market comprehensive lines of residential and commercial gas, gas tankless and electric water heaters. Both segments primarily manufacture and market in their respective regions of the world. The Rest of World segment is primarily comprised of China, Europe and India. The North America segment also manufactures and globally markets specialty commercial water heating equipment, condensing and non-condensing boilers and water system tanks. The Rest of World segment also manufactures and markets water treatment products, primarily in Asia.



**Table of Contents****10. Operations by Segment (continued)**

The company's operations by segment are as follows:

(dollars in millions)

|                                                        | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |            |
|--------------------------------------------------------|--------------------------------|----------|------------------------------|------------|
|                                                        | 2014                           | 2013     | 2014                         | 2013       |
| Net sales                                              |                                |          |                              |            |
| North America                                          | \$ 410.1                       | \$ 389.0 | \$ 798.6                     | \$ 767.7   |
| Rest of World                                          | 193.6                          | 169.5    | 366.4                        | 307.8      |
| Inter-segment sales                                    | (8.3)                          | (9.4)    | (17.4)                       | (16.8)     |
|                                                        | \$ 595.4                       | \$ 549.1 | \$ 1,147.6                   | \$ 1,058.7 |
| Operating earnings                                     |                                |          |                              |            |
| North America <sup>(1) (3) (4)</sup>                   | \$ 63.2                        | \$ 55.0  | \$ 118.5                     | \$ 109.1   |
| Rest of World                                          | 29.3                           | 22.4     | 54.4                         | 40.7       |
|                                                        | 92.5                           | 77.4     | 172.9                        | 149.8      |
| Corporate expense <sup>(2)</sup>                       | (12.5)                         | (14.5)   | (26.6)                       | (28.3)     |
| Interest expense                                       | (1.4)                          | (1.6)    | (2.8)                        | (3.1)      |
| Earnings before income taxes                           | 78.6                           | 61.3     | 143.5                        | 118.4      |
| Provision for income taxes                             | 21.3                           | 19.2     | 39.5                         | 37.3       |
| Net earnings                                           | \$ 57.3                        | \$ 42.1  | \$ 104.0                     | \$ 81.1    |
| (1) Includes non-operating pension costs of:           | \$ (3.9)                       | \$ (3.6) | \$ (7.7)                     | \$ (7.1)   |
| (2) Includes non-operating pension costs of:           | (1.1)                          | (1.2)    | (2.1)                        | (2.4)      |
| (3) Includes restructuring and impairment expenses of: |                                | (4.2)    |                              | (16.9)     |
| (4) Includes settlement income of:                     |                                |          |                              | 11.0       |

**11. Fair Value Measurements**

ASC 820, *Fair Value Measures and Disclosures*, among other things, defines fair value, establishes a consistent framework for measuring fair value and expands disclosure for each major asset and liability category measured at fair value on either a recurring basis or nonrecurring basis. ASC 820 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, ASC 820 establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (Level 1) observable inputs such as quoted prices in active markets; (Level 2) inputs, other than the quoted prices in active markets, that are observable either directly or indirectly; and (Level 3) unobservable inputs in

which there is little or no market data, which require the reporting entity to develop its own assumptions. Assets and liabilities measured at fair value are based on the market approach which are prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

**Table of Contents****11. Fair Value Measurements (continued)**

Assets and liabilities measured at fair value on a recurring basis are as follows:

| (dollars in millions)                                          | June 30,<br>2014 | December 31,<br>2013 |
|----------------------------------------------------------------|------------------|----------------------|
| Fair Value Measurement Using                                   |                  |                      |
| Quoted prices in active markets for identical assets (Level 1) | \$ 103.6         | \$ 107.0             |

There were no changes in the company's valuation techniques used to measure fair values on a recurring basis during the six months ended June 30, 2014.

**12. Derivative Instruments**

ASC 815 *Derivatives and Hedging* as amended, requires that all derivative instruments be recorded on the balance sheet at fair value and establishes criteria for designation and effectiveness of the hedging relationships. The accounting for changes in the fair value of a derivative instrument depends on whether it has been designated and qualifies as a part of a hedging relationship and, further, on the type of hedging relationship. For those derivative instruments that are designated and qualify as hedging instruments, the company must designate the hedging instrument, based upon the exposure hedged, as a fair value hedge, cash flow hedge, or a hedge of a net investment in a foreign operation.

The company designates that all of its hedging instruments are cash flow hedges. For derivative instruments that are designated and qualify as a cash flow hedge (i.e., hedging the exposure to variability in expected future cash flows that is attributable to a particular risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of other comprehensive loss, net of tax, and is reclassified into earnings in the same line item associated with the forecasted transaction and in the same period or periods during which the hedged transaction affects earnings. The amount by which the cumulative change in the value of the hedge more than offsets the cumulative change in the value of the hedged item (i.e., the ineffective portion) is recorded in earnings, net of tax, in the period the ineffectiveness occurs.

The company utilizes certain derivative instruments to enhance its ability to manage currency as well as raw materials price risk. Derivative instruments are entered into for periods consistent with the related underlying exposures and do not constitute positions independent of those exposures. The company does not enter into contracts for speculative purposes. The contracts are executed with major financial institutions with no credit loss anticipated for failure of the counterparties to perform.

*Foreign Currency Forward Contracts*

The company is exposed to foreign currency exchange risk as a result of transactions in currencies other than the functional currency of certain subsidiaries. The company utilizes foreign currency forward purchase and sale contracts to manage the volatility associated with foreign currency purchases, sales and certain intercompany transactions in the normal course of business. Currencies for which the company utilizes foreign currency forward contracts include the British pound, Canadian dollar, Chinese renminbi, Euro, Indian rupee and Mexican peso.

