Xylem Inc.
Form 10-K
February 26, 2016

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

FORM 10-K

(Mark One)

þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2015
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: 1-35229

Xylem Inc.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Indiana | 45-2080495 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

1 International Drive, Rye Brook, NY 10573
(address of principal executive offices and zip code)
(914) 323-5700
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|---|---|
| Common Stock, par value $0.01 per share | New York Stock Exchange |

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes þ No ¨

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No þ

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 þ No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, 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 þ No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant’s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

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 “large accelerated filer,” “accelerated filer,” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer þ Accelerated Filer ¨ Non-Accelerated Filer ¨ Smaller reporting company ¨
(Do not check if a 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 þ

The aggregate market value of the common stock of the registrant held by non-affiliates of the registrant as of June 30, 2015 was approximately $6.7 billion. As of January 29, 2016, there were 178,485,808 outstanding shares of the registrant's common stock, par value $0.01 per share.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement for its 2016 Annual Meeting of Shareowners, to be held in May 2016, are incorporated by reference into Part II and Part III of this Report.

Xylem Inc.
ANNUAL REPORT ON FORM 10-K
For the fiscal year ended December 31, 2015
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* Included pursuant to Instruction 3 of Item 401(b) of Regulation S-K.

PART I

The following discussion should be read in conjunction with the consolidated financial statements, including the notes thereto, included in this Annual Report on Form 10-K (this "Report"). Xylem Inc. was incorporated in Indiana on May 4, 2011. Except as otherwise indicated or unless the context otherwise requires, “Xylem,” “we,” “us,” “our” and “the Company” refer to Xylem Inc. and its subsidiaries. References in the consolidated financial statements to "ITT" or the "former parent" refer to ITT Corporation and its consolidated subsidiaries (other than Xylem Inc.).

Forward-Looking Statements

This Report contains information that may constitute “forward-looking statements" within the meaning of the Private Securities Litigation Act of 1995. Forward-looking statements by their nature address matters that are, to different degrees, uncertain. Generally, the words “anticipate,” “estimate,” “expect,” “project,” “intend,” “plan,” “forecast,” “believe,” “will,” “could,” “would,” “should” and similar expressions identify forward-looking statements. However, the absence of these words or similar expressions does not mean that a statement is not forward-looking. These forward-looking statements include any statements that are not historical in nature, including any such statements about the capitalization of the Company, the Company’s restructuring and realignment, future strategic plans and other statements that describe the Company’s business strategy, outlook, objectives, plans, intentions or goals. All statements that address operating or financial performance, events or developments that we expect or anticipate will occur in the future including statements relating to orders, revenue, operating margins and earnings per share growth, and statements expressing general views about future operating results are forward-looking statements. Forward-looking statements involve known and unknown risks, uncertainties and other important factors that could cause actual results to differ materially from those expressed or implied in, or reasonably inferred from, such forward-looking statements.

Factors that could cause results to differ materially from those anticipated include: overall economic and business conditions, political and other risks associated with our international operations, including military actions, economic sanctions or trade embargoes that could affect customer markets, and non-compliance with laws, including foreign corrupt practice laws, export and import laws and competition laws; potential for unexpected cancellations or delays of customer orders in our reported backlog; our exposure to fluctuations in foreign currency exchange rates; competition and pricing pressures in the markets we serve; the strength of housing and related markets; weather conditions; ability to retain and attract key members of management; our relationship with and the performance of our channel partners; our ability to successfully identify, complete and integrate acquisitions; our ability to borrow or to refinance our existing indebtedness and availability of liquidity sufficient to meet our needs; changes in the value of goodwill or intangible assets; risks relating to product defects, product liability and recalls; governmental investigations; security breaches or other disruptions of our information technology systems; litigation and contingent liabilities; and other factors set forth below under “Item 1A. Risk Factors” and those described from time to time in subsequent reports filed with the Securities and Exchange Commission (“SEC”).

All forward-looking statements made herein are based on information available to the Company as of the date of this Report. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law.

ITEM 1. BUSINESS

Business Overview

Xylem, with 2015 revenue of $3.7 billion and approximately 12,700 employees, is a world leader in the design, manufacturing, and application of highly engineered technologies for the water industry. We are a leading equipment and service provider for water and wastewater applications with a broad portfolio of products and services addressing the full cycle of water, from collection, distribution and use to the return of water to the environment. We have leading market positions among equipment and service providers in the core application areas of the water equipment industry: transport, treatment, test, building services, industrial processing and irrigation. Our Company’s brands, such as Bell & Gossett and Flygt, are well known throughout the industry and have served the water market for many years.

We serve a global customer base across diverse end markets while offering localized expertise. We sell our products in approximately 150 countries through a balanced distribution network consisting of our direct sales force and independent channel partners. In 2015, 59% of our revenue was generated outside the United States, with 21% of revenue generated in emerging markets.

Our Industry

Our planet faces a serious water challenge. Less than 1% of the total water available on earth is fresh water, and this percentage is declining due to factors such as the draining of aquifers, increased pollution and climate change. In addition, demand for fresh water is rising rapidly due to population growth, industrial expansion, and increased agricultural development, with consumption estimated to double every 20 years. By 2025, more than 30% of the world's population is expected to live in areas without adequate water supply. Even in developed countries with sufficient clean water supply, existing infrastructure for water supply is aging and inadequately funded. In the United States, degrading pipe systems leak one out of every six gallons of water, on average, on its way from a treatment plant to the customer. These challenges are driving opportunities for growth in the global water industry, which we estimate to have a total market size of approximately $550 billion. We estimate our total served market size to be approximately $37 billion.

We view these challenges through the lens of water productivity, water quality and resilience. Water productivity refers to the more efficient delivery and use of clean water. Water quality refers to the efficient and effective management of wastewater. Resilience refers to the management of water-related risks and the resilience of water infrastructure. The Company's customers often face all three of these challenges, ranging from inefficient aging water distribution networks (which require increases in "water productivity"); energy-intensive or unreliable wastewater management systems (which require increases in "water quality"); or exposure to natural disasters such as floods or droughts (which require increases in "resilience"). Delivering value in these areas creates significant opportunity for the Company.

The water industry supply chain is comprised of Equipment and Services companies, Design and Build service providers, and Utilities. Equipment and Service providers serve distinct customer types. The Utilities supply water through an infrastructure network. Supply chain companies provide single, or sometimes combined, functions from equipment manufacturing and services to facility design (engineering, procurement and construction, or "EPC" firms) to plant operations (Utilities), as depicted below in Figure 1. The Utilities and EPC customers are looking for technology and application expertise from their Equipment and Services providers to address trends such as rising pollution, stricter regulations, and the increased outsourcing of process knowledge. The end users of water consist of a wide array of entities, including farms, mines, power plants, industrial facilities and residential homes. These customers are predominately served through specialized distributors and original equipment manufacturers ("OEMs").

Figure 1: Water Industry Supply Chain

Our business focuses on the beginning of the supply chain by providing technology-intensive equipment and services. We sell our equipment and services via direct and indirect channels that serve the needs of each customer type. On the utility side, we provide the majority of our sales direct to customers with strong application expertise, with the remaining amount going through distribution partners. To end users of water, we provide the majority of our sales through long-standing relationships with the world's leading distributors, with the remainder going direct to customers.

The Equipment and Services market addresses the key processes of the water industry, which are best illustrated through the cycle of water, as depicted in Figure 2, below. We believe this industry has two distinct sectors within the cycle of water: Water Infrastructure and Usage Applications. The key processes of this cycle begin when raw water is extracted by pumps, which provide the necessary pressure and flow, to move or transport, this water from natural sources, such as oceans, groundwater, lakes and rivers, through pipes to treatment facilities. Treatment facilities can provide many forms of treatment, such as filtration, disinfection and desalination, to remove solids, bacteria, and salt, respectively. Throughout each of these stages, analytical instruments test the water to ensure regulatory requirements are met so that it can be utilized by end-use customers. A network of pipes and pumps again transports this clean water to where it is needed, such as to crops for irrigation, to power plants to provide cooling in industrial water, or to an apartment building as drinking water in residential and commercial buildings. After usage, the wastewater is collected by a separate network of pipes and pumps and transported to a wastewater treatment facility, where processes such as digestion deactivate and reduce the volume of solids, and disinfection purifies effluent water. Once treated, analytical instruments test the water to ensure regulatory requirements are met so that it can be discharged back to the environment, thereby completing the cycle.

Figure 2: Cycle of Water

In the Water Infrastructure sector, two primary end markets exist: public utility and industrial. The public utility market comprises public, private and public-private institutions that handle water and wastewater for mostly residential and commercial purposes. The industrial market involves the supply of water and removal of wastewater for industrial facilities. We view the main macro drivers of this sector to be water quality, the desire for energy-efficient products, water scarcity, regulatory requirements and infrastructure needs, for both the repair of aging systems in developed countries as well as new installations in emerging markets.

In the Usage Applications sector, end-use customers fall into four main markets: residential, commercial, industrial and agricultural. Homeowners represent the end users in the residential market. Owners and managers of properties such as apartment buildings, retail stores, institutional buildings, restaurants, schools, hospitals and hotels are examples of end users in the commercial market. The industrial market is wide ranging, involving OEMs, exploration and production firms, and developers and managers of facilities operated by electrical power generators, chemical manufacturers, machine shops, clothing manufacturers, beverage dispensing and food processing firms, and car washes. The agricultural market end users are owners and operators of businesses such as crop and livestock farms, aquaculture, golf courses, and other turf applications. We believe population growth, urbanization and regulatory requirements are the primary macro drivers of these markets, as these trends drive the need for housing, food, community services and retail goods within growing city centers. Water reuse and conservation are driving the need for new technologies.

Business Strategy

Our strategy is to enhance shareholder value by providing distinctive solutions for our customers' most important water productivity, quality and resilience challenges, enabling us to grow revenue, organically and through strategic acquisitions, as we streamline our cost structure. Key elements of our strategy are summarized below:

- Accelerate Profitable Growth. To achieve our goal of accelerating growth, we have identified the following five priorities:
  - Emerging Markets - We seek to accelerate our growth in priority emerging markets through increased focus on product localization and channel development.
  - Innovation & Technology - We seek to enhance the Company’s innovation efforts with increased focus on technologies and innovation that can significantly improve customers’ water productivity, quality and resilience.
  - Commercial Leadership - We are strengthening our capabilities by focusing on simplifying our commercial processes along with the supporting backend information technology systems.
  - Mergers and acquisitions - We continue to evaluate and, where appropriate, will act upon attractive acquisition candidates to accelerate our growth, including into new markets.
- Drive Continuous Improvement. We seek to embed continuous improvement into our culture and simplify our organizational structure to make the Company more agile, more profitable, and create room to re-invest in growth. To accomplish this, we will continue to strengthen our lean six sigma and global procurement capabilities, and continue to optimize our cost structure through business simplification by eliminating structural, process and product complexity.
- Leadership and Talent Development. We seek to continue to invest in attracting, developing and retaining world-class talent with an increased focus on leadership and talent development programs. We will continue to align individual performance to the objectives of the Company and its shareholders.
- Focus on Execution and Accountability. We seek to ensure the impact of these strategic focus areas by holding our people accountable and streamlining our performance management and goal deployment systems.

