

SMITH A O CORP  
Form 10-Q  
May 09, 2016  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**

**FORM 10-Q**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended March 31, 2016.**

**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)**

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

**(414)359-4000**

**(Registrant's telephone number, including area code)**

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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 May 3, 2016 13,115,988 shares

Common Stock Outstanding as of May 3, 2016 74,428,316 shares

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## A. O. SMITH CORPORATION

## CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(dollars in millions, except for per share data)

(unaudited)

	Three Months Ended March 31,	
	2016	2015
Net sales	\$ 636.9	\$ 618.5
Cost of products sold	374.2	389.3
Gross profit	262.7	229.2
Selling, general and administrative expenses	159.4	147.2
Interest expense	1.7	1.9
Other income	(2.0)	(2.7)
Earnings before provision for income taxes	103.6	82.8
Provision for income taxes	30.1	24.4
Net Earnings	\$ 73.5	\$ 58.4
Net Earnings Per Share of Common Stock	\$ 0.84	\$ 0.65
Diluted Net Earnings Per Share of Common Stock	\$ 0.83	\$ 0.65
Dividends Per Share of Common Stock	\$ 0.24	\$ 0.19

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE EARNINGS

(dollars in millions)

(unaudited)

	Three Months Ended March 31,	
	2016	2015
Net earnings	\$ 73.5	\$ 58.4
Other comprehensive earnings (loss)		
Foreign currency translation adjustments	8.6	(9.3)

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Unrealized net (loss) gain on cash flow derivative instruments, less related income tax benefit (provision) of \$1.2 in 2016 and \$(0.8) in 2015	(2.0)	1.2
Adjustment to pension liability, less related income tax provision of \$(1.5) in 2016 and \$(1.8) in 2015	2.5	2.5
Comprehensive Earnings	\$ 82.6	\$ 52.8

See accompanying notes to unaudited condensed consolidated financial statements.

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## A. O. SMITH CORPORATION

## CONDENSED CONSOLIDATED BALANCE SHEETS

(dollars in millions)

	(unaudited)	
	March 31, 2016	December 31, 2015
<b>Assets</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 305.5	\$ 323.6
Marketable securities	335.3	321.6
Receivables	506.9	501.4
Inventories	230.2	222.9
Other current assets	48.0	45.9
<b>Total Current Assets</b>	1,425.9	1,415.4
Property, plant and equipment	888.3	866.8
Less accumulated depreciation	(437.7)	(424.1)
Net property, plant and equipment	450.6	442.7
Goodwill	423.4	420.9
Other intangibles	288.5	291.0
Other assets	62.2	59.2
<b>Total Assets</b>	\$ 2,650.6	\$ 2,629.2
<b>Liabilities</b>		
<b>Current Liabilities</b>		
Trade payables	\$ 389.0	\$ 424.9
Accrued payroll and benefits	55.5	81.6
Accrued liabilities	99.1	90.1
Product warranties	45.2	43.7
Debt due within one year	13.2	12.9
<b>Total Current Liabilities</b>	602.0	653.2
Long-term debt	274.1	236.1
Pension liabilities	128.4	134.2
Other liabilities	167.6	163.4

<b>Total Liabilities</b>	1,172.1	1,186.9
<b>Stockholders Equity</b>		
Class A Common Stock, \$5 par value: authorized 14,000,000 shares; issued 13,185,178 and 13,186,698	65.9	65.9
Common Stock, \$1 par value: authorized 120,000,000 shares; issued 82,168,618 and 82,167,098	82.2	82.2
Capital in excess of par value	619.6	617.4
Retained earnings	1,403.0	1,350.7
Accumulated other comprehensive loss	(304.3)	(313.4)
Treasury stock at cost	(387.9)	(360.5)
<b>Total Stockholders Equity</b>	1,478.5	1,442.3
<b>Total Liabilities and Stockholders Equity</b>	\$ 2,650.6	\$ 2,629.2

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)