Gains and losses on these instruments are recorded in accumulated other comprehensive loss, net of tax, until the underlying transaction is recorded in earnings. When the hedged item is realized, gains or losses are reclassified from accumulated other comprehensive loss to the statement of earnings. The assessment of effectiveness for forward contracts is based on changes in the forward rates. These hedges have been determined to be effective.

**Table of Contents****12. Derivative Instruments (continued)**

The majority of the amounts in accumulated other comprehensive loss for cash flow hedges is expected to be reclassified into earnings within one year and all of the hedges will be reclassified into earnings no later than December 31, 2015.

The following table summarizes, by currency, the contractual amounts of the company's foreign currency forward contracts:

(dollars in millions)

|                  | June 30, 2014  |                | June 30, 2013  |                |
|------------------|----------------|----------------|----------------|----------------|
|                  | Buy            | Sell           | Buy            | Sell           |
| British pound    | \$             | \$ 0.9         | \$             | \$ 1.1         |
| Canadian dollar  |                | 56.7           |                | 17.7           |
| Chinese renminbi |                |                | 1.7            |                |
| Euro             | 7.1            | 0.8            | 11.6           | 1.0            |
| Indian rupee     |                |                | 7.0            |                |
| Mexican peso     | 11.5           |                | 16.4           |                |
| <b>Total</b>     | <b>\$ 18.6</b> | <b>\$ 58.4</b> | <b>\$ 36.7</b> | <b>\$ 19.8</b> |

*Commodity Futures Contracts*

In addition to entering into supply arrangements in the normal course of business, the company also enters into futures contracts to fix the cost of certain raw material purchases, principally copper, with the objective of minimizing changes in cost due to market price fluctuations. The hedging strategy for achieving this objective is to purchase commodity futures contracts on the open market of the London Metals Exchange (LME) or over the counter contracts based on the LME.

The minimal after-tax gain on the effective portion of the contracts as of June 30, 2014 was recorded in accumulated other comprehensive loss, and will be reclassified into cost of products sold in the period in which the underlying transaction is recorded in earnings. The effective portion of the contracts will be reclassified within one year. Commodity hedges outstanding at June 30, 2014 involve a total of approximately 0.8 million pounds of copper.

The impact of derivative contracts on the company's financial statements is as follows:

Fair value of derivatives designated as hedging instruments under:

(dollars in millions)

|                            | Balance Sheet Location | June 30, 2014 | December 31, 2013 |
|----------------------------|------------------------|---------------|-------------------|
| Foreign currency contracts | Other current assets   | \$ 1.0        | \$ 1.9            |

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|                                                     |        |        |
|-----------------------------------------------------|--------|--------|
| Accrued liabilities                                 | (0.3)  | (0.2)  |
| Total derivatives designated as hedging instruments | \$ 0.7 | \$ 1.7 |

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**Table of Contents****12. Derivative Instruments (continued)**

The effect of derivatives designated as hedging instruments on the Statement of Earnings is as follows:

Three Months Ended June 30 (dollars in millions):

|                                                        | Amount of gain (loss) recognized in OCI on derivative (effective portion) |          | Location of gain (loss) reclassified from accumulated OCI into earnings (effective portion) | Amount of gain (loss) reclassified from accumulated OCI into earnings (effective portion) |          | Location of gain (loss) recognized in earnings on derivative (ineffective portion) | Amount of gain (loss) recognized in earnings on a derivative (ineffective portion) |      |
|--------------------------------------------------------|---------------------------------------------------------------------------|----------|---------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------|----------|------------------------------------------------------------------------------------|------------------------------------------------------------------------------------|------|
|                                                        | 2014                                                                      | 2013     |                                                                                             | 2014                                                                                      | 2013     |                                                                                    | 2014                                                                               | 2013 |
| Derivatives in ASC 815 cash flow hedging relationships |                                                                           |          |                                                                                             |                                                                                           |          |                                                                                    |                                                                                    |      |
| Foreign currency contracts                             |                                                                           |          | Cost of                                                                                     |                                                                                           |          |                                                                                    |                                                                                    |      |
|                                                        | \$ (1.9)                                                                  | (0.4)    | products sold                                                                               | 0.7                                                                                       | 0.9      | N/A                                                                                |                                                                                    |      |
| Commodities contracts                                  |                                                                           |          | Cost of                                                                                     |                                                                                           |          | Cost of                                                                            |                                                                                    |      |
|                                                        | 0.3                                                                       | \$ (0.1) | products sold                                                                               | \$ 0.1                                                                                    | \$ (0.1) | products sold                                                                      | \$                                                                                 | \$   |
|                                                        | \$ (1.6)                                                                  | \$ (0.5) |                                                                                             | \$ 0.8                                                                                    | \$ 0.8   |                                                                                    | \$                                                                                 | \$   |

Six Months Ended June 30 (dollars in millions):

| Derivatives in ASC 815 cash flow hedging relationships | Amount of gain (loss) recognized in OCI on derivative (effective portion) | Location of gain (loss) reclassified from accumulated OCI into earnings (effective portion) | Amount of gain (loss) reclassified from accumulated OCI into earnings (effective portion) | Location of gain (loss) recognized in earnings on derivative (ineffective portion) | Amount of gain (loss) recognized in earnings on a derivative (ineffective portion) |
|--------------------------------------------------------|---------------------------------------------------------------------------|---------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------|------------------------------------------------------------------------------------|
|                                                        |                                                                           |                                                                                             |                                                                                           |                                                                                    |                                                                                    |

