FLOWSERVE CORP
Form 10-Q
October 29, 2012

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, 2012
OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM to .
Commission File No. 1-13179
FLOWSERVE CORPORATION
(Exact name of registrant as specified in its charter)

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

(972) 443-6500
(Registrant's telephone number, including area code)
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. þ Yes ¨ No
Indicate by check mark whether the registrant has submitted electronically 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). þ Yes ¨ No
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "accelerated filer," "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

Smaller reporting company ¨
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ¨ Yes þ No
As of October 23, 2012, there were 49,984,225 shares of the issuer's common stock outstanding.

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PART I — FINANCIAL INFORMATION

Item 1. Financial Statements.
FLOWSERVE CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

(Amounts in thousands, except per share data)	Three Months Ended September 30,	
	2012	2011
Sales	$1,165,923	$1,121,813
Cost of sales	(776,319)	(745,227)
Gross profit	389,604	376,586
Selling, general and administrative expense	(227,797)	(225,996)
Net earnings from affiliates	3,899	4,367
Operating income	165,706	154,957
Interest expense	(12,144)	(8,544)
Interest income	208	216
Other expense, net	(9,167)	(6,621)
Earnings before income taxes	144,603	140,008
Provision for income taxes	(37,769)	(32,052)
Net earnings, including noncontrolling interests	106,834	107,956
Less: Net earnings attributable to noncontrolling interests	(538)	(185)
Net earnings attributable to Flowserve Corporation	$106,296	$107,771
Net earnings per share attributable to Flowserve Corporation common shareholders:		
Basic	$2.09	$1.94
Diluted	2.07	1.92
Cash dividends declared per share	$0.36	$0.32

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

(Amounts in thousands)	Three Months Ended September 30,	
	2012	2011
Net earnings, including noncontrolling interests	$106,834	$107,956
Other comprehensive income (expense):		
Foreign currency translation adjustments, net of taxes of $(19,147) and $61,131, respectively	31,641	(107,740)
Pension and other postretirement effects, net of taxes of $(463) and $(1,302), respectively	180	2,797
Cash flow hedging activity, net of taxes of $(130) and $293, respectively	215	(516)
Other comprehensive income (expense)	32,036	(105,459)
Comprehensive income, including noncontrolling interests	138,870	2,497
Comprehensive (income) loss attributable to noncontrolling interests	(700)	110
Comprehensive income attributable to Flowserve Corporation	$138,170	$2,607

See accompanying notes to condensed consolidated financial statements.

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FLOWSERVE CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

(Amounts in thousands, except per share data)	Nine Months Ended September 30,			
	2012		2011	
Sales	$3,423,128		$3,244,772	
Cost of sales	(2,289,739	)	(2,151,153	)
Gross profit	1,133,389		1,093,619	
Selling, general and administrative expense	(673,578	)	(681,618	)
Net earnings from affiliates	13,214		13,314	
Operating income	473,025		425,315	
Interest expense	(29,876	)	(26,684	)
Interest income	727		1,100	
Other (expense) income, net	(22,151	)	7,852	
Earnings before income taxes	421,725		407,583	
Provision for income taxes	(112,864	)	(103,908	)
Net earnings, including noncontrolling interests	308,861		303,675	
Less: Net earnings attributable to noncontrolling interests	(2,124	)	(191	)
Net earnings attributable to Flowserve Corporation	$306,737		$303,484	
Net earnings per share attributable to Flowserve Corporation common shareholders:				
Basic	$5.77		$5.45	
Diluted	5.73		5.40	
Cash dividends declared per share	$1.08		$0.96	

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

(Amounts in thousands)	Nine Months Ended September 30,			
	2012		2011	
Net earnings, including noncontrolling interests	$308,861		$303,675	
Other comprehensive income (expense):				
Foreign currency translation adjustments, net of taxes of $(4,891) and $17,944, respectively	8,082		(31,625	)
Pension and other postretirement effects, net of taxes of $(2,125) and $(1,946), respectively	2,726		3,256	
Cash flow hedging activity, net of taxes of $29 and $539, respectively	(89	)	(945	)
Other comprehensive income (expense)	10,719		(29,314	)
Comprehensive income, including noncontrolling interests	319,580		274,361	
Comprehensive income attributable to noncontrolling interests	(2,173	)	(322	)
Comprehensive income attributable to Flowserve Corporation	$317,407		$274,039	

See accompanying notes to condensed consolidated financial statements.

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FLOWSERVE CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

(Amounts in thousands, except per share data)	September 30, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$217,420	$337,356
Accounts receivable, net of allowance for doubtful accounts of $21,546 and $20,351, respectively	1,105,641	1,060,249
Inventories, net	1,155,725	1,008,379
Deferred taxes	128,611	121,905
Prepaid expenses and other	113,673	100,465
Total current assets	2,721,070	2,628,354
Property, plant and equipment, net of accumulated depreciation of $767,392 and $719,992, respectively	605,360	598,746
Goodwill	1,047,729	1,045,077
Deferred taxes	19,659	17,843
Other intangible assets, net	151,891	163,482
Other assets, net	198,039	169,112
Total assets	$4,743,748	$4,622,614
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable	$516,500	$597,342
Accrued liabilities	836,330	808,601
Debt due within one year	48,861	53,623
Deferred taxes	8,748	10,755
Total current liabilities	1,410,439	1,470,321
Long-term debt due after one year	879,135	451,593
Retirement obligations and other liabilities	426,949	422,470
Shareholders' equity:		
Common shares, $1.25 par value	73,664	73,664
Shares authorized – 120,000		
Shares issued – 58,931 and 58,931, respectively		
Capital in excess of par value	548,748	621,083
Retained earnings	2,455,401	2,205,524
	3,077,813	2,900,271
Treasury shares, at cost – 8,901 and 5,025 shares, respectively	(866,289)	(424,052)
Deferred compensation obligation	10,711	9,691
Accumulated other comprehensive loss	(205,427)	(216,097)
Total Flowserve Corporation shareholders' equity	2,016,808	2,269,813
Noncontrolling interest	10,417	8,417
Total equity	2,027,225	2,278,230
Total liabilities and equity	$4,743,748	$4,622,614

See accompanying notes to condensed consolidated financial statements.