Business Segments

We have two reportable business segments that are aligned with the cycle of water and the key strategic market applications they provide: Water Infrastructure (collection, distribution, return) and Applied Water (usage). See Note 20, “Segment and Geographic Data,” in our consolidated financial statements for financial information about segments and geographic areas.

The table and descriptions below provide an overview of our business segments.

| | Market Applications | 2015 Revenue (in millions) | % Revenue | Major Products | Primary Brands |
|---|---|---|---|---|---|
| Water Infrastructure | Transport | $1,624 | 73 % | • Water and wastewater pumps<br>• Filtration, disinfection and biological treatment equipment<br>• Test equipment<br>• Controls | • Flygt<br>• Wedeco<br>• Godwin<br>• WTW<br>• Sanitaire<br>• YSI<br>• Leopold |
| | Treatment | 316 | 14 % | | |
| | Test | 291 | 13 % | | |
| | | $2,231 | 100 % | | |
| Applied Water | Building Services | $774 | 54 % | • Pumps<br>• Valves<br>• Heat exchangers<br>• Controls<br>• Dispensing equipment systems | • Goulds Water Technology<br>• Bell & Gossett<br>• A-C Fire Pump<br>• Standard Xchange<br>• Lowara<br>• Jabsco<br>• Flojet<br>• Flowtronex |
| | Industrial Water | 562 | 40 % | | |
| | Irrigation | 86 | 6 % | | |
| | | $1,422 | 100 % | | |

Water Infrastructure

Water Infrastructure involves the process that collects water from a source and distributes it to users, and then returns the wastewater responsibly to the environment. Within the Water Infrastructure segment, our pump systems transport water from oceans, groundwater, aquifers, lakes, rivers and seas. From there, our filtration, ultraviolet ("UV") and ozone systems provide treatment, making the water fit for use. After consumption, our pump lift stations move the wastewater to treatment facilities where our mixers, biological treatment, monitoring, and control systems provide the primary functions in the treatment process. Throughout each of these stages, our analytical systems test the quality of water for consumption as well as for its return to nature. Water Infrastructure serves its customers, public utilities and industrial applications, through three closely linked applications: Transport, Treatment and Test of water and wastewater. We estimate our served market size in this sector to be approximately $21 billion.

Transport

The Transport application includes all of the equipment and services involved in the safe and efficient movement of water from sources such as oceans, groundwater, aquifers, lakes, rivers and seas to treatment facilities, and then to users. It also includes the movement of wastewater from the point of use to a treatment facility and then back into the environment. Finally, the Transport application also includes dewatering pumps, equipment and services which provide the safe removal or draining of groundwater and surface water from a riverbed, construction site or mine shaft and bypass pumping for the repair of aging public utility infrastructure, as well as emergency water removal during severe weather events. We offer a wide range of highly engineered products such as water and wastewater submersible pumps, monitoring controls, and application solutions; we do not serve the market for lower-value equipment such as pipes and fittings. We primarily employ configure-to-order capabilities to maximize manufacturing

and logistics efficiencies by producing high volumes of basic product configurations. When we provide a configure-to-order solution, we configure a standard product to our customers' specifications. To a lesser extent, we provide engineer-to-order products to meet the customization requirements of our customers. This process requires that we apply our technical expertise and production capabilities to provide a non-standard solution to the customer. We believe our business is one of the largest players in this served market based on management estimates. With operations on six continents, we also have one of the world's largest dewatering rental fleets. Our key brands for this application are Flygt and Godwin. Transport accounted for approximately 73% of our Water Infrastructure segment revenue in both 2015 and 2014, and 74% in 2013.

Treatment

The Treatment application includes equipment and services that treat both water for consumption and wastewater to be returned responsibly to the environment or reused. Primary served markets include public utilities and industrial operations. While there are several treatment solutions in the market today, we focus on three basic treatment types: (i) filtration systems, (ii) disinfection systems, (iii) biological treatment systems, including mixers. Our key brands for this application are Leopold, Wedeco, Sanitaire and Flygt. Filtration uses gravity-based media filters and clarifiers to clean both water and wastewater. Leopold, has been a worldwide leader in filtration for over 90 years. Wedeco offers chemical-free and environmentally friendly disinfection systems, both UV and ozone oxidation, to treat public utility drinking water, wastewater and industrial process water. Biological treatment systems are key to the treatment and mixing of solids in wastewater plants, which are provided through our Sanitaire and Flygt brands. We believe our business is one of the largest players in this served market based on management estimates. Treatment accounted for approximately 14% of our Water Infrastructure segment revenue in 2015, 2014 and 2013.

Test

Analytical instrumentation is used across most industries to ensure regulatory requirements are met. Growth in this market is primarily driven by increasing regulation of water and wastewater in North America, Europe and Asia. Our served market is predominately focused on water and the environment for quality levels throughout the water infrastructure loop. Analytical systems are applied in three primary ways: in the field, in a facility laboratory, or real time, online monitoring in a treatment facility process. We believe we have a leading position in this served market based on management estimates. Our key brands for this application are WTW and YSI. Test accounted for approximately 13% of our Water Infrastructure segment revenue in both 2015 and 2014, and 12% in 2013.

Applied Water

Applied Water encompasses the uses of water. Since water is used to some degree in almost every aspect of human, economic and environmental activity, this segment has a significant number of applications and we participate in all major areas of water demand. Residential and Commercial Building Services account for human and building consumption, where we deliver water boosting systems for drinking, heating, ventilation and air conditioning ("HVAC") and fire protection systems. Industrial Water applications account for water consumption activities that use pumps, heat exchangers, valves and controls to provide cooling to power plants and manufacturing facilities, as well as circulation for food and beverage processing. The remaining portion of global water use resides in irrigation applications. Examples of what we provide include: boosting systems for farming irrigation, pumps for dairy operations, and rainwater reuse systems for small scale crop and turf irrigation.We estimate our served market size in this sector to be approximately $16 billion.

Residential & Commercial Building Services

This business is defined by four primary uses of water in building services applications, such as in residential homes and commercial buildings, including offices, hotels, hospitals, schools, restaurants and malls. The first application is in HVAC, where Bell & Gossett and Lowara specialize in pumps and valves that are used in water-driven heating and cooling systems, along with heat exchangers, valves, and monitoring and control products that augment the system. The second is the supply of potable water for consumption, including drinking water and for hygienic purposes . The Goulds Water Technology, Lowara and Bell & Gossett brands provide pumps and boosting systems utilized within buildings, sourcing water from distribution networks or from wells. The third application is wastewater removal with sump and sewage pumps, provided by Bell & Gossett, Goulds Water Technology and Lowara. The fourth water-related building service area is fire protection, where our A-C Fire Pump brand supplies full pump systems for emergency fire suppression. Bell & Gossett, Goulds Water Technology and Lowara have continued to innovate, focusing on providing industry-leading energy-efficient and intelligent pumps for the building services market; many of these products are more efficient than competitive devices. We believe our business is one of the largest players in this served market based on management estimates. Building Services accounted for approximately 54% of our Applied Water segment revenue in 2015, 53% in 2014 and 50% in 2013.

Industrial Water

Water is used in most industrial facilities to provide processing steps such as cooling, heating, cleaning and mixing. Our Goulds Water Technology and Lowara brands supply vertical multistage pumps to bring in source water or to boost pressure for purposes, including water circulation through a manufacturing facility to cool machine tools. Our

Standard Xchange brand delivers heat exchangers for combined heat and power applications within power generation plants. We also service niche applications such as wine processing with Jabsco brand flexible impeller pumps, and water-based detergent dispensing and water circulation for car washes served by Flojet air-operated

diaphragm and Goulds Water Technology end suction pumps. Our boosting pumps are also increasingly being used in hydraulic fracturing applications. We can support mines throughout exploration, development and operation. Our wide range of durable pumps ensures reliability that minimizes risks, maximizes uptime and delivers superior total cost of ownership. Across all these various end applications, we believe our business is the second largest player in this served market based on management estimates. Industrial Water accounted for approximately 40% of our Applied Water segment revenue in 2015 and 2014, and 43% in 2013.

Irrigation

The irrigation business consists of irrigation-related equipment and services associated with bringing water from a source to a production plant or livestock facility, including hoses, sprinklers, center pivot and drip irrigation systems. We focus on the pumps and boosting systems that supply this ancillary equipment with water. Our Goulds Water Technology brand brings mixed flow pumps, and our Flowtronex group specializes in equipment "packaged solutions" incorporating monitoring and controls to optimize energy efficiency in irrigation delivery. Our Lowara brand also produces pumps for agricultural applications and irrigation for gardens and parks. We believe we have a leading position in this served market based on management estimates. Irrigation accounted for approximately 6% of our Applied Water segment revenue in 2015, and 7% in 2014 and 2013.

Geographic Profile

The table below illustrates the annual revenue and percentage of revenue by geographic area for each of the three years ended December 31.

| | Revenue | | | | | |
|---|---|---|---|---|---|---|
| (in millions) | 2015 | | 2014 | | 2013 | |
| | $ Amount | % of Total | $ Amount | % of Total | $ Amount | % of Total |
| United States | $1,490 | 41 % | $1,477 | 38 % | $1,434 | 38 % |
| Europe | 1,179 | 32 % | 1,379 | 35 % | 1,387 | 36 % |
| Asia Pacific | 482 | 13 % | 478 | 12 % | 467 | 12 % |
| Other | 502 | 14 % | 582 | 15 % | 549 | 14 % |
| Total | $3,653 | | $3,916 | | $3,837 | |

In addition to the traditional markets of the United States and Europe, opportunities in emerging markets within Asia Pacific, Eastern Europe, Latin America and other countries are growing. Revenue derived from emerging markets comprised 21%, 21% and 19% of our revenue in 2015, 2014 and 2013, respectively.