OCI into (ineffective  
earnings portion)  
(effective  
portion)

2014 2013 2014 2013 2014 2013

|                            |        |          |                       |        |          |                       |    |    |
|----------------------------|--------|----------|-----------------------|--------|----------|-----------------------|----|----|
| Foreign currency contracts | 0.8    | 1.4      | Cost of products sold | 1.8    | 1.5      | N/A                   |    |    |
| Commodities contracts      | \$     | \$ (0.2) | Cost of products sold | \$     | \$ (0.1) | Cost of products sold | \$ | \$ |
|                            | \$ 0.8 | \$ 1.2   |                       | \$ 1.8 | \$ 1.4   |                       | \$ | \$ |

### 13. Income Taxes

The effective tax rate for the three and six months ended June 30, 2014 was 27.1 percent and 27.5 percent, respectively. The company estimates that its annual effective tax rate for the full year of 2014 will be between 27.0 and 28.0 percent. The full year effective tax rate in 2013 was 28.2 percent.

As of June 30, 2014, the company had \$1.3 million of unrecognized tax benefits of which \$0.9 million would affect its effective tax rate if recognized. The company recognizes potential interest and penalties related to unrecognized tax benefits as a component of tax expense.

The U.S. federal tax returns for 2009 - 2013 are subject to audit. The company is subject to state and local audits for tax years 2000 - 2013. The company is also subject to non-U.S. income tax examinations for years 2006 - 2013.

**Table of Contents****14. Changes in Accumulated Other Comprehensive Loss by Component**

Changes to accumulated other comprehensive loss by component are as follows:

(dollars in millions)

|                                                                                                                                              | Three Months Ended June 30, |                        |
|----------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------|------------------------|
|                                                                                                                                              | 2014                        | 2013                   |
| <b>Cumulative Foreign Currency Translation</b>                                                                                               |                             |                        |
| Balance at beginning of period                                                                                                               | \$ 9.5                      | \$ 18.0                |
| Other comprehensive gain (loss) before reclassifications                                                                                     | 2.7                         | (4.1)                  |
| Balance at end of period                                                                                                                     | 12.2                        | 13.9                   |
| <b>Unrealized Net Gain on Cash Flow Derivatives</b>                                                                                          |                             |                        |
| Balance at beginning of period                                                                                                               | 1.9                         | 1.4                    |
| Other comprehensive loss before reclassifications                                                                                            | (1.1)                       | (0.4)                  |
| Realized gains on derivatives reclassified to cost of products sold (net of tax provision of \$0.3 and \$0.3 in 2014 and 2013, respectively) | (0.4)                       | (0.5)                  |
| Balance at end of period                                                                                                                     | 0.4                         | 0.5                    |
| <b>Pension Liability</b>                                                                                                                     |                             |                        |
| Balance at beginning of period                                                                                                               | (274.7)                     | (334.4)                |
| Other comprehensive loss before reclassifications                                                                                            | (2.1)                       | (5.0)                  |
| Amounts reclassified from accumulated other comprehensive loss: <sup>(1)</sup>                                                               | 5.3                         | 6.3                    |
| Balance at end of period                                                                                                                     | (271.5)                     | (333.1)                |
| <b>Accumulated other comprehensive loss, end of period</b>                                                                                   | <b>\$ (258.9)</b>           | <b>\$ (318.7)</b>      |
| <sup>(1)</sup> Amortization of pension items:                                                                                                |                             |                        |
| Actuarial losses                                                                                                                             | \$ 8.7 <sup>(2)</sup>       | \$ 10.4 <sup>(2)</sup> |
| Prior year service cost                                                                                                                      | (0.2) <sup>(2)</sup>        | (0.2) <sup>(2)</sup>   |
|                                                                                                                                              | 8.5                         | 10.2                   |
| Tax benefit                                                                                                                                  | (3.2)                       | (3.9)                  |
| Reclassification net of tax                                                                                                                  | \$ 5.3                      | \$ 6.3                 |

<sup>(2)</sup> These accumulated other comprehensive loss components are included in the computation of net periodic pension cost. See Note 9 - Pensions for additional details



**Table of Contents****14. Changes in Accumulated Other Comprehensive Loss by Component (continued)**

Changes to accumulated other comprehensive loss by component are as follows:

(dollars in millions)

|                                                                                                                                              | Six Months Ended June 30, |                        |
|----------------------------------------------------------------------------------------------------------------------------------------------|---------------------------|------------------------|
|                                                                                                                                              | 2014                      | 2013                   |
| <b>Cumulative Foreign Currency Translation</b>                                                                                               |                           |                        |
| Balance at beginning of period                                                                                                               | \$ 19.9                   | \$ 19.5                |
| Other comprehensive loss before reclassifications                                                                                            | (7.7)                     | (5.6)                  |
| Balance at end of period                                                                                                                     | 12.2                      | 13.9                   |
| <b>Unrealized Net Gain on Cash Flow Derivatives</b>                                                                                          |                           |                        |
| Balance at beginning of period                                                                                                               | 1.0                       | 0.7                    |
| Other comprehensive earnings before reclassifications                                                                                        | 0.5                       | 0.7                    |
| Realized gains on derivatives reclassified to cost of products sold (net of tax provision of \$0.7 and \$0.5 in 2014 and 2013, respectively) | (1.1)                     | (0.9)                  |
| Balance at end of period                                                                                                                     | 0.4                       | 0.5                    |
| <b>Pension Liability</b>                                                                                                                     |                           |                        |
| Balance at beginning of period                                                                                                               | (280.0)                   | (340.7)                |
| Other comprehensive loss before reclassifications                                                                                            | (2.1)                     | (5.0)                  |
| Amounts reclassified from accumulated other comprehensive loss: <sup>(1)</sup>                                                               | 10.6                      | 12.6                   |
| Balance at end of period                                                                                                                     | (271.5)                   | (333.1)                |
| Accumulated other comprehensive loss, end of period                                                                                          | \$ (258.9)                | \$ (318.7)             |
| <sup>(1)</sup> Amortization of pension items:                                                                                                |                           |                        |
| Actuarial losses                                                                                                                             | \$ 17.6 <sup>(2)</sup>    | \$ 21.0 <sup>(2)</sup> |
| Prior year service cost                                                                                                                      | (0.5) <sup>(2)</sup>      | (0.4) <sup>(2)</sup>   |
|                                                                                                                                              | 17.1                      | 20.6                   |
| Tax benefit                                                                                                                                  | (6.5)                     | (8.0)                  |
| Reclassification net of tax                                                                                                                  | \$ 10.6                   | \$ 12.6                |