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FLOWSERVE CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(Amounts in thousands)

	Nine Months Ended September 30,	
	2012	2011
Cash flows – Operating activities:		
Net earnings, including noncontrolling interests	$308,861	$303,675
Adjustments to reconcile net earnings to net cash provided (used) by operating activities:		
Depreciation	66,027	67,166
Amortization of intangible and other assets	14,751	12,385
Loss on early extinguishment of debt	1,293	—
Net gain on disposition of assets	(10,461)	(484)
Excess tax benefits from stock-based compensation arrangements	(11,056)	(5,201)
Stock-based compensation	25,942	23,655
Net earnings from affiliates, net of dividends received	(5,798)	472
Change in assets and liabilities:		
Accounts receivable, net	(45,566)	(201,636)
Inventories, net	(149,254)	(206,079)
Prepaid expenses and other	(8,968)	(21,606)
Other assets, net	(11,609)	(2,019)
Accounts payable	(75,169)	(101,671)
Accrued liabilities and income taxes payable	26,057	(43,648)
Retirement obligations and other liabilities	(6,737)	13,635
Net deferred taxes	4,251	11,271
Net cash flows provided (used) by operating activities	122,564	(150,085)
Cash flows – Investing activities:		
Capital expenditures	(84,180)	(71,164)
Proceeds from disposal of assets	11,473	3,530
Payments for acquisitions, net of cash acquired	(3,996)	(890)
Affiliate investing activity	(3,825)	—
Net cash flows used by investing activities	(80,528)	(68,524)
Cash flows – Financing activities:		
Excess tax benefits from stock-based compensation arrangements	11,056	5,201
Payments on long-term debt	(475,000)	(18,750)
Proceeds from issuance of senior notes	498,075	—
Proceeds from issuance of long-term debt	400,000	—
Proceeds from short-term financing	475,000	—
Payments on short-term financing	(475,000)	—
Borrowings (payments) under other financing arrangements, net	294	(1,747)
Repurchases of common shares	(533,864)	(41,088)
Payments of dividends	(55,569)	(51,794)
Payments of deferred loan costs	(9,657)	—
Other	(248)	(1,858)
Net cash flows used by financing activities	(164,913)	(110,036)

Effect of exchange rate changes on cash	2,941	(1,049)
Net change in cash and cash equivalents	(119,936)	(329,694)
Cash and cash equivalents at beginning of period	337,356	557,579
Cash and cash equivalents at end of period	$217,420	$227,885

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, 2012, the related condensed consolidated statements of income and comprehensive income for the three and nine months ended September 30, 2012 and 2011, and the condensed consolidated statements of cash flows for the nine months ended September 30, 2012 and 2011, of Flowserve Corporation, 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, 2012 ("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, 2011 ("2011 Annual Report").
European Sovereign Debt Crisis – At September 30, 2012, we had no direct investments in European sovereign or non-sovereign debt. However, certain of our defined benefit plans hold investments in European equity and fixed income securities as discussed in Note 12 to our consolidated financial statements included in our 2011 Annual Report. Other than broad, macro-level economic impacts, including foreign exchange rate impacts, we did not experience any direct or measurable disruptions during the three and nine months ended September 30, 2012 related to the European sovereign debt. We will continue to monitor and evaluate the impact of any future developments in the region on our current business, our customers and suppliers and the state of the global economy.
Events in North Africa and Middle East – As previously disclosed in our 2011 Annual Report, during 2011, political and economic conditions in North Africa caused us to experience shipment delays to this region. For the three and nine months ended September 30, 2012, there was no impact to operating income due to delayed shipments to this region. The preponderance of our physical assets in the region are located in the Kingdom of Saudi Arabia and the United Arab Emirates and have, to date, not been significantly affected by the unrest elsewhere in the region.
Accounting Policies
Significant accounting policies, for which no significant changes have occurred in the nine months ended September 30, 2012, are detailed in Note 1 to our consolidated financial statements included in our 2011 Annual Report.
Accounting Developments
Pronouncements Implemented
In May 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2011-04, "Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs," which clarifies the requirements in accounting principles generally accepted in the United States ("U.S. GAAP") for measuring fair value and for disclosing information about fair value measurements in order to improve the comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with U.S. GAAP and International Financial Reporting Standards ("IFRSs"). The amendments do not result in a major change in the application of the requirements in Topic 820, but clarify the application of existing fair value measurement requirements and change particular principles or requirements for measuring fair value and for disclosing information about fair value measurements. Our adoption of ASU No. 2011-04, effective January 1, 2012, had no impact on our consolidated financial condition and results of

operations.

In June 2011, the FASB issued ASU No. 2011-05, "Comprehensive Income (Accounting Standards Codification ("ASC") 220): Presentation of Comprehensive Income," which specifies that an entity has the option to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This amendment also requires an entity to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income. In December 2011, the FASB issued ASU No. 2011-12, "Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05," to defer the requirement to present on the face of the financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income. Our adoption of ASU Nos. 2011-05 and 2011-12, effective January 1, 2012, had no impact on our consolidated financial condition and results of operations.

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In September 2011, the FASB issued ASU No. 2011-08, "Intangibles - Goodwill and Other (ASC 350): Testing Goodwill for Impairment," which specifies that an entity has the option to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. An entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. Our adoption of ASU No. 2011-08, effective January 1, 2012, had no impact on our consolidated financial condition and results of operations.

Pronouncements Not Yet Implemented

In December 2011, the FASB issued ASU No. 2011-11, "Disclosures about Offsetting Assets and Liabilities," which requires enhanced disclosures about financial instruments and derivative instruments that are either (1) offset in accordance with either ASC 210-20-45, "Balance Sheet - Offsetting," or ASC 815-10-45, "Derivatives and Hedging - Overall," or (2) subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with either ASC 210-20-45 or ASC 815-10-45. ASU No. 2011-11 is effective for fiscal years, and interim periods within those years, beginning after December 31, 2012. The disclosure requirements shall be applied retrospectively for all periods presented. The adoption of ASU No. 2011-11 will not have an impact on our consolidated financial condition and results of operations.

In July 2012, the FASB issued ASU No. 2012-02, "Intangibles-Goodwill and Other (Topic 350): Testing Indefinite-Lived Intangible Assets for Impairment," which specifies that an entity has the option to first assess qualitative factors to determine whether it is more likely than not that the asset is impaired. Unless an entity determines that it is more likely than not that the fair value of such an asset is less than its carrying amount, it would not need to calculate the fair value of the asset in that year. ASU No. 2012-02 is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. The adoption of ASU No. 2012-02 will not have an impact on our consolidated financial condition and results of operations.

2. Acquisition

Lawrence Pumps, Inc.

As discussed in Note 2 to our consolidated financial statements included in our 2011 Annual Report, effective October 28, 2011, we acquired for inclusion in Engineered Product Division ("EPD"), 100% of Lawrence Pumps, Inc ("LPI"), a privately-owned, U.S.-based pump manufacturer. The final purchase price of $88.2 million reflects immaterial adjustments to goodwill and current liabilities during the nine months ended September 30, 2012. LPI specializes in the design, development and manufacture of engineered centrifugal slurry pumps for critical services within the petroleum refining, petrochemical, pulp and paper and energy markets. No pro forma financial information has been presented due to immateriality.