The table below illustrates the property, plant & equipment and percentage of property, plant & equipment by geographic area for each of the three years ended December 31.

| | Property, Plant & Equipment | | | | | |
|---|---|---|---|---|---|---|
| (in millions) | 2015 | | 2014 | | 2013 | |
| | $ Amount | % of Total | $ Amount | % of Total | $ Amount | % of Total |
| United States | $168 | 38 % | $180 | 39 % | $186 | 38 % |
| Europe | 189 | 43 % | 206 | 45 % | 225 | 46 % |
| Asia Pacific | 56 | 13 % | 53 | 11 % | 45 | 9 % |
| Other | 26 | 6 % | 22 | 5 % | 32 | 7 % |
| Total | $439 | | $461 | | $488 | |

Distribution, Training and End Use

Water Infrastructure provides the majority of its sales through direct channels with remaining sales through indirect channels and service capabilities. Both public utility and industrial facility customers increasingly require our teams' global but locally proficient expertise to use our equipment in their specific applications. Several trends are increasing the need for this application expertise: (i) the increase in type and amount of contaminants in water supply, (ii) increasing environmental regulations, (iii) the need to increase system efficiencies to optimize energy costs, (iv) the retirement of a largely aging water industry workforce not systematically replaced at utilities and other end user customers, and (v) the build-out of water infrastructure in the emerging markets.

In the Applied Water segment, many end-use areas are widely different, so specialized distribution partners are often preferred. Our commercial teams have built long-standing relationships around our brands in many of these industries through which we can continue to leverage new product and service applications. Revenue opportunities are balanced

between OEMs and after-market customers. Our products in the Applied Water segment are sold

through our global direct sales and strong indirect channels with the majority of revenue going through indirect channels. We have long-standing relationships with many of the leading independent distributors in the markets we serve, and we provide incentives to distributors, such as specialized loyalty and training programs.

Aftermarket Parts and Service

During their lifecycle, installed products require maintenance, repair services and parts due to the harsh environments in which they operate. We have many service centers around the world, which employ service employees to provide aftermarket parts and services to our large installed base of customers. Service centers offer an array of integrated service solutions for the industry including: preventive monitoring, contract maintenance, emergency field service, engineered upgrades, inventory management, and overhauls for pumps and other rotating equipment.

Depending on the type of product, median lifecycles range from five years to over 50 years, at which time they must be replaced. Many of our products are precisely selected and applied within a larger network of equipment driving a strong preference by customers and installers to replace them with the same exact brand and model when they reach the end of their lifecycle. This dynamic establishes a large recurring revenue stream for our business.

Supply and Seasonality

We have a global manufacturing footprint, with production facilities in Europe, North America, Latin America, and Asia. Our inventory management and distribution practices seek to minimize inventory holding periods by striving to take delivery of the inventory and manufacturing as close as possible to the sale or distribution of products to our customers. All of our businesses require various parts and raw materials, of which the availability and prices may fluctuate. Parts and raw materials commonly used in our products include motors, fabricated parts, castings, bearings, seals, nickel, copper, aluminum, and plastics. While we may recover some cost increases through operational improvements, we are still exposed to some pricing risk. We attempt to control costs through fixed-priced contracts with suppliers and various other programs, such as our global procurement initiative.

Our business relies on third-party suppliers, contract manufacturing and commodity markets to secure raw materials, parts and components used in our products. We typically acquire materials and components through a combination of blanket and scheduled purchase orders to support our materials requirements. For most of our products, we have existing alternate sources of supply, or such sources are readily available.

We may experience price volatility or supply constraints for materials that are not available from multiple sources. From time to time, we acquire certain inventory in anticipation of supply constraints or enter into longer-term pricing commitments with vendors to improve the priority, price and availability of supply. There have been no raw material shortages that have had a significant adverse impact on our business as a whole.

Our Water Infrastructure and Applied Water segments experience some modest level of seasonality in its business. This seasonality is dependent on factors such as capital spending of customers as well as weather conditions, including heavy flooding, droughts, and fluctuations in temperatures, which can positively or negatively impact portions of our business.

Customers

Our business is not dependent on any single customer or a few customers, the loss of which would have a material adverse effect on our Water Infrastructure or Applied Water segments or on the Company as a whole. No individual customer accounted for more than 10% of our consolidated 2015, 2014 or 2013 revenue.

Backlog

Delivery schedules vary from customer to customer based upon their requirements. Typically, large projects require longer lead production cycles and delays can occur from time to time. Total backlog was $716 million at December 31, 2015 and $740 million at December 31, 2014. We anticipate that more than 81% of the backlog at December 31, 2015 will be recognized as revenue during 2016.

Competition

Given the highly fragmented nature of the water industry, the Water Infrastructure segment competes with a large number of businesses. Competition in the water transport and treatment technologies markets focuses on product performance, reliability and innovation, application expertise, brand reputation, energy efficiency, product life cycle cost, timeliness of delivery, proximity of service centers, effectiveness of our distribution channels and price. In the sale of products and services, we benefit from our large installed base of pumps and complementary products, which require maintenance, repair and replacement parts due to the nature of the products and the conditions under which

they operate. Timeliness of delivery, quality and the proximity of service centers are important

customer considerations when selecting a provider for after-market products and services as well as equipment rentals. In geographic regions where we are locally positioned to provide a quick response, customers have historically relied on us, rather than our competitors, for after-market products relating to our highly engineered and customized solutions. Our key competitors within the Water Infrastructure segment include KSB Inc., Sulzer Ltd., Evoqua Water Technologies and Danaher Corporation.

Competition in the Applied Water segment focuses on brand equity, application expertise, product delivery and performance, quality, and price. We compete by offering a wide variety of innovative and high-quality products, coupled with world-class application expertise. We believe our distribution through well-established channels and our reputation for quality significantly enhance our market position. Our ability to deliver innovative product offerings has allowed us to compete effectively, to cultivate and maintain customer relationships and to serve and expand into many niche and new markets. Our key competitors within the Applied Water segment include Grundfos, Wilo SE, Pentair Ltd. and Franklin Electric Co., Inc.

Research and Development

Research and development ("R&D") is a key foundation of our growth strategy and we focus on the design and development of products and application know-how that anticipate customer needs and emerging trends. Our engineers are involved in new product development as well as improvement of existing products to increase customer value. Our businesses invest substantial resources for R&D. We anticipate we will continue to develop and invest in our R&D capabilities to promote a steady flow of innovative, high-quality and reliable products and applications to further strengthen our position in the markets we serve. We invested $95 million, $104 million, and $104 million in R&D in 2015, 2014 and 2013, respectively.

We have R&D and product development capabilities around the world. R&D activities are initially conducted in our technology centers, located in conjunction with some of our major manufacturing facilities to ensure an efficient and robust development process. We have several global technical centers and local development teams around the world where we are supporting global needs and accelerating the customization of our application expertise to local needs. In some cases, our R&D activities are conducted at our piloting and testing facilities and at strategic customer sites. These piloting and testing facilities enable us to serve our strategic markets in each region of the world.

Intellectual Property

We generally seek patent protection for those inventions and improvements that we believe will improve our competitive position. We believe that our patents and applications are important for maintaining the competitive differentiation of our products and improving our return on research and development investments. While we own, control or license a significant number of patents, trade secrets, proprietary information, trademarks, trade names, copyrights, and other intellectual property rights which, in the aggregate, are of material importance to our business, management believes that our business, as a whole, as well as each of our core business segments, is not materially dependent on any one intellectual property right or related group of such rights.

Patents, patent applications, and license agreements expire or terminate over time by operation of law, in accordance with their terms or otherwise. As the portfolio of our patents, patent applications, and license agreements has evolved over time, we do not expect the expiration of any specific patent to have a material adverse effect on our financial position or results of operations.

Environmental Matters and Regulation

Our manufacturing operations worldwide are subject to many requirements under environmental laws. In the United States, the Environmental Protection Agency and similar state agencies administer laws and regulations concerning air emissions, water discharges, waste disposal, environmental remediation, and other aspects of environmental protection. Such environmental laws and regulations in the United States include, for example, the Federal Clean Air Act, the Clean Water Act, the Resource, Conservation and Recovery Act, and the Comprehensive Environmental Response, Compensation and Liability Act. Environmental requirements significantly affect our operations. We have established an internal program to address compliance with applicable environmental requirements and, as a result, management believes that we are in substantial compliance with current environmental regulations.

While environmental laws and regulations are subject to change, such changes can be difficult to predict reliably and the timing of potential changes is uncertain. Management does not believe, based on current circumstances, that compliance costs pursuant to such regulations will have a material adverse effect on our financial position or results of

operations. However, the effect of future legislative or regulatory changes could be material to our financial condition or results of operations.

Accruals for environmental matters are recorded on a site-by-site basis when it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated, based on current law and existing technologies. It can be difficult to estimate reliably the final costs of investigation and remediation due to various factors. Our accrued liabilities for these environmental matters represent the best estimates related to the investigation and remediation of environmental media such as water, soil, soil vapor, air and structures, as well as related legal fees based upon the facts and circumstances as currently known to us. These estimates, and related accruals, are reviewed quarterly and updated for progress of investigation and remediation efforts and changes in facts and legal circumstances. Liabilities for these environmental expenditures are recorded on an undiscounted basis. We do not anticipate these liabilities will have a material adverse effect on our consolidated financial position or results of operations. We cannot make assurances that other sites, or new details about sites known to us, that could give rise to environmental liabilities with such material adverse effects on us will not be identified in the future. At December 31, 2015, we had estimated and accrued $4 million related to environmental matters.

Employees

As of December 31, 2015, Xylem had approximately 12,700 employees worldwide. We have more than 3,700 employees in the United States, of whom approximately 17% are represented by labor unions, and in certain foreign countries, some of our employees are represented by work councils. We believe that our facilities are in favorable labor markets with ready access to adequate numbers of workers and believe our relations with our employees are good.

Company History and Certain Relationships

On October 31, 2011 (the "Distribution Date"), ITT completed the Spin-off (the “Spin-off”) of Xylem, formerly ITT’s water equipment and services businesses ("WaterCo"). The Spin-off was completed pursuant to the Distribution Agreement, dated as of October 25, 2011 (the “Distribution Agreement”), among ITT, Exelis Inc., acquired by Harris Inc. on May 29, 2015, (“Exelis”) and Xylem.

Available Information

We are required to file annual, quarterly and current reports, proxy statements and other information with the SEC. Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements and amendments to those reports are available free of charge on our website www.xyleminc.com as soon as reasonably practicable after such reports are electronically filed with or furnished to the SEC. The information on our website is not, and shall not be deemed to be, a part hereof or incorporated into this or any of our other filings with the SEC.

In addition, the public may read or copy any materials filed with the SEC at the SEC’s Public Reference Room located at 100 F Street NE, Washington, D.C. 20549. The public may also obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. These reports and other information are also available, free of charge, at www.sec.gov.

ITEM 1A. RISK FACTORS

In evaluating our business, each of the following risks should be carefully considered, along with all of the other information in this Report and in our other filings with the SEC. Should any of these risks and uncertainties develop into actual events, our business, financial condition or results of operations could be materially and adversely affected.

Risks Related to Operational and External Factors

Failure to compete successfully in our markets could adversely affect our business.