<sup>(2)</sup> These accumulated other comprehensive loss components are included in the computation of net periodic pension cost. See Note 9 - Pensions for additional details



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**PART I - FINANCIAL INFORMATION**

**ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**  
**OVERVIEW**

We are a leading manufacturer of water heaters and boilers, serving a diverse mix of residential and commercial end markets principally in the U.S. with a strong and growing international presence. Our company is comprised of two reporting segments: North America and Rest of World. Both segments manufacture and market comprehensive lines of residential and commercial gas, gas tankless and electric water heaters. Both segments primarily manufacture and market in their respective region of the world. Our Rest of World segment is primarily comprised of China, Europe and India. The North America segment also manufactures and globally markets specialty commercial water heating equipment, condensing and non-condensing boilers and water systems tanks. The Rest of World segment also manufactures and markets water treatment products, primarily for Asia.

Sales in the North America segment grew approximately five percent in the second quarter of 2014 due to higher sales of U.S. water heaters and Lochinvar branded products. As a result of new home construction and expansion of the replacement market, we expect the residential water heater industry's unit shipments to grow approximately four percent in 2014. We expect the commercial water heater industry's growth in units shipped to be approximately three percent in 2014. Driven by a continued transition in the boiler industry from non-condensing boilers to condensing boilers, we expect sales of Lochinvar branded products to grow approximately ten percent in 2014.

Sales in the Rest of World segment grew approximately 14 percent in the second quarter of 2014, primarily as a result of a 17 percent growth in sales in China. We expect sales in China to grow at least at a rate of approximately two times the growth in China's gross domestic product (GDP) as consumer demand for water heaters and water treatment products and distribution expansion contribute to our growth.

**RESULTS OF OPERATIONS**

**SECOND QUARTER AND FIRST SIX MONTHS OF 2014 COMPARED TO 2013**

Sales for the second quarter of 2014 were \$595.4 million or approximately eight percent higher than sales of \$549.1 million in the second quarter of 2013. Sales in the first half of 2014 increased to \$1,147.6 million from \$1,058.7 million in the same period last year. The increase in sales in both the second quarter and first half of the year is primarily due to higher sales in China. Sales in China grew 17 percent and 21 percent in the second quarter and first half of 2014, respectively, as compared to the same periods of 2013. The second quarter of 2014 also benefitted from higher sales of water heaters in the U.S. and Lochinvar branded products.

Gross profit margin in the second quarter of 2014 of 36.3 percent was almost equal to the gross profit margin of 36.1 percent in the second quarter of 2013. Our gross profit margin in the first half of 2014 increased slightly to 35.9 percent from 35.6 percent in the first half of 2013.

Selling, general and administrative (SG&A) expenses in the second quarter and first half of 2014 increased by \$5.8 million and \$16.7 million, respectively, as compared to the same periods last year. The increase in SG&A expenses in both periods in 2014 was primarily due to higher selling and advertising costs in support of increased volumes in China.



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On March 28, 2013, our board of directors approved a plan to transfer residential water heater production from our Fergus, Ontario plant to our other North American facilities. The majority of our production was consolidated in the second quarter of 2013. As a result of the capacity reduction, we incurred pre-tax restructuring and impairment expenses of \$4.2 million and \$16.9 million in the second quarter and first half of 2013, respectively, related to employee severance costs and impairment of assets.

In addition, included in operating earnings in the first half of 2013 is a pre-tax gain of \$11.0 million from a first quarter settlement with a former supplier related to previous overcharges and warranty costs.

Interest expense in the second quarter of 2014 was \$1.4 million compared to \$1.6 million in the same period last year. Interest expense in the first half of 2014 was \$2.8 million compared to \$3.1 million in the same period last year.

Other income was \$1.2 million in the second quarter of 2014, up from \$0.7 million in the same period last year. Other income in the first half of 2014 was \$2.5 million, up from \$1.7 million in the first half of 2013. The increase in other income in the second quarter and first half of 2014 was partially due to increased interest income as compared to the same periods last year. The second quarter and first half of 2013 were also negatively impacted by devaluation of the Indian rupee.

Our effective tax rates for the second quarter and first half of 2014 were 27.1 percent and 27.5 percent, respectively. Our effective tax rates for the second quarter and first half of 2013 were 31.3 percent and 31.5 percent, respectively. The lower effective tax rates in both periods of 2014 were primarily due to earnings mix where a higher percentage of our pre-tax earnings was earned in jurisdictions with relatively lower tax rates as compared to the same periods in the prior year. The 2014 effective tax rates were also impacted by a one-time tax benefit associated with a revised domestic manufacturers' deduction from a prior year resulting in an increased income tax benefit on an amended prior year tax return filed in the second quarter of 2014.