3. Stock-Based Compensation Plans

We established the Flowserve Corporation Equity and Incentive Compensation Plan (the "2010 Plan") effective January 1, 2010. This shareholder-approved plan authorizes the issuance of up to 2,900,000 shares of our common stock in the form of incentive stock options, non-statutory stock options, restricted shares, restricted share units and performance-based units (collectively referred to as "Restricted Shares"), stock appreciation rights and bonus stock. Of the 2,900,000 shares of common stock authorized under the 2010 Plan, 2,149,479 were available for issuance as of September 30, 2012. In addition to the 2010 Plan, we also maintain the Flowserve Corporation 2004 Stock Compensation Plan (the "2004 Plan"), which was established on April 21, 2004. The 2004 Plan authorizes the issuance of up to 3,500,000 shares of common stock through grants of Restricted Shares, stock options and other equity-based awards. Of the 3,500,000 shares of common stock authorized under the 2004 Plan, 275,945 were available for issuance as of September 30, 2012. No stock options have been granted since 2006.

Restricted Shares – Awards of Restricted Shares are valued at the closing market price of our common stock on the date of grant. The unearned compensation is amortized to compensation expense over the vesting period of the restricted shares. We had unearned compensation of $38.7 million and $27.0 million at September 30, 2012 and December 31, 2011, respectively, which is expected to be recognized over a weighted-average period of approximately one year. These amounts will be recognized into net earnings in prospective periods as the awards vest. The total fair value of Restricted Shares vested during the three months ended September 30, 2012 and 2011 was $0.1 million and $0.2 million, respectively. The total fair value of Restricted Shares vested during the nine months ended September 30, 2012 and 2011 was $36.4 million and $35.0 million, respectively.

We recorded stock-based compensation expense of $6.9 million ($10.5 million pre-tax) and $4.9 million ($7.4 million pre-tax) for the three months ended September 30, 2012 and 2011, respectively. We recorded stock-based compensation expense of $17.1 million ($25.9 million pre-tax) and $15.9 million ($23.7 million pre-tax) for the nine months ended September 30, 2012 and 2011, respectively.

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The following table summarizes information regarding Restricted Shares:

	Nine Months Ended September 30, 2012	
	Shares	Weighted Average Grant-Date Fair Value
Number of unvested shares:		
Outstanding - January 1, 2012	1,052,199	$84.62
Granted	355,417	115.54
Vested	(576,648)	63.04
Cancelled	(28,750)	115.12
Outstanding - September 30, 2012	802,218	$112.74

Unvested Restricted Shares outstanding as of September 30, 2012, includes approximately 325,000 units with performance-based vesting provisions. Performance-based units are issuable in common stock and vest upon the achievement of pre-defined performance targets, primarily based on our average annual return on net assets over a three-year period as compared with the same measure for a defined peer group for the same period. Most units were granted in three annual grants since January 1, 2010 and have a vesting percentage between 0% and 200% depending on the achievement of the specific performance targets. Compensation expense is recognized ratably over a cliff-vesting period of 36 months, based on the fair market value of our common stock on the date of grant, as adjusted for anticipated forfeitures. During the performance period, earned and unearned compensation expense is adjusted based on changes in the expected achievement of the performance targets. Vesting provisions range from 0 to approximately 644,000 shares based on performance targets. As of September 30, 2012, we estimate vesting of approximately 502,000 shares based on expected achievement of performance targets.

4. Derivative Instruments and Hedges

Our risk management and derivatives policy specifies the conditions under which we may enter into derivative contracts. See Notes 1 and 6 to our consolidated financial statements included in our 2011 Annual Report and Note 7 of this Quarterly Report for additional information on our derivatives. We enter into forward exchange contracts to hedge our cash flow risks associated with transactions denominated in currencies other than the local currency of the operation engaging in the transaction. At September 30, 2012 and December 31, 2011, we had $571.2 million and $481.2 million, respectively, of notional amount in outstanding forward exchange contracts with third parties. At September 30, 2012, the length of forward exchange contracts currently in place ranged from one day to 15 months. Also as part of our risk management program, we enter into interest rate swap agreements to hedge exposure to floating interest rates on certain portions of our debt. At September 30, 2012 and December 31, 2011, we had $300.0 million and $330.0 million, respectively, of notional amount in outstanding interest rate swaps with third parties. All interest rate swaps are highly effective. At September 30, 2012, the maximum remaining length of any interest rate swap contract in place was approximately 33 months.

We are exposed to risk from credit-related losses resulting from nonperformance by counterparties to our financial instruments. We perform credit evaluations of our counterparties under forward exchange contracts and interest rate swap agreements and expect all counterparties to meet their obligations. If necessary, we would adjust the values of our derivative contracts for our or our counterparties' credit risks. We have not experienced credit losses from our counterparties.

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

(Amounts in thousands)	September 30, 2012	December 31, 2011
Current derivative assets	$3,995	$2,330
Noncurrent derivative assets	250	10

Current derivative liabilities	7,339	11,196
Noncurrent derivative liabilities	15	516

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The fair value of interest rate swaps in cash flow hedging relationships are summarized below:

(Amounts in thousands)	September 30, 2012	December 31, 2011
Current derivative assets	$—	$33
Noncurrent derivative assets	—	71
Current derivative liabilities	1,598	761
Noncurrent derivative liabilities	564	547

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

The impact of net changes in the fair values of forward exchange contracts not designated as hedging instruments are summarized below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Amounts in thousands)	2012	2011	2012	2011
(Loss) gain recognized in income	$(855)	$(9,892)	$(6,496)	$211

The impact of net changes in the fair values of interest rate swaps in cash flow hedging relationships are summarized below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Amounts in thousands)	2012	2011	2012	2011
Loss reclassified from accumulated other comprehensive income into income for settlements, net of tax	$(237)	$(396)	$(636)	$(1,203)
Loss recognized in other comprehensive income, net of tax	(22)	(912)	(725)	(2,149)

Gains and losses recognized in our condensed consolidated statements of income for forward exchange contracts and interest rate swaps are classified as other (expense) income, net, and interest expense, respectively. At September 30, 2012, we expect to recognize losses of $1.1 million, net of deferred taxes, into earnings in the next twelve months related to interest rate swap agreements based on their fair values at September 30, 2012.