We offer our products and services in competitive markets. We believe the principal points of competition in our markets are product performance, reliability and innovation, application expertise, brand reputation, energy efficiency, product life cycle cost, timeliness of delivery, proximity of service centers, effectiveness of our distribution channels and price. Maintaining and improving our competitive position will require successful management of these factors, including continued investment by us in manufacturing, research and development, engineering, marketing, customer service and support, and our distribution networks. We may not be successful in maintaining our competitive position. Our competitors may develop products that are superior to our products, or may develop more efficient or effective methods of providing products and services or may adapt more quickly than we do to new technologies or evolving customer requirements. Pricing pressures also could cause us to adjust the prices of certain products to stay competitive, which could adversely affect our financial performance. Failure to continue competing successfully or to win large contracts could adversely affect our business, financial condition or results of operations.

Our results of operations and financial condition may be adversely affected by global economic and financial market conditions.

We compete around the world in various geographic and product markets. In 2015, 41%, 32% and 21% of our total revenue was from customers located in the United States, Europe and emerging markets, respectively. We expect revenue from these markets to be significant for the foreseeable future. Important factors impacting our businesses include the overall strength of these economies and our customers' confidence in both local and global macro-economic conditions; industrial and federal, state, local and municipal governmental spending; the strength of the residential and commercial real estate markets; interest rates; availability of commercial financing for our customers and end-users; and unemployment rates. A slowdown or prolonged downturn in financial or macro-economic conditions in these areas or in the United States could have a material adverse effect on our business, financial condition and results of operations.

Economic and other risks associated with international sales and operations could adversely affect our business.

In 2015, 59% of our total revenue was from customers outside the United States, with 21% of total revenue generated in emerging markets. We expect our international operations sales and export sales to continue to be a significant portion of our revenue. We have placed a particular emphasis on increasing our growth and presence in emerging markets. Both our sales from international operations and export sales are subject, in varying degrees, to risks inherent to doing business outside the United States. These risks include the following:

- possibility of unfavorable circumstances arising from host country laws or regulations;
- currency exchange rate fluctuations and restrictions on currency repatriation;
- potential negative consequences from changes to taxation policies;
- disruption of operations from labor and political disturbances;
- changes in tariff and trade barriers and import and export licensing requirements;
- increased costs and risks of developing, staffing and simultaneously managing a number of global operations as a result of distance as well as language and cultural differences; and
- insurrection, armed conflict, terrorism or war.

Any payment of distributions, loans or advances to us by our foreign subsidiaries could be subject to restrictions on, or taxation of, dividends on repatriation of earnings under applicable local law, monetary transfer restrictions and foreign currency exchange regulations in the jurisdictions in which our subsidiaries operate. In addition to the general risks that we face outside the United States, we now conduct more of our operations in emerging markets than we have in the past, which could involve additional uncertainties for us, including risks that governments may impose limitations on our ability to repatriate funds; governments may impose withholding or other taxes on

remittances and other payments to us, or the amount of any such taxes may increase; an outbreak or escalation of any insurrection or armed conflict may occur; governments may seek to nationalize our assets; or governments may impose or increase investment barriers or other restrictions affecting our business. In addition, emerging markets pose other uncertainties, including the difficulty of enforcing agreements, challenges collecting receivables, protection of our intellectual property and other assets, pressure on the pricing of our products, higher business conduct risks, less qualified talent and risks of political instability. We cannot predict the impact such future, largely unforeseeable events might have on our business, financial condition and results of operations.

Failure to comply with laws, regulations and policies, including the U.S. Foreign Corrupt Practices Act or other applicable anti-corruption legislation could result in fines, criminal penalties and an adverse effect on our business.

We are subject to regulation under a wide variety of U.S. federal and state and non-U.S. laws, regulations and policies, including laws related to anti-corruption, export and import compliance, anti-trust and money laundering, due to our global operations. The U.S. Foreign Corrupt Practices Act (the "FCPA"), the U.K. Bribery Act of 2010 and similar anti-bribery laws in other jurisdictions generally prohibit companies and their intermediaries from making improper payments to government officials or other persons for the purpose of obtaining or retaining business. There has been an increase in anti-bribery law enforcement activity in recent years, with more frequent and aggressive investigations and enforcement proceedings by both the Department of Justice ("DOJ") and the SEC, increased enforcement activity by non-U.S. regulators, and increases in criminal and civil proceedings brought against companies and individuals. Our policies mandate compliance with these anti-bribery laws. We operate in many parts of the world that are recognized as having governmental and commercial corruption and in certain circumstances, strict compliance with anti-bribery laws may conflict with local customs and practices. We cannot assure you that our internal control policies and procedures will always protect us from improper conduct of our employees or business partners. In the event that we believe or have reason to believe that our employees or agents have or may have violated applicable laws, including anti-corruption laws, we may be required to investigate or have outside counsel investigate the relevant facts and circumstances, which can be expensive and require significant time and attention from senior management. Any such violation could result in substantial fines, sanctions, civil and/or criminal penalties, and curtailment of operations in certain jurisdictions, and might materially and adversely affect our business, results of operations or financial condition. In addition, actual or alleged violations could damage our reputation and ability to do business. Furthermore, detecting, investigating, and resolving actual or alleged violations is expensive and can consume significant time and attention of our senior management.

Our business could be adversely affected by the inability of suppliers to meet delivery requirements.

Our business relies on third-party suppliers, contract manufacturing and commodity markets to secure raw materials, parts and components used in our products. Parts and raw materials commonly used in our products include motors, fabricated parts, castings, bearings, seals, nickel, copper, aluminum, and plastics. We are exposed to the availability of these materials, which may be subject to curtailment or change due to, among other things, interruptions in production by suppliers, labor disputes, the impaired financial condition of a particular supplier, suppliers' allocations to other purchasers, changes in exchange rates and prevailing price levels, ability to meet regulatory requirements, weather emergencies or acts of war or terrorism. Any delay in our suppliers' abilities to provide us with necessary materials could impair our ability to deliver products to our customers and, accordingly, could have a material adverse effect on our business, financial condition or results of operations.

Our business could be adversely affected by significant movements in foreign currency exchange rates.

We conduct approximately 59% of our business in various locations outside the United States. We are exposed to fluctuations in foreign currency transaction exchange rates, particularly with respect to the Euro, Swedish Krona, Canadian Dollar, British Pound, Polish Zloty and Australian Dollar. Any significant change in the value of currencies of the countries in which we do business relative to the value of the U.S. Dollar or Euro could affect our ability to sell products competitively and control our cost structure, which could have a material adverse effect on our business, financial condition and results of operations. Additionally, we are subject to foreign exchange translation risk due to changes in the value of foreign currencies in relation to our reporting currency, the U.S. dollar. The translation risk is primarily concentrated in the exchange rate between the U.S. Dollar and the Euro, British Pound, Chinese Yuan, Swedish Krona, Canadian Dollar and Australian Dollar. As the U.S. Dollar fluctuates against other currencies in which we transact business, revenue and income can be impacted. For instance, our 2015 revenue decreased by 8.0%

due to unfavorable foreign currency impacts. Continued strengthening of the U.S. Dollar relative to the Euro and the currencies of the other countries in which we do business, could materially and adversely affect our revenue growth in future periods. Refer to Item 7A "Quantitative and Qualitative Disclosures about Market Risk" for additional information on foreign exchange risk.

Weather conditions and climate changes may adversely affect, or cause volatility to/in, our financial results.
Weather conditions, including heavy flooding, droughts and fluctuations in temperatures or shifting conditions as a result of climate change, can positively or negatively impact portions of our business. Within the dewatering space, our pumps provided through our Godwin and Flygt brands are used to remove excess or unwanted water. Heavy flooding due to weather conditions drives increased demand for these applications. On the other hand, drought conditions drive higher demand for pumps used in agricultural and turf irrigation applications, such as those provided by our Goulds Water Technology, Flowtronex and Lowara brands. Fluctuations to warmer and cooler temperatures result in varying levels of demand for products used in residential and commercial applications where homes and buildings are heated and cooled with HVAC units such as those provided by our B&G brand. Given the unpredictable nature of weather conditions and climate change, this may result in volatility for certain portions of our business, as well as the operations of certain of our customers and suppliers.
Our financial results can be difficult to predict.
Our business is impacted by an increasing amount of short cycle, and book-and-bill business, which we have limited insight into, particularly for the business that we transact through our distributors. We are also impacted by large projects, whose timing can change based upon customer requirements due to a number of factors affecting the project, such as funding, readiness of the project and regulatory approvals. Accordingly, our financial results for any given period can be difficult to predict.
Our strategy includes acquisitions, and we may not be able to make acquisitions of suitable candidates or integrate acquisitions successfully.
Our historical growth has included acquisitions. As part of our growth strategy, we plan to pursue the acquisition of other companies, assets and product lines that either complement or expand our existing business. We cannot make assurances, however, that we will be able to identify suitable candidates successfully, negotiate appropriate acquisition terms, obtain financing that may be needed to consummate those acquisitions, complete proposed acquisitions, successfully integrate acquired businesses into our existing operations or expand into new markets. In addition, we cannot make assurances that any acquisition, once successfully integrated, will perform as planned, be accretive to earnings, or prove to be beneficial to our operations or cash flow.
Acquisitions involve a number of risks and present financial, managerial and operational challenges, including: diversion of management attention from existing businesses and operations; integration of technology, operations personnel, and financial and other systems; potentially insufficient internal controls over financial activities or financial reporting at an acquired entity that could impact us on a combined basis; the failure to realize expected synergies; the possibility that we become exposed to substantial undisclosed liabilities or new material risks associated with the acquired businesses; and the loss of key employees of the acquired businesses.
We may incur impairment charges for our goodwill and other indefinite-lived intangible assets which would negatively impact our operating results.
We have a significant amount of goodwill and purchased intangible assets on our balance sheet as a result of acquisitions we have completed. As of December 31, 2015, the net carrying value of our goodwill and other indefinite-lived intangible assets totaled approximately $2 billion. The carrying value of goodwill represents the fair value of an acquired business in excess of identifiable assets and liabilities as of the acquisition date. The carrying value of indefinite-lived intangible assets represents the fair value of trademarks and trade names as of the acquisition date. We do not amortize goodwill and indefinite-lived intangible assets that we expect to contribute indefinitely to our cash flows, but instead we evaluate these assets for impairment at least annually, or more frequently if interim indicators suggest that a potential impairment could exist. In testing for impairment, we will make a qualitative assessment, and if we believe that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, the quantitative two-step goodwill impairment test is required. Significant negative industry or economic trends, disruptions to our business, inability to effectively integrate acquired businesses, unexpected significant changes or planned changes in use of the assets, divestitures and market capitalization declines may impair our goodwill and other indefinite-lived intangible assets. Any charges relating to such impairments could adversely affect our results of operations and financial condition in the periods recognized.
We may not achieve some or all of the expected benefits of our restructuring plans and our restructuring may adversely affect our business.

