FLOWSERVE CORP
Form 10-Q
November 01, 2007

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

FORM 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2007**

OR

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

Commission File No. 1-13179

FLOWSERVE CORPORATION

(Exact name of registrant as specified in its charter)

New York	**31-0267900**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
5215 N. O Connor Blvd., Suite 2300, Irving, Texas	**75039**
(Address of principal executive offices)	(Zip Code)

(972) 443-6500

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

As of October 29, 2007, there were 57,139,380 shares of the issuer s common stock outstanding.

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PART I FINANCIAL INFORMATION
Item 1. Financial Statements.

FLOWSERVE CORPORATION
(Unaudited)
CONDENSED CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended September 30,	
(Amounts in thousands, except per share data)	**2007**	**2006**
Sales	$ 919,247	$ 770,757
Cost of sales	(605,664)	(520,954)
Gross profit	313,583	249,803
Selling, general and administrative expense	(210,135)	(191,252)
Net earnings from affiliates	4,781	3,326
Operating income	108,229	61,877
Interest expense	(15,332)	(16,385)
Interest income	919	1,634
Other income (expense), net	1,224	(1,835)
Earnings before income taxes	95,040	45,291
Provision for income taxes	(31,985)	(16,817)
Income from continuing operations	63,055	28,474
Discontinued operations, net of tax		805
Net earnings	$ 63,055	$ 29,279
Earnings per share:		
Basic:		
Continuing operations	$ 1.12	$ 0.51
Discontinued operations		0.02
Net earnings	$ 1.12	$ 0.53
Diluted:		
Continuing operations	$ 1.10	$ 0.49
Discontinued operations		0.02
Net earnings	$ 1.10	$ 0.51
Dividends per share	$ 0.15	$

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Three Months Ended September 30,

(Amounts in thousands)	2007	2006
Net earnings	$ 63,055	$ 29,279
Other comprehensive income (expense):		
Foreign currency translation adjustments, net of tax	24,637	(1,611)
Pension and other postretirement effects, net of tax	(646)	
Cash flow hedging activity, net of tax	(2,159)	(1,814)
Other comprehensive income (loss)	21,832	(3,425)
Comprehensive income	$ 84,887	$ 25,854

See accompanying notes to condensed consolidated financial statements.

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FLOWSERVE CORPORATION
(Unaudited)

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Amounts in thousands, except per share data)	Nine Months Ended September 30, 2007	2006
Sales	$ 2,653,325	$ 2,177,473
Cost of sales	(1,771,852)	(1,457,079)
Gross profit	881,473	720,394
Selling, general and administrative expense	(623,253)	(555,164)
Net earnings from affiliates	14,341	11,124
Operating income	272,561	176,354
Interest expense	(45,164)	(48,327)
Interest income	2,490	3,786
Other income, net	2,159	3,694
Earnings before income taxes	232,046	135,507
Provision for income taxes	(72,172)	(54,825)
Income from continuing operations	159,874	80,682
Discontinued operations, net of tax		805
Net earnings	$ 159,874	$ 81,487
Earnings per share:		
Basic:		
Continuing operations	$ 2.83	$ 1.44
Discontinued operations		0.02
Net earnings	$ 2.83	$ 1.46
Diluted:		
Continuing operations	$ 2.79	$ 1.41
Discontinued operations		0.02
Net earnings	$ 2.79	$ 1.43
Dividends per share	$ 0.45	$

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Amounts in thousands)	Nine Months Ended September 30, 2007	2006
Net earnings	$ 159,874	$ 81,487

Other comprehensive income (expense):		
Foreign currency translation adjustments, net of tax	44,769	21,351
Pension and other postretirement effects, net of tax	(433)	
Cash flow hedging activity, net of tax	(2,020)	546
Other comprehensive income	42,316	21,897
Comprehensive income	$ 202,190	$ 103,384

See accompanying notes to condensed consolidated financial statements.

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FLOWSERVE CORPORATION
(Unaudited)

CONDENSED CONSOLIDATED BALANCE SHEETS

(Amounts in thousands, except per share data)	September 30, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 71,107	$ 67,000
Restricted cash	3,730	3,457
Accounts receivable, net of allowance for doubtful accounts of $13,033 and $13,135, respectively	704,734	551,815
Inventories, net	729,871	547,373
Deferred taxes	99,080	95,027
Prepaid expenses and other	82,874	38,209
Total current assets	1,691,396	1,302,881
Property, plant and equipment, net of accumulated depreciation of $560,495 and $509,033, respectively	472,704	442,892
Goodwill	855,477	851,123
Deferred taxes	1,139	25,731
Other intangible assets, net	137,234	143,358
Other assets, net	116,706	103,250
Total assets	$ 3,274,656	$ 2,869,235
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 412,583	$ 412,869
Accrued liabilities	639,815	458,230
Debt due within one year	64,554	8,050
Deferred taxes	4,507	4,887
Total current liabilities	1,121,459	884,036
Long-term debt due after one year	552,109	556,519
Retirement obligations and other liabilities	434,415	408,094
Shareholders equity:		
Common shares, $1.25 par value Shares authorized 120,000 Shares issued 58,712 and 58,631, respectively	73,390	73,289
Capital in excess of par value	555,127	543,159
Retained earnings	687,079	582,767
	1,315,596	1,199,215
Treasury shares, at cost 2,576 and 2,609 shares, respectively	(107,425)	(95,262)
Deferred compensation obligation	6,526	6,973
Accumulated other comprehensive loss	(48,024)	(90,340)

Total shareholders equity		1,166,673		1,020,586
Total liabilities and shareholders equity	$	3,274,656	$	2,869,235

See accompanying notes to condensed consolidated financial statements.