5. Debt

Debt, including capital lease obligations, consisted of:

(Amounts in thousands, except percentages)	September 30, 2012	December 31, 2011
3.50% Senior Notes due September 15, 2022 (net of unamortized discount)	$498,084	$—
Term Loan Facility, interest rate of 1.86% at September 30, 2012	400,000	—
Prior Term Loan Facility, interest rate of 2.58% at December 31, 2011	—	475,000
Capital lease obligations and other borrowings	29,912	30,216
Debt and capital lease obligations	927,996	505,216
Less amounts due within one year	48,861	53,623
Total debt due after one year	$879,135	$451,593

Senior Notes

On September 11, 2012, we completed a public offering of $500.0 million in aggregate principal amount of senior notes due September 15, 2022 ("Senior Notes"). The Senior Notes bear an interest rate of 3.50% per year, payable on

March 15 and September 15 of each year, commencing on March 15, 2013. The Senior Notes were priced at 99.615% of par value, reflecting a discount to the aggregate principal amount.
At any time prior to June 15, 2022, we have the right to redeem the Senior Notes, in whole or in part, at our option, at a redemption price equal to the greater of: (1) 100% of the principal amount of the Senior Notes being redeemed; or (2) the sum of the present values of the remaining scheduled payments of principal and interest in respect of the Senior Notes being redeemed discounted to the redemption date on a semi-annual basis, at the applicable Treasury Rate plus 30 basis points. In addition, at any time on or after June 15, 2022, we may redeem the Senior Notes at a redemption price equal to 100% of the principal amount of the Senior Notes being redeemed. In each case, we will also pay the accrued and unpaid interest on the principal amount being redeemed to the redemption date.
The Senior Notes are unsecured and are jointly and severally and fully and unconditionally guaranteed by certain of our domestic subsidiaries that are guarantors under our primary credit facility. The guarantees will be automatically and unconditionally released and discharged when: the subsidiary is sold or sells all of its assets; the requirement for legal or covenant defeasance or to discharge our obligations has been satisfied; or upon the delivery of an officer's certificate to the trustee that such guarantor does not guarantee our obligations under our primary bank credit facility. The Senior Notes rank equally in right of payment with all of our other unsecured indebtedness.
We used a portion of the net proceeds of the Senior Notes offering to repay the $250.0 million outstanding principal balance on the Bridge Loan (described below). We used the remaining portion of the net proceeds for general corporate purposes, including repayment of the outstanding balance on the Prior Revolving Credit Facility (described below) and the repurchase of shares of our common stock (as discussed in Note 13).

Senior Credit Facility
On August 20, 2012, we entered into a credit agreement with Bank of America, N.A., as swingline lender, letter of credit issuer and administrative agent, and the other lenders party thereto (together, the “Lenders”), providing for term debt and a revolving credit facility. The credit agreement provides for an aggregate commitment of $1.25 billion, including a $400.0 million term loan facility with a maturity date of August 20, 2017 (“Term Loan Facility”) and an $850.0 million revolving credit facility with a maturity date of August 20, 2017 (“Revolving Credit Facility” and, together with the Term Loan Facility, the “Senior Credit Facility”). The Revolving Credit Facility includes a $300.0 million sublimit for the issuance of letters of credit and a $30.0 million sublimit for swingline loans. Subject to certain conditions, we have the right to increase the amount of the Term Loan Facility or the Revolving Credit Facility by an aggregate amount not to exceed $250.0 million. Our obligations under the Senior Credit Facility are guaranteed by certain of our domestic subsidiaries. The Lenders have agreed to release such guarantees if we achieve certain credit ratings. We had not achieved these ratings as of September 30, 2012.
We used all of the $400.0 million proceeds advanced under the Term Loan Facility, along with approximately $217 million advanced under the Revolving Credit Facility, to repay all outstanding indebtedness under our then-existing term loan ("Prior Term Loan Facility") and revolving credit facility (“Prior Revolving Credit Facility”) pursuant to our then-existing credit agreement dated as of December 14, 2010, as amended (the “Prior Credit Agreement”). In connection with this repayment, our outstanding letters of credit under the Prior Credit Agreement were transferred to the Revolving Credit Facility, and we terminated the Prior Credit Agreement on August 20, 2012. Future borrowings under the Revolving Credit Facility will be subject to various conditions, including the absence of any default under the Senior Credit Facility.
At September 30, 2012 and December 31, 2011, we had no amounts outstanding under the Revolving Credit Facility or the Prior Revolving Credit Facility, respectively. We had outstanding letters of credit of $156.3 million and $147.4 million at September 30, 2012 and December 31, 2011, respectively, which reduced our borrowing capacity under the Revolving Credit Facility and Prior Revolving Credit Facility to $693.7 million and $352.6 million, respectively.
The Senior Credit Facility contains, among other things, covenants defining our and our subsidiaries' ability to dispose of assets, merge, pay dividends, repurchase or redeem capital stock and indebtedness, incur indebtedness and guarantees, create liens, enter into agreements with negative pledge clauses, make certain investments or acquisitions, enter into transactions with affiliates or engage in any business activity other than our existing business. The Senior Credit Facility also contains covenants requiring us to deliver certificates of compliance to the Lenders regarding our financial statements for each fiscal quarter and fiscal year. The Senior Credit Facility requires us to have a maximum permitted leverage ratio of 3.25 times debt to total Consolidated EBITDA (as defined in the Senior Credit Facility)

and a minimum interest coverage of 3.25 times Consolidated EBITDA to total interest expense. Our compliance with these financial covenants under the Senior Credit Facility is tested quarterly.
We may prepay loans under our Senior Credit Facility in whole or in part, without premium or penalty, at any time. A commitment fee, which is payable quarterly on the daily unused portions of the Senior Credit Facility, was 0.225% during the period ended September 30, 2012. During the nine months ended September 30, 2012, we made scheduled repayments of $12.5 million under our Prior Credit Agreement. We made no mandatory repayment or optional payments under the Prior Credit Agreement as of September 30, 2012, with the exception of the repayment of all outstanding indebtedness under the Prior Credit Agreement at August 20, 2012 with proceeds advanced under the Senior Credit Facility. We have scheduled repayments of $5.0 million due in each of the next four quarters under our Senior Credit Facility. Our Senior Credit Facility bears a floating rate of interest, and we have entered into $300.0 million of notional amount of interest rate swaps at September 30, 2012 to hedge exposure to floating interest rates.

Bridge Loan
On June 15, 2012, we entered into a loan agreement with JPMorgan Chase Bank, N.A., as administrative agent, and the other lenders party thereto, providing for a term loan with an aggregate commitment of $250.0 million for a term of 364 days ("Bridge Loan"). The proceeds from the Bridge Loan were used to fund our share repurchase program described in Note 13 to our condensed consolidated financial statements included in this Quarterly Report. The Bridge Loan was repaid in its entirety in the third quarter of 2012 using a portion of the net proceeds from the Senior Notes offering.