	Three Months Ended March 31,	
	2016	2015
<b>Operating Activities</b>		
Net earnings	\$ 73.5	\$ 58.4
Adjustments to reconcile net earnings to cash provided by (used in) operating activities:		
Depreciation and amortization	16.2	15.6
Pension income	(1.7)	
Stock based compensation expense	5.1	5.7
Loss on disposal of assets		0.1
Net changes in operating assets and liabilities:		
Current assets and liabilities	(69.7)	(68.0)
Noncurrent assets and liabilities	3.3	(12.0)
<b>Cash Provided by (Used in) Operating Activities - continuing operations</b>	<b>26.7</b>	<b>(0.2)</b>
<b>Cash Used in Operating Activities - discontinued operations</b>	<b>(0.2)</b>	<b>(0.2)</b>
<b>Cash Provided by (Used in) Operating Activities</b>	<b>26.5</b>	<b>(0.4)</b>
<b>Investing Activities</b>		
Capital expenditures	(19.4)	(14.9)
Investments in marketable securities	(143.5)	(121.9)
Net proceeds from sale of marketable securities	132.4	54.0
<b>Cash Used in Investing Activities</b>	<b>(30.5)</b>	<b>(82.8)</b>
<b>Financing Activities</b>		
Term debt incurred		75.0
Long-term debt incurred	37.4	6.9
Common stock repurchases	(30.5)	(20.7)
Net proceeds from stock option activity	0.2	3.8
Dividends paid	(21.2)	(17.1)
<b>Cash (Used In) Provided by Financing Activities</b>	<b>(14.1)</b>	<b>47.9</b>



Net decrease in cash and cash equivalents	(18.1)	(35.3)
Cash and cash equivalents - beginning of period	323.6	319.4
<b>Cash and Cash Equivalents - End of Period</b>	<b>\$ 305.5</b>	<b>\$ 284.1</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**

**March 31, 2016**

**(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 month period ended March 31, 2016 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 Annual Report on Form 10-K for the year ended December 31, 2015 filed with the SEC on February 17, 2016.

*Recent Accounting Pronouncements*

In March 2016, the Financial Accounting Standards Board (FASB) amended Accounting Standard Codification (ASC) 718, *Compensation - Stock Compensation* (issued under Accounting Standards Update (ASU) 2016-09). This amendment simplifies several aspects of the accounting for share-based payment transactions. The amendment is effective for periods beginning January 1, 2017 and permitted early adoption. The Company adopted this amendment effective for the three months ended March 31, 2016.

The amendment requires the benefits or deficiencies of tax deductions in excess of or less than the recognized compensation cost to be recorded as income tax benefit or expense in the income statement in the period in which they occur. The amendment also eliminates previous guidance that required unrecognized future excess income tax benefits to be used to repurchase shares in the calculation of diluted shares which resulted in lower diluted shares outstanding than the calculation under the adopted guidance. The Company elected to apply this guidance prospectively. As such, in the first quarter of 2016, the Company recognized \$2.5 million of discrete income tax benefits associated with excess tax benefits on settled stock based compensation awards and the Company's diluted shares outstanding for the three months ended March 31, 2016 increased compared to the way it was calculated under previous guidance.

The amendment also requires that cash paid by an employer to a taxing authority when shares are directly withheld for employee income tax withholding purposes be classified as financing activities in the statements of cash flows. As required, the Company applied this guidance retrospectively in the presentation of the consolidated statements of cash flows for the periods beginning January 1, 2015 and, as a result, reclassified \$3 million of cash paid from operating

activities to financing activities for the three months ended March 31, 2015.

In February 2016, the FASB amended ASC 842, *Leases* (issued under ASU 2016-02). This amendment requires the recognition of lease assets and lease liabilities on the balance sheet for most leasing arrangements currently classified as operating leases. This amendment is effective for periods beginning January 1, 2019 and early adoption is permitted. The Company is in the process of determining whether the adoption of ASU 2016-02 will have an impact on its consolidated balance sheets, statements of earnings or cash flows.