Our pension costs and credits are developed from actuarial valuations. The valuations reflect key assumptions regarding, among other things, discount rates, expected return on assets, retirement ages, and years of service. We consider current market conditions including changes in interest rates in making these assumptions. Our assumption for the expected rate of return on plan assets is 7.75 percent in 2014 compared to 8.00 percent in 2013. The discount rate used to determine net periodic pension costs increased from 4.05 percent in 2013 to 4.85 percent in 2014. Pension expense for the first half of 2014 was \$13.2 million compared to \$14.0 million in the first half of 2013. Total pension expense for 2014 is expected to be \$28.6 million. Our pension costs are reflected in cost of products sold and SG&A expense.

We are providing non-GAAP measures (adjusted earnings, adjusted earnings per share, adjusted segment operating earnings and adjusted segment operating margins) that exclude certain items as well as non-operating pension costs consisting of interest cost, expected return on plan assets, amortization of actuarial gains (losses) and curtailments. Prior year results are provided on a comparable basis. Reconciliations to measures on a GAAP basis are provided later in this section.

### *North America*

Sales in the North America segment were \$410.1 million in the second quarter of 2014 or \$21.1 million higher than sales of \$389.0 million in the second quarter of 2013. Sales for the first half of 2014 were \$798.6 million or \$30.9 million higher than sales of \$767.7 million in the same period last



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year. The increased sales in the second quarter and first six months of 2014 were primarily due to higher sales of commercial and residential water heaters in the U.S., as well as higher sales of Lochinvar branded products.

North America operating earnings were \$63.2 million in the second quarter of 2014 or approximately 15 percent higher than earnings of \$55.0 million in the same period of 2013. Operating earnings in the first half of 2014 were \$118.5 million or approximately nine percent higher than operating earnings of \$109.1 million in the first half of 2013. Adjusted segment operating earnings were \$67.1 million in the second quarter of 2014 compared to \$62.8 million in the second quarter of 2013. Adjusted segment operating earnings were \$126.2 million in the first half of 2014 compared to \$122.1 million in the first half of last year. Adjusted operating margin of 16.4 percent in the second quarter of 2014 was slightly higher than 16.1 percent in the same period last year. Adjusted operating margin of 15.8 percent in the first half of 2014 percent was almost equal to 15.9 percent in the same period in 2013. Increased volumes of water heaters and boilers in the U.S., partially offset by higher steel prices contributed to higher adjusted operating earnings in the second quarter and first half of 2014.

Adjusted segment operating earnings exclude non-operating pension costs in all periods presented. Adjusted segment operating earnings in the second quarter of 2013 also exclude \$4.2 million of pre-tax restructuring and impairment charges associated with the transfer of production from Fergus, Ontario. Adjusted segment operating earnings in the first half of 2013 also exclude \$16.9 million of pre-tax restructuring and impairment charges associated with the transfer of production from Fergus, Ontario and an \$11.0 million pre-tax gain on the settlement with a former supplier.

*Rest of World*

Sales in the Rest of World segment were \$193.6 million in the second quarter of 2014 or \$24.1 million higher than sales of \$169.5 million in the second quarter of 2013. Sales in the first half of 2014 were \$366.4 million or \$58.6 million higher than sales of \$307.8 million in the first half of 2013. Sales of water heaters and water treatment products in China grew 17 percent and 21 percent in the second quarter and first half of 2014, respectively, as compared to the same periods in 2013.

Rest of World operating earnings were \$29.3 million in the second quarter of 2014 or approximately 31 percent higher than operating earnings of \$22.4 million in the second quarter of 2013. Operating earnings in the first half of 2014 were \$54.4 million or approximately 34 percent higher than operating earnings of \$40.7 million in the first half of 2013. The 2014 second quarter operating margin of 15.1 percent was higher than operating margin of 13.2 percent in the same period last year. Operating margin of 14.8 percent in the first half of 2014 was higher than operating margin of 13.2 percent in the same period last year. The improved operating earnings and operating margin in the second quarter and first half of 2014 were due to higher sales in China and improvements in profitability associated with water treatment products in China. Operating margin in the second quarter of 2014 also benefitted from lower selling and advertising costs as a percent of sales in China compared with the same period last year.

**Outlook**

While a sustained housing recovery in North America remains elusive, we are benefitting from strong residential replacement water heater business as well as strength in commercial water heater volumes. In addition, Lochinvar has continued to meet our growth expectations with its ten percent year-to date increase in sales. The growth of our China business has continued to exceed two times that country's GDP growth, as customers have continued to demand our high-value water heating and water treatment products. Given confidence from our strong first half, we upgraded our



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guidance for 2014. We believe A. O. Smith Corporation will achieve full-year GAAP earnings of between \$2.20 and \$2.26 per share, and achieve full-year adjusted earnings of between \$2.34 and \$2.40 per share.

The strength in profitability in our Rest of World segment has given us confidence to upgrade our high-level outlook for 2015. We revised our 2015 Rest of World segment operating margin forecast to 14 percent and reduced our estimated shares outstanding to reflect our share repurchase activity. As a result, we upgraded our 2015 earnings outlook relating to our existing portfolio of businesses to \$2.60 per share from \$2.50 per share, which represents a ten percent increase over the mid-point of our 2014 adjusted EPS guidance. We maintained our 2015 projection for revenues relating to our existing portfolio of businesses of over \$2.5 billion, which implies organic growth of seven to nine percent per year. North America segment operating margin forecast remains at 16 percent.