European Letter of Credit Facilities
On October 30, 2009, we entered into a 364-day unsecured European Letter of Credit Facility ("European LOC Facility") with an initial commitment of €125.0 million. The European LOC Facility is renewable annually and is used for contingent obligations in respect of surety and performance bonds, bank guarantees and similar obligations with maturities up to five years. We renewed the European LOC Facility in October 2012 for an additional 364-day period and amended certain provisions to conform to those in our Senior Credit Facility and Senior Notes. We had outstanding letters of credit drawn on the European LOC Facility of €62.0 million ($79.7 million) and €81.0 million ($105.0 million) as of September 30, 2012 and December 31, 2011, respectively.
Our ability to issue additional letters of credit under our previous European Letter of Credit Facility ("Old European LOC Facility"), which had a commitment of €110.0 million, expired November 9, 2009. We had outstanding letters of credit written against the Old European LOC Facility of €3.4 million ($4.4 million) and €12.2 million ($15.8 million) as of September 30, 2012 and December 31, 2011, respectively.
Certain banks are parties to both facilities and are managing their exposures on an aggregated basis. As such, the commitment under the European LOC Facility is reduced by the face amount of existing letters of credit written against the Old European LOC Facility prior to its expiration. After consideration of outstanding commitments under both facilities, the available capacity under the European LOC Facility was €122.7 million ($157.8 million) as of September 30, 2012, of which €62.0 million ($79.7 million) has been utilized.
6. Supplemental Guarantor Financial Information
On September 11, 2012, we completed a public offering of Senior Notes that are fully and unconditionally and jointly and severally guaranteed by certain of our 100% owned domestic subsidiaries. In accordance with Rule 3−10 of Regulation S−X promulgated under the Securities Act of 1933, the following condensed consolidating financial statements present the financial position, results of operations and cash flows of Flowserve Corporation (referred to as "Parent" for the purpose of this note only) on a Parent−only (Issuer) basis, the combined guarantor subsidiaries on a guarantor−only basis, the combined non-guarantor subsidiaries on a non-guarantor-only basis and elimination adjustments necessary to arrive at the information for the Parent, guarantor subsidiaries and non-guarantor subsidiaries on a consolidated basis. Investments in subsidiaries have been accounted for using the equity method for this presentation.

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FLOWSERVE CORPORATION
CONDENSED CONSOLIDATING STATEMENTS OF INCOME

	Three Months Ended September 30, 2012				
	Parent (Issuer)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Total
(Amounts in thousands)					
Sales	$—	$444,206	$ 807,668	$(85,951)	$1,165,923
Cost of sales	—	(290,892)	(571,378)	85,951	(776,319)
Gross profit	—	153,314	236,290	—	389,604
Selling, general and administrative expense	325	(95,054)	(133,068)	—	(227,797)
Net earnings from affiliates	—	1,199	2,700	—	3,899
Net earnings from consolidated subsidiaries, net of tax	109,165	60,848	—	(170,013)	—
Operating income	109,490	120,307	105,922	(170,013)	165,706
Interest expense, net	(4,428)	(4,958)	(2,550)	—	(11,936)
Other expense, net	—	(1,176)	(7,991)	—	(9,167)
Earnings before income taxes	105,062	114,173	95,381	(170,013)	144,603
Provision for income taxes	1,234	(5,008)	(33,995)	—	(37,769)
Net earnings, including noncontrolling interests	106,296	109,165	61,386	(170,013)	106,834
Less: Net earnings attributable to noncontrolling interests	—	—	(538)	—	(538)
Net earnings attributable to Flowserve Corporation	$106,296	$109,165	$ 60,848	$(170,013)	$106,296
Comprehensive income attributable to Flowserve Corporation	$138,170	$140,824	$ 90,871	$(231,695)	$138,170

	Three Months Ended September 30, 2011				
	Parent (Issuer)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Total
(Amounts in thousands)					
Sales	$—	$428,789	$ 779,744	$(86,720)	$1,121,813
Cost of sales	—	(271,212)	(560,735)	86,720	(745,227)
Gross profit	—	157,577	219,009	—	376,586
Selling, general and administrative expense	(383)	(94,200)	(131,413)	—	(225,996)
Net earnings from affiliates	—	1,030	3,337	—	4,367
Net earnings from consolidated subsidiaries, net of tax	108,197	61,396	—	(169,593)	—
Operating income	107,814	125,803	90,933	(169,593)	154,957
Interest expense, net	(230)	(4,693)	(3,405)	—	(8,328)
Other expense, net	—	(1,508)	(5,113)	—	(6,621)
Earnings before income taxes	107,584	119,602	82,415	(169,593)	140,008
Provision for income taxes	187	(11,405)	(20,834)	—	(32,052)
	107,771	108,197	61,581	(169,593)	107,956

Net earnings, including noncontrolling interests					
Less: Net earnings attributable to noncontrolling interests	—	—	(185)	—	(185)
Net earnings attributable to Flowserve Corporation	$107,771	$108,197	$ 61,396	$(169,593)	$107,771
Comprehensive income attributable to Flowserve Corporation	$2,607	$3,546	$ (44,838)	$41,292	$2,607

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	Nine Months Ended September 30, 2012				
(Amounts in thousands)	Parent (Issuer)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Total
Sales	$—	$1,337,117	$ 2,343,241	$(257,230)	$3,423,128
Cost of sales	—	(880,848)	(1,666,121)	257,230	(2,289,739)
Gross profit	—	456,269	677,120	—	1,133,389
Selling, general and administrative expense	(2,655)	(290,428)	(380,495)	—	(673,578)
Net earnings from affiliates	—	3,154	10,060	—	13,214
Net earnings from consolidated subsidiaries, net of tax	312,681	195,451	—	(508,132)	—
Operating income	310,026	364,446	306,685	(508,132)	473,025
Interest expense, net	(5,776)	(14,334)	(9,039)	—	(29,149)
Other income (expense), net	—	673	(22,824)	—	(22,151)
Earnings before income taxes	304,250	350,785	274,822	(508,132)	421,725
Provision for income taxes	2,487	(38,104)	(77,247)	—	(112,864)
Net earnings, including noncontrolling interests	306,737	312,681	197,575	(508,132)	308,861
Less: Net earnings attributable to noncontrolling interests	—	—	(2,124)	—	(2,124)
Net earnings attributable to Flowserve Corporation	$306,737	$312,681	$ 195,451	$(508,132)	$306,737
Comprehensive income attributable to Flowserve Corporation	$317,407	$323,427	$ 202,268	$(525,695)	$317,407