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FLOWSERVE CORPORATION
(Unaudited)
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts in thousands)	Nine Months Ended September 30, 2007	2006
Cash flows Operating activities:		
Net earnings	$ 159,874	$ 81,487
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	49,029	44,598
Amortization of intangible and other assets	7,408	8,041
Amortization of deferred loan costs	1,694	1,445
Net gain on the disposition of assets	(2,018)	(122)
Excess tax benefits from stock-based payment arrangements	(8,177)	(1,177)
Stock-based compensation	19,213	19,941
Net earnings from affiliates, net of dividends received	(6,339)	(3,868)
Change in assets and liabilities:		
Accounts receivable, net	(119,022)	(28,489)
Inventories, net	(147,729)	(101,092)
Prepaid expenses and other	(34,831)	(7,268)
Other assets, net	(4,665)	(6,602)
Accounts payable	(24,111)	6,399
Accrued liabilities	152,866	2,601
Retirement obligations and other liabilities	12,531	(2,489)
Net deferred taxes	(10,623)	1,015
Net cash flows provided by operating activities	45,100	14,420
Cash flows Investing activities:		
Capital expenditures	(60,941)	(43,520)
Proceeds from disposal of assets	3,906	
Change in restricted cash	(274)	(52)
Net cash flows used by investing activities	(57,309)	(43,572)
Cash flows Financing activities:		
Net borrowings under lines of credit	58,000	
Excess tax benefits from stock-based payment arrangements	8,177	1,177
Payments on long-term debt	(1,420)	(16,897)
Payments under other financing arrangements	(4,486)	
Repurchase of common shares	(44,798)	
Payments of dividends	(17,176)	
Proceeds from stock option activity	13,341	
Net cash flows provided (used) by financing activities	11,638	(15,720)

Effect of exchange rate changes on cash		4,678		745
Net change in cash and cash equivalents		4,107		(44,127)
Cash and cash equivalents at beginning of year		67,000		92,864
Cash and cash equivalents at end of period	$	71,107	$	48,737

See accompanying notes to condensed consolidated financial statements.

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FLOWSERVE CORPORATION
(Unaudited)

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation and Accounting Policies

Basis of Presentation

The accompanying condensed consolidated balance sheet as of September 30, 2007, and the related condensed consolidated statements of income and comprehensive income for the three and nine months ended September 30, 2007 and 2006, and the condensed consolidated statements of cash flows for the nine months ended September 30, 2007 and 2006, are unaudited. In management s opinion, all adjustments comprising normal recurring adjustments necessary for a fair presentation of such condensed consolidated financial statements have been made.

The accompanying condensed consolidated financial statements and notes in this Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2007 (Quarterly Report) are presented as permitted by Regulation S-X and do not contain certain information included in our annual financial statements and notes thereto. Accordingly, the accompanying condensed consolidated financial information should be read in conjunction with the consolidated financial statements presented in our Annual Report on Form 10-K for the year ended December 31, 2006 (2006 Annual Report).

Certain reclassifications have been made to prior period amounts to conform to the current period presentation.

Income Taxes, Deferred Taxes, Tax Valuation Allowances and Tax Reserves

As of January 1, 2007, we adopted Financial Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109. FIN No. 48 addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under FIN No. 48, we may recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities. The determination is based on the technical merits of the position and presumes that each uncertain tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information.

Other Accounting Policies

Other significant accounting policies, for which no significant changes have occurred in the three months ended September 30, 2007, are detailed in Note 1 of our 2006 Annual Report.

Accounting Developments

Pronouncements Implemented

In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 155, Accounting for Certain Hybrid Financial Instruments, which amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. SFAS No. 155 improves the financial reporting of certain hybrid financial instruments and simplifies the accounting for these instruments. In particular, SFAS No. 155:

- permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation;
- clarifies which interest-only and principal-only strips are not subject to the requirements of SFAS No. 133;
- establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation;
- clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and
- amends SFAS No. 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument.

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SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity s fiscal year that begins after September 15, 2006. Our adoption of SFAS No. 155 effective January 1, 2007 had no impact on our consolidated financial condition or results of operations.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of Statement No. 140. SFAS No. 156 clarifies when an obligation to service financial assets should be separately recognized as a servicing asset or a servicing liability, requires that a separately recognized servicing asset or servicing liability be initially measured at fair value and permits an entity with a separately recognized servicing asset or servicing liability to choose either the amortization method or fair value method for subsequent measurement. SFAS No. 156 is effective for all separately recognized servicing assets and liabilities acquired or issued after the beginning of an entity s fiscal year that begins after September 15, 2006. Our adoption of SFAS No. 156 effective January 1, 2007 had no impact on our consolidated financial condition or results of operations.