**Table of Contents****1. Basis of Presentation (continued)**

In November 2015, the FASB amended ASC 740, *Income Taxes* (issued under ASU 2015-17). This amendment required that deferred tax assets and liabilities be classified as noncurrent in the balance sheet. The amendment was effective for periods beginning January 1, 2016 and allowed for either prospective adoption or retrospective adoption. The Company adopted ASU 2015-17 retrospectively and, as a result, has classified all deferred tax assets and liabilities as non-current in the Company's consolidated balance sheets for all periods presented. Current deferred taxes of \$40.5 million as of December 31, 2015 were reclassified to non-current deferred taxes in the Company's consolidated balance sheet.

In May 2014, the FASB issued ASC 606-10, *Revenue from Contracts with Customers* (issued under ASU 2014-09). ASC 601-10 will replace all existing revenue recognition guidance when effective. In July 2015, the FASB approved a one year deferral of the effective date to periods beginning January 1, 2018, with early application permitted as of January 1, 2017. Either full retrospective adoption or modified retrospective adoption is allowed under ASC 606-10. The Company is in the process of determining whether the adoption of ASC 606-10 will have an impact on its consolidated balance sheets, statements of earnings or cash flows.

**2. Inventories**

(dollars in millions)		
	March 31, 2016	December 31, 2015
Finished products	\$ 92.7	\$ 85.7
Work in process	13.1	13.4
Raw materials	140.1	139.6
Inventories, at FIFO cost	245.9	238.7
LIFO reserve	(15.7)	(15.8)
Net inventory	\$ 230.2	\$ 222.9

**3. 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)		
	2016	2015
Balance at January 1	\$ 139.4	\$ 136.2
Expense	16.3	17.2
Claims settled	(15.1)	(16.2)

Balance at March 31	\$	140.6	\$	137.2
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#### **4. Long-Term Debt**

The Company has a \$400 million multi-currency revolving credit agreement with a group of 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 March 31, 2016.

**Table of Contents****4. Long-Term Debt (continued)**

On January 15, 2015, the Company issued \$75 million in term notes to an insurance company. Principal payments commence in 2020 and the notes mature in 2030. The notes have an interest rate of 3.52 percent. The proceeds of the notes were used to pay down borrowings under the Company's revolving credit facility.

**5. 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 March 31,	
	2016	2015
Denominator for basic earnings per share - weighted average shares	87,847,003	89,436,496
Effect of dilutive stock options, restricted stock and share units	1,058,358	730,429
Denominator for diluted earnings per share	88,905,361	90,166,925

**6. Stock Based Compensation**

The Company adopted the A. O. Smith Combined Incentive Compensation Plan (the "Plan") effective January 1, 2007. The Plan was reapproved by stockholders 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 or share units at March 31, 2016 was 1,659,216. Upon stock option exercise or share unit vesting, shares are issued from treasury stock.

Total stock based compensation expense recognized in the three months ended March 31, 2016 and 2015 was \$5.1 million and \$5.7 million, respectively.

*Stock Options*

The stock options granted in the three months ended March 31, 2016 and 2015 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 2016 and 2015 expire ten years after date of grant. The Company's stock options are expensed ratably over the three year vesting period; however, included in stock option expense for the three months ended March 31, 2016 and 2015 was 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 expense attributable to stock options in the three months ended March 31, 2016 and 2015 was \$2.5 million and \$2.6 million, respectively.



**Table of Contents****6. Stock Based Compensation (continued)**

Changes in option awards, all of which relate to Common Stock, were as follows for the three months ended March 31, 2016:

	Weighted-Avg. Per Share Exercise Price	Number of Contractual Options	Average Remaining Aggregate Intrinsic Value Life (dollars in millions)
Outstanding at January 1, 2016	\$ 36.05	1,326,779	
Granted	63.03	266,330	
Exercised	22.64	(73,815)	