	Nine Months Ended September 30, 2011				
(Amounts in thousands)	Parent (Issuer)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Total
Sales	$—	$1,264,002	$ 2,228,441	$(247,671)	$3,244,772
Cost of sales	—	(808,936)	(1,589,888)	247,671	(2,151,153)
Gross profit	—	455,066	638,553	—	1,093,619
Selling, general and administrative expense	(4,417)	(274,034)	(403,167)	—	(681,618)
Net earnings from affiliates	—	3,072	10,242	—	13,314
Net earnings from consolidated subsidiaries, net of tax	307,808	186,215	—	(494,023)	—
Operating income	303,391	370,319	245,628	(494,023)	425,315
Interest expense, net	(874)	(13,466)	(11,244)	—	(25,584)
Other (expense) income, net	—	(4,280)	12,132	—	7,852
Earnings before income taxes	302,517	352,573	246,516	(494,023)	407,583
Provision for income taxes	967	(44,765)	(60,110)	—	(103,908)
Net earnings, including noncontrolling interests	303,484	307,808	186,406	(494,023)	303,675
Less: Net earnings attributable to noncontrolling interests	—	—	(191)	—	(191)

Net earnings attributable to Flowserve Corporation	$303,484	$307,808	$ 186,215	$(494,023)	$303,484
Comprehensive income attributable to Flowserve Corporation	$274,039	$279,308	$ 153,932	$(433,240)	$274,039

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FLOWSERVE CORPORATION
CONDENSED CONSOLIDATING BALANCE SHEETS

	September 30, 2012				
	Parent (Issuer)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Total
(Amounts in thousands)					
ASSETS					
Current assets:					
Cash and cash equivalents	$23,808	$—	$ 193,612	$—	$217,420
Accounts receivable, net	—	264,717	840,924	—	1,105,641
Intercompany receivables	13,217	136,812	37,632	(187,661)	—
Inventories, net	—	382,732	772,993	—	1,155,725
Other current assets, net	2,037	135,061	105,186	—	242,284
Total current assets	39,062	919,322	1,950,347	(187,661)	2,721,070
Property, plant and equipment, net	—	192,058	413,302	—	605,360
Goodwill	—	671,858	375,871	—	1,047,729
Intercompany receivables	475,000	33,476	1,145	(509,621)	—
Investment in consolidated subsidiaries	2,401,573	1,524,919	—	(3,926,492)	—
Other assets, net	15,729	189,261	164,599	—	369,589
Total assets	$2,931,364	$3,530,894	$ 2,905,264	$(4,623,774)	$4,743,748
LIABILITIES AND EQUITY					
Current liabilities:					
Accounts payable	$—	$140,702	$ 375,798	$—	$516,500
Intercompany payables	23	50,826	136,812	(187,661)	—
Accrued liabilities	7,593	260,776	567,961	—	836,330
Debt due within one year	20,000	196	28,665	—	48,861
Deferred taxes	—	—	8,748	—	8,748
Total current liabilities	27,616	452,500	1,117,984	(187,661)	1,410,439
Long-term debt due after one year	878,084	20	1,031	—	879,135
Intercompany payables	1,145	475,000	33,476	(509,621)	—
Retirement obligations and other liabilities	7,711	201,801	217,437	—	426,949
Total liabilities	914,556	1,129,321	1,369,928	(697,282)	2,716,523
Total Flowserve Corporation shareholders' equity	2,016,808	2,401,573	1,524,919	(3,926,492)	2,016,808
Noncontrolling interest	—	—	10,417	—	10,417
Total equity	2,016,808	2,401,573	1,535,336	(3,926,492)	2,027,225
Total liabilities and equity	$2,931,364	$3,530,894	$ 2,905,264	$(4,623,774)	$4,743,748

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	December 31, 2011				
	Parent (Issuer)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Total
(Amounts in thousands)					
ASSETS					
Current assets:					
Cash and cash equivalents	$150,308	$—	$ 187,048	$—	$337,356
Accounts receivable, net	—	271,571	788,678	—	1,060,249
Intercompany receivables	—	118,292	33,883	(152,175)	—
Inventories, net	—	357,870	650,509	—	1,008,379
Other current assets, net	1,530	94,413	126,427	—	222,370
Total current assets	151,838	842,146	1,786,545	(152,175)	2,628,354
Property, plant and equipment, net	—	194,671	404,075	—	598,746
Goodwill	—	673,013	372,064	—	1,045,077
Intercompany receivables	475,000	14,697	1,144	(490,841)	—
Investment in consolidated subsidiaries	2,122,734	1,336,856	—	(3,459,590)	—
Other assets, net	10,039	184,855	155,543	—	350,437
Total assets	$2,759,611	$3,246,238	$ 2,719,371	$(4,102,606)	$4,622,614
LIABILITIES AND EQUITY					
Current liabilities:					
Accounts payable	$—	$153,137	$ 444,205	$—	$597,342
Intercompany payables	223	33,660	118,292	(152,175)	—
Accrued liabilities	6,143	271,535	530,923	—	808,601
Debt due within one year	25,000	5	28,618	—	53,623
Deferred taxes	—	—	10,755	—	10,755
Total current liabilities	31,366	458,337	1,132,793	(152,175)	1,470,321
Long-term debt due after one year	450,000	40	1,553	—	451,593
Intercompany payables	1,144	475,000	14,697	(490,841)	—
Retirement obligations and other liabilities	7,288	190,127	225,055	—	422,470
Total liabilities	489,798	1,123,504	1,374,098	(643,016)	2,344,384
Total Flowserve Corporation shareholders' equity	2,269,813	2,122,734	1,336,856	(3,459,590)	2,269,813
Noncontrolling interest	—	—	8,417	—	8,417
Total equity	2,269,813	2,122,734	1,345,273	(3,459,590)	2,278,230
Total liabilities and equity	$2,759,611	$3,246,238	$ 2,719,371	$(4,102,606)	$4,622,614

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FLOWSERVE CORPORATION
CONDENSED CONSOLIDATING STATEMENTS OF CASH FLOWS