In March 2006, the Emerging Issues Task Force (EITF) issued EITF Issue No. 06-03, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation). EITF No. 06-03 requires that the presentation of taxes assessed by a governmental authority that are directly imposed on a revenue-producing transaction between a seller and a customer on either a gross (included in revenues and costs) or a net (excluded from revenues) basis is an accounting policy decision that should be disclosed pursuant to Accounting Principles Board Opinion (APB) No. 22, Disclosure of Accounting Policies. In addition, if any of such taxes are reported on a gross basis, a company should disclose, on an aggregated basis, the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented if those amounts are significant. EITF Issue No. 06-03 is effective for interim and annual reporting periods beginning after December 31, 2006. As we have historically presented such taxes on a net basis within our results of operations, our adoption of EITF Issue No. 06-03 effective January 1, 2007 did not have a material impact on our consolidated financial position or results of operations.

In July 2006, the FASB issued FIN No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. FIN No. 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, as well as guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The evaluation of a tax position in accordance with FIN No. 48 is a two-step process. The first step is a recognition process whereby the enterprise determines whether it is more-likely-than-not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. The second step is a measurement process whereby a tax position that meets the more-likely-than-not recognition threshold is calculated to determine the amount of benefit to recognize in the financial statements. The provisions of FIN No. 48 are effective for fiscal years beginning after December 15, 2006. The impact on our consolidated financial condition and results of operations of adopting FIN No. 48 effective January 1, 2007 is presented in Note 12.

Pronouncements Not Yet Implemented

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 establishes a single definition of fair value and a framework for measuring fair value under accounting principles generally accepted in the United States (GAAP), and expands disclosures about fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements; however, it does not require any new fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We are still evaluating the impact of SFAS No. 157 on our consolidated financial condition and results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. It provides entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are still evaluating the impact of SFAS No. 159 on our consolidated financial condition and results of operations.

Although there are no other final pronouncements recently issued that we have not adopted and that we expect to impact reported financial information or disclosures, accounting promulgating bodies have a number of pending projects that may directly impact us. We continue to evaluate the status of these projects and as these projects become final, we will provide disclosures regarding the likelihood and magnitude of their impact, if any.

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2. Discontinued Operations

General Services Group During the first quarter of 2005 we committed to a plan to divest certain non-core service operations, collectively called the General Services Group (GSG). On December 31, 2005, we sold GSG to Furmanite, a unit of Dallas-based Xanser Corporation for a contingent sales price of $15.5 million in gross cash proceeds, including $2.0 million held in escrow pending final settlement and excluding approximately $12 million of net accounts receivable. Utilizing the $15.5 million contingent sales price, the sale resulted in a loss of $2.5 million ($3.8 million pre-tax), which we recognized in the fourth quarter of 2005. During the third quarter of 2006, we recognized $0.8 million ($1.1 million pre-tax) of reduction in the loss after an independent arbitrator issued a binding decision with respect to the valuation of inventory, which resolved one element of the contingent sales price. During the fourth quarter of 2006, we negotiated the final sales price of $17.1 million, whereby we recognized an additional reduction in the loss on sale of $0.2 million ($0.5 million pre-tax), bringing the aggregate loss on sale recognized in 2006 and 2005 to $1.5 million ($2.2 million pre-tax). All remaining amounts due to us under the terms of the sale were collected in December 2006.

We used $10.9 million of the initial net cash proceeds to reduce our indebtedness in January 2006, and an additional $3.5 million in December 2006 using the final proceeds collected pursuant to this sale transaction. As a result of this sale, we have presented the results of operations of GSG and the impact of subsequent sales price adjustments as discontinued operations.

3. Stock-Based Compensation Plans

Our stock-based compensation includes stock options, restricted stock and other equity-based awards, and is accounted for under SFAS No. 123(R), Share-Based Payment. Under this method, we recorded stock-based compensation as follows:

	Three Months Ended September 30,					
	2007			2006		
(Amounts in millions)	Stock Options	Restricted Stock	Total	Stock Options (1)	Restricted Stock	Total
Stock-based compensation expense	$ 0.7	$ 6.7	$ 7.4	$ 1.7	$ 3.3	$ 5.0
Related income tax benefit	(0.1)	(2.1)	(2.2)	(0.2)	(0.9)	(1.1)
Net stock-based compensation expense	$ 0.6	$ 4.6	$ 5.2	$ 1.5	$ 2.4	$ 3.9

	Nine Months Ended September 30,					
	2007			2006		
(Amounts in millions)	Stock Options	Restricted Stock	Total	Stock Options (1)	Restricted Stock	Total
Stock-based compensation expense	$ 2.9	$ 16.3	$ 19.2	$ 5.2	$ 9.1	$ 14.3
Related income tax benefit	(0.8)	(5.1)	(5.9)	(1.0)	(2.7)	(3.7)
Net stock-based compensation expense	$ 2.1&nb					