**Liquidity & Capital Resources**

Working capital of \$683.9 million at June 30, 2014 was \$69.2 million higher than at December 31, 2013. Higher cash balances in China, higher inventory balances in North America and lower accounts payable balances in China account for the majority of the increase. As of June 30, 2014, almost all of the \$496.6 million of cash, cash equivalents and marketable securities was held by our foreign subsidiaries. We would incur a cost to repatriate these funds to the U.S. and have accrued \$54.8 million for the repatriation of a portion of these funds.

Cash provided by continuing operating activities in the first half of 2014 was \$90.9 million compared with \$106.4 million during the same period last year. The reduced operating cash flows were primarily related to larger working capital requirements, which were partially offset by higher earnings. For the full year 2014, we expect total cash provided by continuing operating activities to be \$240 to \$250 million.

Capital expenditures totaled \$50.8 million in the first half of 2014, compared with \$38.2 million spent in the year ago period. We are projecting 2014 capital expenditures to be \$75 to \$85 million, including approximately \$20 million to support our enterprise resource planning software implementation. Full year depreciation and amortization is expected to be approximately \$65 million.

In December 2012, we completed a \$400 million multi-currency credit facility with a group of eight banks which expires in December 2017. The facility has an accordion provision which allows it to be increased up to \$500 million if certain conditions (including lender approval) are satisfied. Borrowing rates under the facility are determined by our leverage ratio. The facility requires us to maintain two financial covenants, a leverage ratio test and an interest coverage test, and we were in compliance with the covenants as of June 30, 2014.

The facility backs up commercial paper and credit line borrowings. As a result of the long-term nature of this facility, our commercial paper and credit line borrowings, as well as drawings under the facility, are classified as long-term debt. At June 30, 2014, we had available borrowing capacity of \$197.5 million under this facility. We believe the combination of available borrowing capacity and operating cash flow will provide sufficient funds to finance our existing operations for the foreseeable future.

Our total debt increased \$58.5 million from \$191.9 million at December 31, 2013 to \$250.4 million at June 30, 2014. Our leverage, as measured by the ratio of total debt to total capitalization, was 15.6 percent at June 30, 2014, compared with 12.6 percent at December 31, 2013.

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Our pension plan continues to meet all funding requirements under ERISA regulations. We are not required to make contributions to the plan in 2014.

In July 2013, our board of directors approved a stock repurchase program authorizing the purchase of 2,000,000 shares of our common stock. On April 7, 2014 our board of directors approved adding an additional 1,500,000 shares of common stock to the existing discretionary share repurchase authority. During the first half of 2014, we repurchased 1,280,200 shares at a total cost of \$60.8 million. A total of approximately 1,373,000 shares remained of the existing repurchase authority at June 30, 2014. Depending on factors such as stock price, working capital requirements and alternative investment opportunities, we expect to repurchase one million of the remainder of the authorized shares in 2014 and spend an aggregate of approximately \$110 million in 2014 for share repurchases.

On July 7, 2014, our board of directors declared a regular cash dividend of \$.15 per share on our common stock and Class A common stock. The dividend is payable on August 15, 2014 to shareholders of record on July 31, 2014.

## **Non-GAAP Financial Information**

We provide non-GAAP measures (adjusted earnings, adjusted earnings per share (EPS) and adjusted segment operating earnings) that exclude certain items as well as non-operating pension costs consisting of interest cost, expected returns on assets, amortization of actuarial gains (losses) and curtailments.

We believe that the measures of adjusted earnings, adjusted EPS and adjusted segment operating earnings provide useful information to investors about our operating performance and allow management and our investors to compare our performance period over period.

Table of Contents**A. O. SMITH CORPORATION****Adjusted Earnings and Adjusted EPS****(dollars in millions, except per share data)****(unaudited)**

The following is a reconciliation of net earnings and diluted EPS to adjusted earnings (non-GAAP) and adjusted EPS (non-GAAP):

|                                                                      | Three Months Ended<br>June 30, |         | Six Months Ended<br>June 30, |         |
|----------------------------------------------------------------------|--------------------------------|---------|------------------------------|---------|
|                                                                      | 2014                           | 2013    | 2014                         | 2013    |
| <b>Net Earnings (GAAP)</b>                                           | \$ 57.3                        | \$ 42.1 | \$ 104.0                     | \$ 81.1 |
| Non-operating pension costs, before tax                              | 5.0                            | 4.8     | 9.8                          | 9.6     |
| Tax effect of non-operating pension costs                            | (2.0)                          | (1.8)   | (3.8)                        | (3.6)   |
| Restructuring and impairment expenses, before tax                    |                                | 4.2     |                              | 16.9    |
| Tax effect of restructuring and impairment expenses                  |                                | (1.1)   |                              | (4.3)   |
| Settlement income, before tax                                        |                                |         |                              | (11.0)  |
| Tax effect of settlement income                                      |                                |         |                              | 4.2     |
| <b>Adjusted Earnings</b>                                             | \$ 60.3                        | \$ 48.2 | \$ 110.0                     | \$ 92.9 |
| <b>Diluted EPS (GAAP)</b>                                            | \$ 0.63                        | \$ 0.45 | \$ 1.14                      | \$ 0.87 |
| Non-operating pension costs per diluted share, before tax            | 0.05                           | 0.05    | 0.10                         | 0.10    |
| Tax effect of non-operating pension costs per diluted share          | (0.02)                         | (0.02)  | (0.04)                       | (0.04)  |
| Restructuring and impairment expenses per diluted share, before tax  |                                | 0.05    |                              | 0.19    |
| Tax effect of restructuring and impairment expense per diluted share |                                | (0.01)  |                              | (0.05)  |
| Settlement income per diluted share, before tax                      |                                |         |                              | (0.12)  |
| Tax effect of settlement income per diluted share                    |                                |         |                              | 0.05    |
| <b>Adjusted EPS</b>                                                  | \$ 0.66                        | \$ 0.52 | \$ 1.20                      | \$ 1.00 |