	Nine Months Ended September 30, 2012				
	Parent (Issuer)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Total
(Amounts in thousands)					
Net cash flows provided (used) by operating activities	$49,256	$74,283	$ 50,767	$(51,742)	$122,564
Cash flows — Investing activities:					
Capital expenditures	—	(25,366)	(58,814)	—	(84,180)
Payments for acquisitions, net of cash acquired	—	—	(3,996)	—	(3,996)
Intercompany loan proceeds	—	7,869	—	(7,869)	—
Intercompany loan payments	—	(26,648)	—	26,648	—
Intercompany return of capital	—	1,982	—	(1,982)	—
Intercompany capital contribution	—	(483)	—	483	—
Proceeds from disposition of assets	—	87	11,386	—	11,473
Affiliate investment activity, net	—	—	(3,825)	—	(3,825)
Net cash flows used by investing activities	—	(42,559)	(55,249)	17,280	(80,528)
Cash flows — Financing activities:					
Excess tax benefits from stock-based payment arrangements	—	8,837	2,219	—	11,056
Payments on long-term debt	(475,000)	—	—	—	(475,000)
Proceeds from issuance of senior notes	498,075	—	—	—	498,075
Proceeds from issuance of long-term debt	400,000	—	—	—	400,000
Proceeds from short-term financing	475,000	—	—	—	475,000
Payments on short-term financing	(475,000)	—	—	—	(475,000)
Borrowings under other financing arrangements, net	9	171	114	—	294
Repurchases of common shares	(533,864)	—	—	—	(533,864)
Payments of dividends	(55,569)	—	—	—	(55,569)
Payments of deferred loan costs	(9,657)	—	—	—	(9,657)
Intercompany loan proceeds	—	—	26,648	(26,648)	—
Intercompany loan payments	—	—	(7,869)	7,869	—
Intercompany distributions of capital	—	—	(1,982)	1,982	—
Intercompany capital contribution	—	—	483	(483)	—
Intercompany dividends	—	(40,732)	(11,010)	51,742	—
All other financing, net	250	—	(498)	—	(248)
Net cash flows (used) provided by financing activities	(175,756)	(31,724)	8,105	34,462	(164,913)
Effect of exchange rate changes on cash	—	—	2,941	—	2,941
Net change in cash and cash equivalents	(126,500)	—	6,564	—	(119,936)
Cash and cash equivalents at beginning of period	150,308	—	187,048	—	337,356
Cash and cash equivalents at end of period	$23,808	$—	$ 193,612	$—	$217,420

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	Nine Months Ended September 30, 2011				
	Parent (Issuer)	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Total
(Amounts in thousands)					
Net cash flows (used) provided by operating activities	$(18,148)	$37,570	$ (151,665)	$(17,842)	$(150,085)
Cash flows — Investing activities:					
Capital expenditures	—	(20,734)	(50,430)	—	(71,164)
Payments for acquisitions, net of cash acquired	—	(890)	—	—	(890)
Intercompany loan proceeds	—	36,912	—	(36,912)	—
Intercompany loan payments	—	(75,431)	—	75,431	—
Intercompany return of capital	—	18,971	—	(18,971)	—
Proceeds from disposition of assets		118	3,412	—	3,530
Net cash flows used by investing activities	—	(41,054)	(47,018)	19,548	(68,524)
Cash flows — Financing activities:					
Excess tax benefits from stock-based payment arrangements	—	3,499	1,702	—	5,201
Payments on long-term debt	(18,750)	—	—	—	(18,750)
Payments under other financing arrangements, net	—	(15)	(1,732)	—	(1,747)
Repurchases of common shares	(41,088)	—	—	—	(41,088)
Payments of dividends	(51,794)	—	—	—	(51,794)
Intercompany loan proceeds	—	—	75,431	(75,431)	—
Intercompany loan payments	—	—	(36,912)	36,912	—
Intercompany distributions of capital	—	—	(18,971)	18,971	—
Intercompany dividends	—	—	(17,842)	17,842	—
All other financing, net	310	—	(2,168)	—	(1,858)
Net cash flows (used) provided by financing activities	(111,322)	3,484	(492)	(1,706)	(110,036)
Effect of exchange rate changes on cash	—	—	(1,049)	—	(1,049)
Net change in cash and cash equivalents	(129,470)	—	(200,224)	—	(329,694)
Cash and cash equivalents at beginning of period	211,507	—	346,072	—	557,579
Cash and cash equivalents at end of period	$82,037	$—	$ 145,848	$—	$227,885

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7. Fair Value

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Where available, fair value is based on observable market prices or parameters or derived from such prices or parameters. Where observable prices or inputs are not available, valuation models may be applied. Assets and liabilities recorded at fair value in our condensed consolidated balance sheets are categorized by hierarchical levels based upon the level of judgment associated with the inputs used to measure their fair values. Recurring fair value measurements are limited to investments in derivative instruments and certain equity securities. The fair value measurements of our derivative instruments are determined using models that maximize the use of the observable market inputs including interest rate curves and both forward and spot prices for currencies, and are classified as Level II under the fair value hierarchy. The fair values of our derivatives are included in Note 4. The fair value measurements of our investments in equity securities are determined using quoted market prices and are classified as Level I. The fair values of our investments in equity securities, and changes thereto, are immaterial to our consolidated financial position and results of operations.

The fair value of our debt, excluding the Senior Notes, was estimated using interest rates on similar debt recently issued by companies with credit metrics similar to ours and is classified as Level II under the fair value hierarchy. The carrying value of our debt is included in Note 5 and, except for the Senior Notes, approximates fair value. The estimated fair value of our Senior Notes at September 30, 2012 was $507.8 million compared to the carrying value of $498.1 million. The estimated fair value of the Senior Notes is based on Level I quoted market rates. The carrying amounts of our other financial instruments (i.e., accounts receivable, net and accounts payable) approximated fair value at September 30, 2012 and December 31, 2011.

8. Inventories

Inventories, net consisted of the following:

(Amounts in thousands)	September 30, 2012	December 31, 2011
Raw materials	$361,151	$329,120
Work in process	872,156	793,053
Finished goods	313,212	279,267
Less: Progress billings	(312,985)	(320,934)
Less: Excess and obsolete reserve	(77,809)	(72,127)
Inventories, net	$1,155,725	$1,008,379

9. Equity Method Investments

As of September 30, 2012, we had investments in eight joint ventures (one located in each of Japan, Saudi Arabia, South Korea, and the United Arab Emirates and two located in each of China and India) that were accounted for using the equity method. Summarized below is the combined financial statement information of the joint ventures, based on the most recent financial information (unaudited) for those joint ventures:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Amounts in thousands)	2012	2011	2012	2011
Revenues	$72,690	$91,832	$223,598	$243,688
Gross profit	19,928	21,356	64,679	68,966
Income before provision for income taxes	12,747	14,772	45,180	47,607
Provision for income taxes	(3,539)	(4,189)	(13,345)	(14,237)
Net income	$9,208	$10,583	$31,835	$33,370

The $19.1 million and $20.0 million reduction in revenues for the three and nine months ended September 30, 2012 compared with the same periods in 2011 was primarily attributed to our Engineered Product Division ("EPD") joint venture in Japan and our Flow Control Division ("FCD") joint venture in India.

The provision for income taxes is based on the tax laws and rates in the countries in which our investees operate. The taxation regimes vary not only by their nominal rates, but also by the allowability of deductions, credits and other benefits. Our share of net income is reflected in our condensed consolidated statements of income.