We have announced restructuring plans in an effort to reposition our European and North American businesses to optimize our cost structure and improve our operational efficiency and effectiveness. We may not be able to obtain the cost savings and benefits that were initially anticipated in connection with our restructuring. Additionally, as a

result of our restructuring, we may experience a loss of continuity, loss of accumulated knowledge or inefficiency during transitional periods. Reorganization and restructuring can require a significant amount of management and other employees' time and focus, which may divert attention from operating and growing our business.

The successful implementation and execution of our restructuring and realignment actions is critical to achieving our expected cost savings as well as effectively competing in the marketplace. Factors that may impede a successful implementation is retention of key employees, the impact of regulatory matters, and adverse economic market conditions. If the restructuring and realignment actions are not executed successfully, it could have a material adverse effect on our competitive position, business, financial condition and results of operations.

Changes in our effective tax rates may adversely affect our financial results.

We sell our products in more than 150 countries and 59% of our revenue was generated outside the United States in 2015. Given the global nature of our business, a number of factors may increase our future effective tax rates, including:

- our decision to repatriate non-U.S. earnings for which we have not previously provided for U.S. taxes;
- the jurisdictions in which profits are determined to be earned and taxed;
- sustainability of historical income tax rates in the jurisdictions in which we conduct business;
- the resolution of issues arising from tax audits with various tax authorities; and
- changes in the valuation of our deferred tax assets and liabilities, and changes in deferred tax valuation allowances.

Any significant increase in our future effective tax rates could reduce net income for future periods.

Our business could be adversely affected by inflation and other manufacturing and operating cost increases.

Our operating costs are subject to fluctuations, particularly due to changes in commodity prices, raw materials, energy and related utilities, freight, and cost of labor. In order to remain competitive, we may not be able to recuperate all or a portion of these higher costs from our customers through product price increases. Further, in a declining price environment, our operating margins may contract because we account for inventory using the first-in, first- out method. Actions we take to mitigate volatility in manufacturing and operating costs may not be successful and, as a result, our business, financial condition and results of operation could be materially and adversely affected.

Product defects and unanticipated use or inadequate disclosure with respect to our products could adversely affect our business, reputation and financial statements.

Manufacturing or design defects in (including in products or components that we source from third parties), unanticipated use of, or inadequate disclosure of risks relating to the use of products there can be no assurance that we or our customers or other third parties will not experience operational process failures or other problems that could result in potential product safety, regulatory or environmental risk which can lead to personal injury, death or property damage. These events could lead to recalls or safety alerts relating to our products, result in the removal of a product from the market and result in product liability claims being brought against us. Although we have liability insurance, we cannot be certain that this insurance coverage will continue to be available to us at a reasonable cost or will be adequate to cover any product liability claims. Recalls, removals and product liability claims can result in significant costs, as well as negative publicity and damage to our reputation that could reduce demand for our products.

Our indebtedness may affect our business and may restrict our operational flexibility.

As of December 31, 2015, our total outstanding indebtedness was $1,274 million, including our 3.55% Senior Notes of $600 million aggregate principal amount due September 2016 and 4.875% Senior Notes of $600 million aggregate principal amount due October 2021. We have an existing Five-Year Competitive Advance and Revolving Credit Facility (the “Credit Facility”), which provides for an aggregate principal amount of up to $600 million. We have a Risk Sharing Finance Facility Agreement (the "R&D Facility Agreement") with The European Investment Bank ("EIB") in an aggregate principal amount of up to €120 million (approximately $132 million).

Our indebtedness could:

- increase our vulnerability to general adverse economic and industry conditions;
- limit our ability to obtain additional financing or borrow additional funds;

- limit our ability to pay future dividends;
- limit our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate;
- require that a substantial portion of our cash flow from operations be used for the payment of interest on our indebtedness instead of funding working capital, capital expenditures, acquisitions or other general corporate purposes; and
- increase the amount of interest expense that we must pay because some of our borrowings are at variable interest rates, which, as interest rates increase, would result in higher interest expense.

In addition, there can be no assurance that future borrowings or equity financing will be available to us on favorable terms or at all for the payment or refinancing of our indebtedness. If we incur additional debt or raise equity through the issuance of preferred stock, the terms of the debt or preferred stock issued may give the holders rights, preferences and privileges senior to those of holders of our common stock, particularly in the event of liquidation. The terms of the debt may also impose additional and more stringent restrictions on our operations than we currently have.

Our ability to make scheduled principal payments of, to pay interest on, or to refinance our indebtedness and to satisfy our other debt obligations will depend on our future operating performance, which may be affected by factors beyond our control. If we are unable to service our indebtedness, our business, financial condition and results of operations would be materially adversely affected.

We may be negatively impacted by litigation and regulatory proceedings.

We are subject to laws, regulations and potential liability relating to claims, complaints and proceedings, including those related to antitrust, environmental, product, and other matters.

We are subject to various laws, ordinances, regulations and other requirements of government authorities in foreign countries and in the United States, any violation of which could potentially create substantial liability for us and also damage to our reputation. Changes in laws, ordinances, regulations or other government policies, the nature, timing, and effect of which are uncertain, may significantly increase our expenses and liabilities.

From time to time, we are involved in legal proceedings that are incidental to the operation of our businesses, including acquisitions and divestitures. Some of these proceedings seek remedies relating to environmental matters, intellectual property matters, product liability and personal injury claims, employment, labor and pension matters, and government and commercial or contract issues, sometimes related to acquisitions or divestitures. We may become subject to significant claims of which we are currently unaware, or the claims of which we are aware may result in our incurring a significantly greater liability than we anticipate or can estimate. Additionally, we may receive fines or penalties or be required to change or cease operations at one or more facilities if a regulatory agency determines that we have failed to comply with laws, regulations or orders applicable to our business.

Our business could be adversely affected by interruptions in information technology, communications networks and operations or cybersecurity threats.

Our business operations rely on information technology and communications networks, and operations that are vulnerable to damage or disturbance from a variety of sources. Regardless of protection measures, essentially all systems are susceptible to disruption due to failure, vandalism, computer viruses, security breaches, natural disasters, power outages and other events. In addition, we, and some of our third party vendors, have experienced cybersecurity attacks in the past and may experience them in the future, potentially with more frequency. To date, none have resulted in any material adverse impact to our business or operations. We have adopted measures to mitigate potential risks associated with information technology disruptions and cybersecurity threats, however, given the unpredictability of the timing, nature and scope of such disruptions, we could potentially be subject to production downtimes, operational delays, other detrimental impacts on our operations or ability to provide products and services to our customers, the compromising of confidential or otherwise protected information, destruction or corruption of data, security breaches, other manipulation or improper use of our systems or networks, financial losses from remedial actions, loss of business or potential liability, regulatory enforcement actions, and/or damage to our reputation, any of which could have a material adverse effect on our competitive position, results of operations, cash flows or financial condition. We also have a concentration of operations on certain sites, e.g. production and shared services centers, where business interruptions could cause material damage and costs. Transport of goods from suppliers, and to customers, could also be hampered for the reasons stated above. Although we continue to assess these risks, implement controls, and perform business continuity planning, we cannot be sure that interruptions with material

adverse effects will not occur.

Failure to retain our existing senior management, engineering, sales and other key personnel or the inability to attract and retain new qualified personnel could negatively impact our ability to operate or grow our business.

Our success will continue to depend to a significant extent on our ability to retain or attract a significant number of employees in senior management, engineering, sales and other key personnel. The ability to attract or retain employees will depend on our ability to offer competitive compensation, training and cultural benefits. We will need to continue to develop a roster of qualified talent to support business growth and replace departing employees. Effective succession planning is also important to our long-term success. Failure to ensure effective transfer of knowledge and smooth transitions involving key employees could hinder our strategic planning and execution. A failure to retain or attract highly skilled personnel could adversely affect our operating results or ability to operate or grow our business.

If we do not or cannot adequately protect our intellectual property, if third parties infringe our intellectual property rights, or if third parties claim that we are infringing or misappropriating their intellectual property rights, we may suffer competitive injury, expend significant resources enforcing our rights or defending against such claims, or be prevented from selling products or services.

We own numerous patents, trademarks, copyrights, trade secrets and other intellectual property and licenses to intellectual property owned by others, which in aggregate are important to our business. The intellectual property rights that we obtain, however, may not provide us with a significant competitive advantage because they may not be sufficiently broad or may be challenged, invalidated, circumvented, independently developed, or designed-around, particularly in countries where intellectual property rights laws are not highly developed, protected or enforced. Our failure to obtain or maintain intellectual property rights that convey competitive advantage, adequately protect our intellectual property or detect or prevent circumvention or unauthorized use of such property and the cost of enforcing our intellectual property rights could adversely impact our business, financial condition and results of operations.

From time to time, we receive notices from third parties alleging intellectual property infringement or misappropriation. Any dispute or litigation regarding intellectual property could be costly and time-consuming due to the complexity and the uncertainty of intellectual property litigation. Our intellectual property portfolio may not be useful in asserting a counterclaim, or negotiating a license, in response to a claim of infringement or misappropriation. In addition, as a result of such claims of infringement or misappropriation, we could lose our rights to critical technology, be unable to license critical technology or sell critical products and services, be required to pay substantial damages or license fees with respect to the infringed rights or be required to redesign our products at substantial cost, any of which could adversely impact our competitive position, financial condition and results of operations. Even if we successfully defend against claims of infringement or misappropriation, we may incur significant costs and diversion of management attention and resources, which could adversely affect our business, financial condition and results of operations.

We cannot make assurances that we will pay dividends on our common stock or continue to repurchase our common stock under Board approved share repurchase plans, and likewise our indebtedness could limit our ability to pay dividends or make share repurchases.

The timing, declaration, amount and payment of future dividends to our shareholders fall within the discretion of our Board of Directors and will depend on many factors, including our financial condition, results of operations and capital requirements, as well as applicable law, regulatory constraints, industry practice and other business considerations that our Board of Directors considers relevant. There can be no assurance that we will pay a dividend in the future or continue to pay dividends.

Further, the timing and amount of the repurchase of our common stock under Board approved share repurchase plans has similar dependencies as the payment of dividends and accordingly, there can be no assurances that we will continue to repurchase our common stock.

Additionally, if we cannot generate sufficient cash flow from operations to meet our debt payment obligations, then our ability to pay dividends, if so determined by the Board of Directors, or make share repurchases will be impaired and we may be required to attempt to restructure or refinance our debt, raise additional capital or take other actions such as selling assets, reducing or delaying capital expenditures, reducing our dividend or delaying or curtailing share repurchases. There can be no assurance, however, that any such actions could be effected on satisfactory terms, if at all, or would be permitted by the terms of our debt or our other credit and contractual arrangements.