Table of Contents**A. O. SMITH CORPORATION****Adjusted Segment Operating Earnings****(dollars in millions)****(unaudited)**

The following is a reconciliation of segment operating earnings to adjusted segment operating earnings (non-GAAP):

|                                                  | Three Months Ended<br>June 30, |                | Six Months Ended<br>June 30, |                 |
|--------------------------------------------------|--------------------------------|----------------|------------------------------|-----------------|
|                                                  | 2014                           | 2013           | 2014                         | 2013            |
| <b>Segment Operating Earnings (GAAP)</b>         |                                |                |                              |                 |
| North America                                    | \$ 63.2                        | \$ 55.0        | \$ 118.5                     | \$ 109.1        |
| Rest of World                                    | 29.3                           | 22.4           | 54.4                         | 40.7            |
| <b>Total Segment Operating Earnings (GAAP)</b>   | <b>\$ 92.5</b>                 | <b>\$ 77.4</b> | <b>\$ 172.9</b>              | <b>\$ 149.8</b> |
| <b>Adjustments</b>                               |                                |                |                              |                 |
| North America                                    | \$ 3.9                         | \$ 7.8         | \$ 7.7                       | \$ 13.0         |
| Rest of World                                    |                                |                |                              |                 |
| <b>Total Adjustments</b>                         | <b>\$ 3.9</b>                  | <b>\$ 7.8</b>  | <b>\$ 7.7</b>                | <b>\$ 13.0</b>  |
| <b>Adjusted Segment Operating Earnings</b>       |                                |                |                              |                 |
| North America                                    | \$ 67.1                        | \$ 62.8        | \$ 126.2                     | \$ 122.1        |
| Rest of World                                    | 29.3                           | 22.4           | 54.4                         | 40.7            |
| <b>Total Adjusted Segment Operating Earnings</b> | <b>\$ 96.4</b>                 | <b>\$ 85.2</b> | <b>\$ 180.6</b>              | <b>\$ 162.8</b> |

Additional information:

|                                                | Three Months Ended<br>June 30, |               | Six Months Ended<br>June 30, |                |
|------------------------------------------------|--------------------------------|---------------|------------------------------|----------------|
|                                                | 2014                           | 2013          | 2014                         | 2013           |
| <b>Adjustments: North America Segment</b>      |                                |               |                              |                |
| Non-operating pension costs                    | \$ 3.9                         | \$ 3.6        | \$ 7.7                       | \$ 7.1         |
| Restructuring and impairment expenses          |                                | 4.2           |                              | 16.9           |
| Settlement income                              |                                |               |                              | (11.0)         |
| <b>Total North America Segment Adjustments</b> | <b>\$ 3.9</b>                  | <b>\$ 7.8</b> | <b>\$ 7.7</b>                | <b>\$ 13.0</b> |



Table of Contents**A. O. SMITH CORPORATION****Adjusted 2014 EPS Guidance and Adjusted 2013 EPS****(unaudited)**

The following is a reconciliation of diluted EPS to adjusted EPS (non-GAAP) (all items are net of tax):

|                                                         | 2014<br>Guidance     | 2013           |
|---------------------------------------------------------|----------------------|----------------|
| <b>Diluted EPS (GAAP)</b>                               | <b>\$2.20 - 2.26</b> | <b>\$ 1.83</b> |
| Non-operating pension costs per diluted share           | 0.14                 | 0.13           |
| Settlement income per diluted share                     |                      | (0.07)         |
| Restructuring and impairment expenses per diluted share |                      | 0.17           |
| <b>Adjusted EPS</b>                                     | <b>\$2.34 - 2.40</b> | <b>\$ 2.06</b> |

**Critical Accounting Policies**

The preparation of our consolidated financial statements is in conformity with accounting principles generally accepted in the U.S. which requires the use of estimates and assumptions about future events that affect the amounts reported in the financial statements and accompanying notes. Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results inevitably will differ from those estimates, and such differences may be material to the financial statements. The critical accounting policies that we believe could have the most significant effect on our reported results or require complex judgment by management are contained in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, of our Annual Report on Form 10-K for the year ended December 31, 2013. We believe that as of June 30, 2014 there has been no material change to this information.

**Recent Accounting Pronouncements**

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Codification (ASC) 606-10, *Revenue from Contracts with Customers* (issued under Accounting Standards Update No. 2014-09).

ASC 606-10 will replace all existing revenue recognition guidance when effective. ASC 606-10 is effective for the year beginning January 1, 2017. We are in the process of determining whether the adoption of ASC 606-10 will have an impact on our consolidated financial condition, results of operations or cash flows.

**ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

As is more fully described in our Annual Report on Form 10-K for the year ended December 31, 2013, we are exposed to various types of market risks, including currency and certain commodity risks. Our quantitative and qualitative disclosures about market risk have not materially changed since that report was filed. We monitor our currency and commodity risks on a continuous basis and generally enter into forward and futures contracts to minimize these exposures. The majority of the contracts are for periods of less than one year. Our company does not engage in speculation in our derivative strategies. It is important to note that gains and losses from our forward and

futures contract activities are offset by changes in the underlying costs of the transactions being hedged.