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10. Earnings Per Share

The following is a reconciliation of net earnings of Flowserve Corporation and weighted average shares for calculating net earnings per common share. Earnings per weighted average common share outstanding was calculated as follows:

	Three Months Ended September 30,	
(Amounts in thousands, except per share data)	2012	2011
Net earnings of Flowserve Corporation	$106,296	$107,771
Dividends on restricted shares not expected to vest	4	4
Earnings attributable to common and participating shareholders	$106,300	$107,775
Weighted average shares:		
Common stock	50,706	55,381
Participating securities	264	262
Denominator for basic earnings per common share	50,970	55,643
Effect of potentially dilutive securities	315	518
Denominator for diluted earnings per common share	51,285	56,161
Earnings per common share:		
Basic	$2.09	$1.94
Diluted	2.07	1.92

	Nine Months Ended September 30,	
(Amounts in thousands, except per share data)	2012	2011
Net earnings of Flowserve Corporation	$306,737	$303,484
Dividends on restricted shares not expected to vest	11	11
Earnings attributable to common and participating shareholders	$306,748	$303,495
Weighted average shares:		
Common stock	52,883	55,407
Participating securities	262	275
Denominator for basic earnings per common share	53,145	55,682
Effect of potentially dilutive securities	382	565
Denominator for diluted earnings per common share	53,527	56,247
Earnings per common share:		
Basic	$5.77	$5.45
Diluted	5.73	5.40

Diluted earnings per share above is based upon the weighted average number of shares as determined for basic earnings per share plus shares potentially issuable in conjunction with stock options, restricted share units and performance share units.

For the three and nine months ended both September 30, 2012 and 2011, no options to purchase common stock were excluded from the computation of potentially dilutive securities.

11. Legal Matters and Contingencies

Asbestos-Related Claims

We are a defendant in a substantial number of lawsuits that seek to recover damages for personal injury allegedly caused by exposure to asbestos-containing products manufactured and/or distributed by our heritage companies in the past. While the overall number of asbestos-related claims has generally declined in recent years, there can be no assurance that this trend will continue, or that the average cost per claim will not further increase. Asbestos-containing materials incorporated into any such products were primarily encapsulated and used as internal components of process equipment, and we do not believe that any significant emission of asbestos fibers occurred during the use of this equipment.

Our practice is to vigorously contest and resolve these claims, and we have been successful in resolving a majority of claims with little or no payment. Historically, a high percentage of resolved claims have been covered by applicable insurance or

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indemnities from other companies, and we believe that a substantial majority of existing claims should continue to be covered by insurance or indemnities. Accordingly, we have recorded a liability for our estimate of the most likely settlement of asserted claims and a related receivable from insurers or other companies for our estimated recovery, to the extent we believe that the amounts of recovery are probable and not otherwise in dispute. While unfavorable rulings, judgments or settlement terms regarding these claims could have a material adverse impact on our business, financial condition, results of operations and cash flows, we currently believe the likelihood is remote. Additionally, we have claims pending against certain insurers that, if resolved more favorably than reflected in the recorded receivables, would result in discrete gains in the applicable quarter. We are currently unable to estimate the impact, if any, of unasserted asbestos-related claims, although future claims would also be subject to then existing indemnities and insurance coverage.

United Nations Oil-for-Food Program

In mid-2006, French authorities began an investigation of over 170 French companies, of which our French subsidiary was included, concerning suspected inappropriate activities conducted in connection with the United Nations Oil for Food Program. As anticipated and as previously disclosed, the French investigation of our French subsidiary was formally opened in the first quarter of 2010, and our French subsidiary has filed a formal response with the French court. In July 2012, the French court ruled against our procedural motions to challenge the constitutionality of the charges and quash the indictment, and the French Court ruling is currently proceeding through a formal review process. We currently do not expect to incur additional case resolution costs of a material amount in this matter; however, if the French authorities take enforcement action against our French subsidiary regarding its investigation, we may be subject to monetary and non-monetary penalties, which we currently do not believe will have a material adverse financial impact on our company.

In addition to the governmental investigation referenced above, on June 27, 2008, the Republic of Iraq filed a civil suit in federal court in New York against 93 participants in the United Nations Oil-for-Food Program, including us and our two foreign subsidiaries that participated in the program. There have been no material developments in this case since it was initially filed. We intend to vigorously contest the suit, and we believe that we have valid defenses to the claims asserted. While we cannot predict the outcome of the suit at the present time, we do not currently believe the resolution of this suit will have a material adverse financial impact on our company.

Other

We are currently involved as a potentially responsible party at seven former public waste disposal sites in various stages of evaluation or remediation. The projected cost of remediation at these sites, as well as our alleged "fair share" allocation, will remain uncertain until all studies have been completed and the parties have either negotiated an amicable resolution or the matter has been judicially resolved. At each site, there are many other parties who have similarly been identified. Many of the other parties identified are financially strong and solvent companies that appear able to pay their share of the remediation costs. Based on our information about the waste disposal practices at these sites and the environmental regulatory process in general, we believe that it is likely that ultimate remediation liability costs for each site will be apportioned among all liable parties, including site owners and waste transporters, according to the volumes and/or toxicity of the wastes shown to have been disposed of at the sites. We believe that our financial exposure for existing disposal sites will not be materially in excess of accrued reserves.

We are also a defendant in a number of other lawsuits, including product liability claims, that are insured, subject to the applicable deductibles, arising in the ordinary course of business, and we are also involved in other uninsured routine litigation incidental to our business. We currently believe none of such litigation, either individually or in the aggregate, is material to our business, operations or overall financial condition. However, litigation is inherently unpredictable, and resolutions or dispositions of claims or lawsuits by settlement or otherwise could have an adverse impact on our financial position, results of operations or cash flows for the reporting period in which any such resolution or disposition occurs.

Although none of the aforementioned potential liabilities can be quantified with absolute certainty except as otherwise indicated above, we have established reserves covering exposures relating to contingencies, to the extent believed to be reasonably estimable and probable based on past experience and available facts. While additional exposures beyond these reserves could exist, they currently cannot be estimated. We will continue to evaluate and update the reserves as necessary and appropriate.

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12. Retirement and Postretirement Benefits

Components of the net periodic cost for retirement and postretirement benefits for the three months ended September 30, 2012 and 2011 were as follows:

	U.S. Defined Benefit Plans		Non-U.S. Defined Benefit Plans		Postretirement Medical Benefits	
(Amounts in millions)	2012	2011	2012	2011	2012	2011
Service cost	$5.3	$4.9	$1.2	$1.3	$—	$—
Interest cost	4.1	4.3	3.4	3.3	0.4	0.5
Expected return on plan assets	(5.3)	(5.4)	(2.1)	(2.1)	—	—
Amortization of prior service benefit	(0.3)	(0.3)	—	—	—	(0.4)
Amortization of unrecognized net loss (gain)	3.1	2.7	0.9	0.5	(0.4)	(0.4)
Net periodic cost (benefit) recognized	$6.9	$6.2	$3.4			