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The level of returns on postretirement benefit plan assets, changes in interest rates and other factors could affect our earnings and cash flows in future periods.

Certain members of our current and retired employee population are covered by pension and other employee-related defined benefit plans (collectively, postretirement benefit plans). We may experience significant fluctuations in costs related to our postretirement benefit plans as a result of macro-economic factors, such as interest rates, that are beyond our control. The cost of our postretirement plans is incurred over long periods of time and involves factors and uncertainties during those periods which can be volatile and unpredictable, including rates of return on postretirement benefit plan assets, discount rates used to calculate liabilities and expenses and rates of future compensation increases. Management develops each assumption using relevant plan and Company experience and expectations in conjunction with market-related data. Our liquidity, financial position (including shareholders' equity) and results of operations could be materially affected by significant changes in key economic indicators, actuarial experience, financial market volatility, future legislation and other governmental regulatory actions.

We make contributions to fund our postretirement benefit plans when considered necessary or advantageous to do so. The macro-economic factors discussed above, including the return on postretirement benefit plan assets and the minimum funding requirements established by local government funding or taxing authorities, or established by other agreement, may influence future funding requirements. A significant decline in the fair value of our plan assets, or other adverse changes to our overall pension and other employee-related benefit plans, could require us to make significant funding contributions and affect cash flows in future periods.

Unforeseen environmental issues could impact our financial position or results of operations.

Our operations are subject to and affected by many federal, state, local and foreign environmental laws and regulations. In addition, we could be affected by future environmental laws or regulations, including, for example, those imposed in response to climate change concerns. Compliance with current and future environmental laws and regulations currently requires and is expected to continue to require operating and capital expenditures.

Environmental laws and regulations may authorize substantial fines and criminal sanctions as well as facility shutdowns to address violations, and may require the installation of costly pollution control equipment or operational changes to limit emissions or discharges. We also incur, and expect to continue to incur, costs to comply with current environmental laws and regulations.

Developments such as the adoption of new environmental laws and regulations, stricter enforcement of existing laws and regulations, violations by us of such laws and regulations, discovery of previously unknown or more extensive contamination, litigation involving environmental impacts, our inability to recover costs associated with any such developments, or financial insolvency of other responsible parties could in the future have a material adverse effect on our financial position and results of operations.

The market price of our common stock may fluctuate significantly.

We cannot predict the prices at which our common stock may trade. The market price of our common stock may fluctuate widely, depending on many factors, some of which may be beyond our control, including:

- actual or anticipated fluctuations in our operating results due to factors related to our business;
- success or failure of our business strategy;
- our quarterly or annual earnings, or those of other companies in our industry;
- our ability to obtain financing as needed;
- announcements by us or our competitors of significant new business awards;
- announcements by us or our competitors of significant acquisitions or dispositions;
- changes in accounting standards, policies, guidance, interpretations or principles;
- changes in earnings estimates by securities analysts or our ability to meet those estimates;
- our ability to execute restructuring and realignment actions;
- the operating and stock price performance of other comparable companies;
- natural or environmental disasters that investors believe may affect us;
- overall market fluctuations;
- fluctuations in the budgets of federal, state and local governmental entities around the world;

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- results from any material litigation or government investigation;
- changes in laws and regulations affecting our business; and
- general economic conditions and other external factors.

Stock markets in general have experienced volatility that has often been unrelated to the operating performance of a particular company. These broad market fluctuations could adversely affect the trading price of our common stock.

Anti-takeover provisions in our organizational documents and Indiana law could delay or prevent a change in control.

Certain provisions of our third amended and restated articles of incorporation and our amended and restated by-laws may delay or prevent a merger or acquisition of part or all of our business operations. For example, the third amended and restated articles of incorporation and the amended and restated by-laws, among other things, require advance notice for shareholder proposals and nominations and do not permit action by written consent of the shareholders, unless unanimous. In addition, the amended and restated articles of incorporation authorize our Board of Directors to issue one or more series of preferred stock. These provisions may also discourage acquisition proposals of our business operations or delay or prevent a change in control, which could harm our stock price. Indiana law also imposes some restrictions on mergers and other business combinations between any holder of 10% or more of our outstanding common stock and us.

Risks Related to our 2011 Spin-off from ITT Corporation

In connection with our Spin-off, ITT and Exelis, acquired by Harris Inc. on May 29, 2015, will indemnify us for certain liabilities and we will indemnify ITT or Exelis for certain liabilities. If we are required to indemnify ITT or Exelis, we may need to divert cash to meet those obligations and our financial results could be negatively impacted. In the case of ITT's or Exelis's indemnity, there can be no assurance that those indemnities will be sufficient to insure us against the full amount of such liabilities, or as to ITT's or Exelis's ability to satisfy its indemnification obligations in the future.

Pursuant to the Distribution Agreement and certain other agreements with ITT and Exelis, ITT and Exelis agreed to indemnify us from certain liabilities, and we agreed to indemnify ITT and Exelis for certain liabilities. Indemnities that we may be required to provide ITT and Exelis may be significant and could negatively impact our business, particularly indemnities relating to our actions that could impact the tax-free nature of the Spin-off. Third parties could also seek to hold us responsible for any of the liabilities that ITT or Exelis has agreed to retain. Further, there can be no assurance that the indemnities from ITT and Exelis will be sufficient to protect us against the full amount of such liabilities, or that ITT and Exelis will be able to fully satisfy their indemnification obligations. Moreover, even if we ultimately were to succeed in recovering from ITT and Exelis any amounts for which we are held liable, we may be temporarily required to bear these losses ourselves. Each of these risks could negatively affect our business, results of operations and financial condition.

ITEM 1B. UNRESOLVED STAFF COMMENTS.

None.

ITEM 2. PROPERTIES

We have approximately 350 locations in more than 40 countries. These properties total approximately 10.2 million square feet, of which more than 300 locations, or approximately 5.5 million square feet, are leased. We consider the offices, plants, warehouses and other properties that we own or lease to be in good condition and generally suitable for the purposes for which they are used. The following table shows the significant locations by segment:

| Location | State or Country | Principal Business Activity | Approx. Square Feet | Owned or Expiration Date of Lease |
|---|---|---|---|---|
| Water Infrastructure | | | | |
| Emmaboda | Sweden | Administration and Manufacturing | 1,194,000 | Owned |
| Stockholm | Sweden | Administration and Research & Development | 172,000 | 2019 |
| Shenyang | China | Manufacturing | 125,000 | Owned |
| Bridgeport | NJ | Administration and Manufacturing | 136,000 | 2020 |
| Yellow Springs | OH | Administration and Manufacturing | 112,000 | Owned |
| Quenington | UK | Manufacturing | 86,000 | 2020 |
| Applied Water | | | | |
| Morton Grove | IL | Administration and Manufacturing | 530,000 | Owned |
| Montecchio | Italy | Administration and Manufacturing | 379,000 | Owned |
| Nanjing | China | Manufacturing | 363,000 | Owned |
| Auburn | NY | Manufacturing | 273,000 | Owned |
| Lubbock | TX | Manufacturing | 229,000 | Owned |
| Cheektowaga | NY | Manufacturing | 147,000 | Owned |
| Corporate Headquarters | | | | |
| Rye Brook | NY | Administration | 67,000 | 2023 |

ITEM 3. LEGAL PROCEEDINGS

From time to time, we are involved in legal proceedings that are incidental to the operation of our businesses. Some of these proceedings seek remedies relating to environmental matters, intellectual property matters, personal injury claims, employment and pension matters, government contract issues and commercial or contractual disputes, sometimes related to acquisitions or divestitures. See Note 18, "Commitments and Contingencies", of the consolidated financial statements included in Item 8 of Part II of this 10-K for information regarding certain legal proceedings in which we are involved.

ITEM 4. MINE SAFETY DISCLOSURES

None.

EXECUTIVE OFFICERS OF THE REGISTRANT

The following information is provided regarding the executive officers of Xylem as of February 1, 2016:

| NAME | AGE | CURRENT TITLE | OTHER BUSINESS EXPERIENCE DURING PAST 5 YEARS |
|---|---|---|---|
| Patrick K. Decker | 51 | President and Chief Executive Officer (2014) | • President and Chief Executive Officer, Harsco Corp. (diversified, worldwide industrial company) (2012)<br>• President, Flow Control Segment, Tyco International Ltd. (industrial products and services company) (2003) |
| Shashank Patel | 55 | Interim Chief Financial Officer (2015) | • VP, Finance, Applied Water Systems (2010) |
| Tomas Brannemo | 46 | Senior VP and President, Transport (2014) | • VP, Transport (2013)<br>• VP and Director of Business Unit Aftermarket and Service (2010) |
| David Flinton | 45 | Senior VP and President, Dewatering (2015) | • VP, Engineering and Marketing, Applied Water Systems (2013)<br>• VP, Global Product Management, Applied Water Systems (2012)<br>• VP, Strategy and Integrated Management System (former Water Solutions division) (2010) |
| Pak Steven Leung | 55 | Senior VP and President, Emerging Markets (2015) | • VP, Global Sales, Valves and Controls, Pentair Plc (diversified, worldwide industrial manufacturing company) (2013)<br>• VP and General Manager, Global Process, Tyco International Ltd. (industrial products and services company) (2010) |
| Kenneth Napolitano | 53 | Senior VP and President, Applied Water Systems (2012) | • Senior VP and President, Residential and Commercial Water (2011)<br>• President, Residential and Commercial Water (2009) |
| Colin R. Sabol | 48 | Senior VP and President, Analytics and Treatment (2015) | • Senior VP and President, Dewatering (2013)<br>• Senior VP and Chief Strategy and Growth Officer (2011) |
| Kairus Tarapore | 54 | Senior VP and Chief Human Resources Officer (2015) | • Senior VP and Chief Administrative Officer, Babcock & Wilcox Company (2013)<br>• Executive VP, Human Resources, Ceridian Corporation (2006) |

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| NAME | AGE | CURRENT TITLE | OTHER BUSINESS EXPERIENCE DURING PAST 5 YEARS |
|---|---|---|---|
| Claudia S. Toussaint | 52 | Senior VP, General Counsel and Corporate Secretary (2014) | • Senior VP, General Counsel and Secretary, Barnes Group Inc. (international industrial and aerospace manufacturing) (2012)<br>• General Counsel, Flow Control Segment, Tyco International Ltd. (industrial products and services company) (2012)<br>• Senior VP, General Counsel and Secretary, Barnes Group Inc. (international industrial and aerospace manufacturing) (2010) |

Note: Date in parentheses indicates the year in which the position was assumed.