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**ITEM 4 - CONTROLS AND PROCEDURES**

**Evaluation of disclosure controls and procedures**

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (Exchange Act). Based upon their evaluation of these disclosure controls and procedures, the principal executive officer and principal financial officer concluded that the disclosure controls and procedures were effective as of June 30, 2014 to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time period specified in the SEC rules and forms, and to ensure that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate, to allow timely decisions regarding disclosure.

**Changes in internal control over financial reporting**

There have been no significant changes in our internal control over financial reporting during the quarter ended June 30, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Forward Looking Statements**

This filing contains statements that the company believes are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements generally can be identified by the use of words such as may, will, expect, intend, estimate, anticipate, believe, forecast, guidance or words meaning. All statements regarding 2015 outlook are forward-looking statements. All forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those anticipated as of the date of this filing. Important factors that could cause actual results to differ materially from these expectations include, among other things, the following: uncertain costs, savings and timeframes associated with the implementation of the new enterprise resource planning system; potential weakening in the high efficiency boiler segment in the U.S.; the ability to execute our acquisition strategy; significant volatility in raw material prices; competitive pressures on the company's businesses; inability to implement pricing actions; instability in the company's replacement markets; strength or duration of any recoveries in U.S. residential or commercial construction; a further slowdown in the growth of the Chinese economy; foreign currency fluctuations; and adverse general economic conditions and capital market deterioration.

Forward-looking statements included in this filing are made only as of the date of this filing, and the company is under no obligation to update these statements to reflect subsequent events or circumstances. All subsequent written and oral forward-looking statements attributed to the company, or persons acting on its behalf, are qualified entirely by these cautionary statements.

**Table of Contents****PART II - OTHER INFORMATION****ITEM 1 - LEGAL PROCEEDINGS**

There have been no material changes in the legal and environmental matters discussed in Part 1, Item 3 and Note 15 of the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended December 31, 2013.

**ITEM 2 - UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

On July 8, 2013, our board of directors approved a stock repurchase program authorizing the purchase of 2,000,000 shares of our common stock. On April 7, 2014, our board of directors approved adding 1,500,000 shares of common stock to the existing discretionary share repurchase authority. Under the share repurchase program, the company's common stock may be purchased through a combination of Rule 10b5-1 automatic trading plan and discretionary purchases in accordance with applicable securities laws. The number of shares purchased and the timing of the purchases will depend on a number of factors, including share price, trading volume and general market conditions, as well as working capital requirements, general business conditions and other factors, including alternative investment opportunities. The stock repurchase authorization remains effective until terminated by our board of directors which may occur at any time, subject to the parameters of any Rule 10b5-1 automatic trading plan that we may then have in effect. In the second quarter of 2014, we repurchased 834,408 shares at an average price of \$47.35 per share and at a total cost of \$39.5 million. As of June 30, 2014, there were 1,372,576 shares remaining on the repurchase authorization.

**ISSUER PURCHASES OF EQUITY SECURITIES**

| Period                   | (a) Total<br>Number of<br>Shares<br>Purchased | (b) Average<br>Price Paid<br>per Share | (c) Total Number of<br>Shares Purchased as<br>Part of Publicly<br>Announced Plans or<br>Programs | (d) Maximum<br>Number of Shares<br>that may yet be<br>Purchased Under the<br>Plans or Programs |
|--------------------------|-----------------------------------------------|----------------------------------------|--------------------------------------------------------------------------------------------------|------------------------------------------------------------------------------------------------|
| April 1 - April 30, 2014 | 358,759                                       | \$ 46.03                               | 358,759                                                                                          | 1,848,225                                                                                      |
| May 1 - May 31, 2014     | 306,827                                       | 47.59                                  | 306,827                                                                                          | 1,541,398                                                                                      |
| June 1 - June 30, 2014   | 168,822                                       | 49.72                                  | 168,822                                                                                          | 1,372,576                                                                                      |

**ITEM 5 - OTHER INFORMATION**

None.

**ITEM 6 - EXHIBITS**

Refer to the Exhibit Index on page 31 of this report.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has authorized this report to be signed on its behalf by the undersigned.

**A. O. SMITH CORPORATION**

August 5, 2014

/s/ Daniel L. Kempken  
Daniel L. Kempken  
Vice President and Controller

August 5, 2014

/s/ John J. Kita  
John J. Kita  
Executive Vice President  
and Chief Financial Officer

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**INDEX TO EXHIBITS**

| Exhibit<br>Number | Description                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
|-------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.1              | Summary of Directors Compensation                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                             |
| 31.1              | Certification of Periodic Report by the Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |
| 31.2              | Certification of Periodic Report by the Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934.                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |
| 32.1              | Written Statement of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| 32.2              | Written Statement of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                           |
| 101               | The following materials from A. O. Smith Corporation's Quarterly Report on Form 10-Q for the six months ended June 30, 2014 are filed herewith, formatted in XBRL (Extensive Business Reporting Language): (i) the Condensed Consolidated Statements of Earnings for the three and six months ended June 30, 2014 and 2013, (ii) the Condensed Consolidated Statements of Comprehensive Earnings for the three and six months ended June 30, 2014 and 2013, (iii) the Condensed Consolidated Balance Sheets as of June 30, 2014, and December 31, 2013, (iv) the Condensed Consolidated Statements of Cash Flows for the six months ended June 30, 2014 and 2013 (v) the Notes to Condensed Consolidated Financial Statements |