BOARD OF DIRECTORS

The following information is provided regarding the Board of Directors of Xylem:

| NAME | TITLE |
|---|---|
| Markos I. Tambakeras | Chairman, Xylem Inc., Former Chairman, President and Chief Executive Officer, Kennametal, Inc. |
| Curtis J. Crawford, Ph.D. | President and Chief Executive Officer, XCEO, Inc. |
| Patrick K. Decker | President and Chief Executive Officer, Xylem Inc. |
| Robert F. Friel | Chairman, President and Chief Executive Officer, PerkinElmer, Inc. |
| Victoria D. Harker | Chief Financial Officer, TEGNA Inc. |
| Sten E. Jakobsson | Former President and Chief Executive Officer, ABB AB |
| Steven R. Loranger | Former Chairman, President and Chief Executive Officer, ITT Corporation |
| Edward J. Ludwig | Former Chairman, President and Chief Executive Officer, Becton, Dickinson and Company |
| Surya N. Mohapatra, Ph.D. | Former Chairman, President and Chief Executive Officer, Quest Diagnostics Incorporated |
| Jerome A. Peribere | President and Chief Executive Officer, Sealed Air Corporation |

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

2015 and 2014 Market Price and Dividends

Our common stock trades publicly on the New York Stock Exchange under the trading symbol "XYL". The following table shows the high and low prices per share of our common stock as reported by the New York Stock Exchange and the dividends declared per share for the periods indicated.

| | High | Low | Dividend |
|---|---|---|---|
| Fiscal Year ended December 31, 2015 | | | |
| First Quarter | $38.59 | $33.54 | $0.1408 |
| Second Quarter | 37.70 | 34.80 | 0.1408 |
| Third Quarter | 37.32 | 29.90 | 0.1408 |
| Fourth Quarter | 38.00 | 32.16 | 0.1408 |
| | | | |
| Fiscal Year ended December 31, 2014 | | | |
| First Quarter | $39.79 | $32.62 | $0.1280 |
| Second Quarter | 40.00 | 34.50 | 0.1280 |
| Third Quarter | 39.43 | 34.77 | 0.1280 |
| Fourth Quarter | 39.23 | 31.80 | 0.1280 |

The closing price of our common stock on the NYSE on January 29, 2016 was $35.95 per share. As of January 29, 2016, there were 13,784 holders of record of our common stock.

Dividends are declared and paid on the common stock at the discretion of our Board of Directors and depend on our profitability, financial condition, capital needs, future prospects, and other factors deemed relevant by our Board. Therefore, there can be no assurance as to what level of dividends, if any, will be paid in the future. In the first quarter of 2016, we declared a dividend of $0.1549 per share to be paid on March 16, 2016 for shareholders of record on February 18, 2016.

There have been no unregistered offerings of our common stock during 2015.

Fourth Quarter 2015 Share Repurchase Activity

The following table summarizes our purchases of our common stock for the quarter ended December 31, 2015:

(in millions, except per share amounts)

| Period | Total Number of Shares Purchased | Average Price Paid per Share (a) | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (b) | Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs (b) |
|---|---|---|---|---|
| 10/1/15 - 10/31/15 | — | — | — | $479 |
| 11/1/15 - 11/30/15 | 0.7 | 36.80 | 0.7 | $454 |
| 12/1/15 - 12/31/15 | 0.7 | 36.71 | 0.7 | $429 |

(a) Average price paid per share is calculated on a settlement basis.

(b) On August 24, 2015, our Board of Directors authorized the repurchase of up to $500 million in shares with no expiration date. The program's objective is to deploy our capital in a manner that benefits our shareholders and maintains our focus on growth. During the three months ended December 31, 2015, we repurchased 1.4 million shares for $50 million. There are up to $420 million in shares that may still be purchased under this plan as of December 31, 2015.

On August 18, 2012, the Board of Directors authorized the repurchase of up to 2.0 million shares of common stock with no expiration date. The program's objective is to offset dilution associated with various Xylem employee stock plans by acquiring shares in the open market from time to time. There were no shares purchased under this program during the three months ended December 31, 2015 and there are 0.3 million shares (approximately $9 million based on the closing share price on December 31, 2015) that may still be purchased under this plan.

PERFORMANCE GRAPH

CUMULATIVE TOTAL RETURN

The following graph compares the relative performance of our common stock, the S&P 500 Index and the S&P 500 Industrials Index. This graph covers the period from October 13, 2011 (the first day our common stock began "when-issued" trading on the NYSE) through December 31, 2015. Our common stock began "regular-way" trading following the Spin-off on November 1, 2011.

| | XYL | S&P 500 | S&P 500 Industrials Index |
|---|---|---|---|
| October 13, 2011 | $100 | $100 | $100 |
| October 31, 2011 | 110 | 104 | 106 |
| December 31, 2011 | 106 | 105 | 108 |
| December 31, 2012 | 114 | 121 | 124 |
| December 31, 2013 | 148 | 161 | 175 |
| December 31, 2014 | 165 | 183 | 192 |
| December 31, 2015 | 161 | 186 | 187 |

The graph is not, and is not intended to be, indicative of future performance of our common stock.

This performance graph shall not be deemed "filed" with the SEC or subject to the liabilities of Section 18 of the Securities Exchange Act of 1934, and should not be deemed incorporated by reference into any of our prior or subsequent filings under the Securities Act of 1933 or the Securities Exchange Act of 1934, except as shall be expressly set forth by specific reference in such filing.

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth selected consolidated financial data for the five years ended December 31, 2015. This selected consolidated financial data should be read in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and the consolidated financial statements and the notes thereto included in this Report.

On and prior to the Distribution Date, our financial position and results of operations consisted of WaterCo, the water equipment and services businesses of ITT Corporation. The Spin-off was completed pursuant to the Distribution Agreement among ITT, Exelis Inc., acquired by Harris Inc. on May 29, 2015, and Xylem. Xylem's financial position and results of operations have been derived from ITT’s historical accounting records and are presented on a carve-out basis through the Distribution Date, while our financial results for Xylem post Spin-off are prepared on a stand-alone basis. Further, financial information for the twelve months ended December 31, 2011 consists of the consolidated results of Xylem on a stand-alone basis for the two months of November and December and the combined results of operations of WaterCo for the first ten months on a carve-out basis.

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| (in millions, except per share data) | 2015 | 2014 | 2013 | 2012 | 2011 (a) |
| Results of Operations Data: | | | | | |
| Revenue | $3,653 | $3,916 | $3,837 | $3,791 | $3,803 |
| Gross profit | 1,404 | 1,513 | 1,499 | 1,502 | 1,461 |
| Gross margin | 38.4 % | 38.6 % | 39.1 % | 39.6 % | 38.4 % |
| Operating income | 449 | 463 | 363 | 443 | 395 |
| Operating margin | 12.3 % | 11.8 % | 9.5 % | 11.7 % | 10.4 % |
| Net income | 340 | 337 | 228 | 297 | 279 |
| Per Share Data: | | | | | |
| Earnings per share: | | | | | |
| Basic | $1.88 | $1.84 | $1.23 | $1.60 | $1.51 |
| Diluted | 1.87 | 1.83 | 1.22 | 1.59 | 1.50 |
| Basic shares outstanding | 180.9 | 183.1 | 185.2 | 185.8 | 185.1 |
| Diluted shares outstanding | 181.7 | 184.2 | 186.0 | 186.2 | 185.3 |
| Cash dividends per share | $0.5632 | $0.5120 | $0.4656 | $0.4048 | $0.1012 |
| Balance Sheet Data (at period end): | | | | | |
| Cash and cash equivalents | $680 | $663 | $533 | $504 | $318 |
| Working capital* | 810 | 882 | 930 | 859 | 834 |
| Total assets (b)(c) | 4,657 | 4,833 | 4,857 | 4,639 | 4,350 |
| Total debt (b) | 1,274 | 1,284 | 1,235 | 1,197 | 1,197 |

* The Company calculates Working capital as follows: net accounts receivable + inventories - accounts payable - customer advances.

(a) In 2011, we acquired YSI Incorporated, which contributed revenue of $35 million in 2011 and $371 million of total assets on date of acquisition.

(b) Debt issuance costs of $6 million, $8 million and $9 million in 2013, 2012 and 2011, respectively, were reclassified to long-term debt from other non-current assets within the Consolidated Balance Sheet. See Note 2, “Recently Issued Accounting Pronouncements,” of the consolidated financial statements.

(c) Deferred tax assets of $33 million, $32 million and $41 million in 2013, 2012 and 2011, respectively, were reclassified to deferred tax liabilities within the Consolidated Balance Sheet. See Note 2, “Recently Issued Accounting Pronouncements,” of the consolidated financial statements.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with our consolidated financial statements and the notes thereto. This discussion summarizes the significant factors affecting our results of operations and the financial condition of our business during each of the fiscal years in the three-year period ended December 31, 2015. Except as otherwise indicated or unless the context otherwise requires, "Xylem," "we," "us," "our" and "the Company" refer to Xylem In and its subsidiaries.

Overview

Xylem is a leading equipment and service provider for water and wastewater applications with a broad portfolio of products and services addressing the full cycle of water, from collection, distribution and use to the return of water to the environment. Our business focuses on providing technology-intensive equipment and services. Our product and service offerings are organized into two reportable segments: Water Infrastructure and Applied Water. Our segments are aligned with each of the sectors in the cycle of water, water infrastructure and usage applications.

- Water Infrastructure serves the water infrastructure sector with pump systems that transport water from aquifers, lakes, rivers and seas; with filtration, ultraviolet and ozone systems that provide treatment, making the water fit to use; and pumping solutions that move the wastewater to treatment facilities where our mixers, biological treatment, monitoring and control systems provide the primary functions in the treatment process. We provide analytical instrumentation used to measure water quality, flow and level in wastewater, surface water and coastal environments. In the Water Infrastructure segment, we provide the majority of our sales directly to customers with strong application expertise, while the remaining amount is through distribution partners.
- Applied Water serves the usage applications sector with water pressure boosting systems for heating, ventilation and air conditioning and for fire protection systems to the residential and commercial building services markets. In addition, our pumps, heat exchangers, valves and controls provide cooling to power plants and manufacturing facilities, as well as circulation for food and beverage processing. We also provide boosting systems for farming irrigation, pumps for dairy operations and rainwater reuse systems for small scale crop and turf irrigation. In the Applied Water segment, we provide the majority of our sales through long-standing relationships with the world's leading distributors, with the remainder going directly to customers.

We sell our equipment and services through direct and indirect channels that serve the needs of each customer type. In the Water Infrastructure segment, we provide the majority of our sales direct to customers with strong application expertise, while the remaining amount is through distribution partners. In the Applied Water segment, we provide the majority of our sales through long-standing relationships with the world's leading distributors, with the remainder going direct to customers.

Key Performance Indicators and Non-GAAP Measures

Management reviews key performance indicators including revenue, gross margin, segment operating income and margins, earnings per share, orders growth, working capital, free cash flow and backlog, among others. In addition, we consider certain measures to be useful to management and investors evaluating our operating performance for the periods presented, and provide a tool for evaluating our ongoing operations, liquidity and management of assets. This information can assist investors in assessing our financial performance and measures our ability to generate capital for deployment among competing strategic alternatives and initiatives, including, but not limited to, dividends, acquisitions, share repurchases and debt repayment. These metrics, however, are not measures of financial performance under GAAP and should not be considered a substitute for revenue, operating income, net income, earnings per share (basic and diluted) or net cash from operations as determined in accordance with GAAP. We consider the following non-GAAP measures, which may not be comparable to similarly titled measures reported by other companies, to be key performance indicators:

- "organic revenue" and "organic orders" defined as revenue and orders, respectively, excluding the impact of fluctuations in foreign currency translation, intercompany transactions and contributions from acquisitions and divestitures. Divestitures include sales of insignificant portions of our business that did not meet the criteria for classification as a discontinued operation. The period-over-period change resulting from foreign currency translation assumes no change in exchange rates from the prior period.
-

"constant currency" defined as financial results adjusted for foreign currency translation impacts by translating current period and prior period activity using the same currency conversion rate. This approach is used for countries whose functional currency is not the U.S. Dollar.

- "adjusted net income" and "adjusted earnings per share" defined as net income and earnings per share, respectively, adjusted to exclude restructuring and realignment costs, special charges, tax-related special items and gain from sale of businesses. A reconciliation of adjusted net income is provided below.

| (in millions, except per share data) | 2015 | 2014 | 2013 |
|---|---|---|---|
| Net income | $340 | $337 | $228 |
| Restructuring and realignment, net of tax benefit of $5, $12 and $18, respectively | 15 | 31 | 46 |
| Special charges, net of tax benefit of $0 and $9, respectively | 5 | — | 23 |
| Tax-related special items | (15) | 5 | 14 |
| Gain on sale of business, net of $0 tax in both years | (9) | (11) | — |
| Adjusted net income | $336 | $362 | $311 |
| Weighted average number of shares - Diluted | 181.7 | 184.2 | 186.0 |
| Adjusted earnings per share | $1.85 | $1.97 | $1.67 |

- "operating expenses excluding restructuring and realignment costs and special charges" defined as operating expenses, adjusted to exclude restructuring and realignment costs and special charges.
- "adjusted operating income (loss)" defined as operating income (loss), adjusted to exclude restructuring and realignment costs and special charges, and "adjusted operating margin" defined as adjusted operating income divided by total revenue.
- “realignment costs” defined as costs not included in restructuring costs that are incurred as part of actions taken to reposition our business, including items such as professional fees, severance, relocation, travel, facility set-up and other costs.
- “special charges" defined as costs incurred by the Company, such as legal and professional fees, associated with the Korea matters, costs incurred for the contractual indemnification of tax obligations to ITT, certain costs incurred during the third quarter of 2013 for the settlement of legal proceedings with Xylem Group LLC, as well as the change in chief executive officer and other special non-operating items.
- "tax-related special items" defined as tax items, such as tax return versus tax provision adjustments, tax exam impacts, tax law change impacts and other discrete tax adjustments.
- "free cash flow" defined as net cash from operating activities, as reported in the Statement of Cash Flow, less capital expenditures, as well as adjustments for other significant items that impact current results that management believes are not related to our ongoing operations and performance. Our definition of free cash flow does not consider certain non-discretionary cash payments, such as debt. The following table provides a reconciliation of free cash flow.

| (in millions) | 2015 | 2014 | 2013 |
|---|---|---|---|
| Net cash provided by operating activities | $464 | $416 | $324 |
| Capital expenditures | (117) | (119) | (126) |
| Free cash flow | $347 | $297 | $198 |

Executive Summary

Xylem reported revenue of $3,653 million for 2015, a decrease of 6.7% from $3,916 million reported in 2014. Revenue increased 1.3% on a constant currency basis due to strong organic growth in the public utility, commercial and residential markets, partially offset by declines in industrial in the oil and gas market. Operating income for 2015 was $449 million, reflecting a decrease of $14 million or 3.0% compared to $463 million in 2014. Operating income as a percentage of revenue was 12.3% for 2015 versus 11.8% for 2014, an increase of 50 basis points. This increase in operating margin was primarily due to reduced restructuring and realignment costs as well as incremental cost savings from continuous improvement initiatives and restructuring actions. Partially offsetting these actions were cost inflation, unfavorable mix and unfavorable foreign exchange translation impacts.

Additional financial highlights for 2015 include the following:

- Net income of $340 million, or $1.87 per diluted share ($336 million or $1.85 per diluted share on an adjusted basis)
- Free cash flow of $347 million, and net cash from operating activities of $464 million
- Orders of $3,711 million (a 0.5% increase from 2014 on an organic basis)
- We repurchased a total of $175 million in shares under our share repurchase programs approved by our Board of Directors as part of our strategy to enhance shareholder return
- Dividends paid to shareholders increased 10% in 2015.

2016 Business Outlook

We continue to anticipate organic revenue growth in the low-to-mid single digits in 2016. The following is a summary of our outlook by market.

- Industrial was down 1% for 2015 as general industrial strength was more than offset by oil and gas declines in Canada and the United States. For 2016, we expect growth to be flat to up in the low-single-digits. This projection assumes low-single-digit growth in light industrial applications, and double-digit declines in oil and gas, and mining applications.
- Public utilities increased 4% for 2015 driven by the United States recovery and continued emerging markets investments. We expect growth in mid-single-digits for 2016 as we anticipate continued growth in the United States and continued investments across emerging markets. We also anticipate that market conditions in Europe will remain stable.
- Commercial experienced growth of 4% for 2015 driven by a recovering institutional building sector in the United States. We expect continued growth in the mid-single-digit range for 2016. Our expectation is that growth in the U.S. institutional building market will continue through the year, urbanization will continue to drive growth in most emerging markets and that conditions in Europe will modestly improve.
- Residential markets grew 4% in 2015 with the strongest growth in the U.S. For 2016 we expect low-to-mid-single digit growth driven by continued strength in the U.S. We also expect continued low-single-digit growth in Europe.
- Our agriculture markets, which is our smallest end market, declined 8% in 2015 driven by unfavorable U.S. weather conditions. We expect 2016 to grow low-single-digits as we will likely see a modest recovery from the significant weather events in 2015.

We will continue to strategically execute restructuring and realignment actions primarily to reposition our European and North American business in an effort to optimize our cost structure and improve our operational efficiency and effectiveness. During 2015, we incurred $6 million and $14 million in restructuring and realignment costs, respectively. As a result of the restructuring actions in 2015, we realized $2 million of net savings and expect to realize approximately $1 million of incremental net savings in 2016. During 2016, we expect to incur approximately $25 million in restructuring and realignment costs. We expect to realize approximately $8 million of savings from our 2016 actions.

Additional strategic actions we are taking include strategic initiatives to drive above-market growth, advance continuous improvement activities to increase productivity, focus on improving cash performance and drive a disciplined capital deployment strategy.

| Results of Operations (in millions) | 2015 | 2014 | 2013 | 2015 v. 2014 | 2014 v. 2013 |
|---|---|---|---|---|---|
| Revenue | $3,653 | $3,916 | $3,837 | (6.7)% | 2.1 % |
| Gross profit | 1,404 | 1,513 | 1,499 | (7.2)% | 0.9 % |
| Gross margin | 38.4 % | 38.6 % | 39.1 % | (20)bp | (50)bp |
| Operating expenses excluding restructuring and realignment costs and special charges | 930 | 1,007 | 1,048 | (7.6)% | (3.9)% |
| Expense to revenue ratio | 25.5 % | 25.7 % | 27.3 % | (20)bp | (160)bp |
| Restructuring and realignment costs | 20 | 43 | 64 | (53.5)% | (32.8)% |
| Special charges | 5 | — | 24 | NM | NM |
| Total operating expenses | 955 | 1,050 | 1,136 | (9.0)% | (7.6)% |
| Operating income | 449 | 463 | 363 | (3.0)% | 27.5 % |
| Operating margin | 12.3 % | 11.8 % | 9.5 % | 50 bp | 230 bp |
| Interest and other non-operating expense (income), net | 55 | 53 | 65 | 3.8 % | (18.5)% |
| Gain on sale of business | 9 | 11 | — | (18.2)% | NM |
| Income tax expense | 63 | 84 | 70 | (25.0)% | 20.0 % |
| Tax rate | 15.6 % | 19.8 % | 23.5 % | (420)bp | (370)bp |
| Net income | $340 | $337 | $228 | 0.9 % | 47.8 % |

NM Not Meaningful

2015 versus 2014

Revenue

Revenue generated for 2015 was $3,653 million, a decrease of $263 million, or 6.7%, compared to $3,916 million in 2014. On a constant currency basis, revenue grew 1.3%. This increase was primarily driven by strong organic growth within emerging markets, particularly in China and India. The United States and western Europe also grew organically, which was partially offset by declines in Canada. In addition, the organic growth was partially offset by the divestiture of the Wolverhampton valves business early in the third quarter of 2014.

The following table illustrates the impact on 2015 revenue from organic growth, recent acquisitions/divestitures, and foreign currency translation in relation to revenue.

| (in millions) | $ Change | % Change |
|---|---|---|
| 2014 Revenue | $3,916 | |
| Organic Growth | 60 | 1.5 % |
| Acquisitions/(Divestitures) | (10) | (0.3)% |
| Constant Currency | 50 | 1.3 % |
| Foreign currency translation (a) | (313) | (8.0)% |
| Total change in revenue | (263) | (6.7)% |
| 2015 Revenue | $3,653 | |

(a) Foreign currency translation impact primarily due to fluctuations in the value of the Euro, Swedish Krona, Australian Dollar, British Pound, Canadian Dollar and Norwegian Krone against the U.S. Dollar.

The following table summarizes revenue by segment for 2015 and 2014:

| (in millions) | 2015 | 2014 | As Reported Change | Constant Currency Change |
|---|---|---|---|---|
| Water Infrastructure | $2,231 | $2,442 | (8.6)% | 0.9 % |
| Applied Water | 1,422 | 1,474 | (3.5)% | 1.8 % |
| Total | $3,653 | $3,916 | (6.7)% | 1.3 % |

Water Infrastructure

Water Infrastructure's revenue decreased $211 million, or 8.6% in 2015 (0.9% increase on a constant currency basis) compared to 2014. The constant currency increase was driven by organic growth of $22 million or 0.9% due to continued strength in the public utility end market partially offset by weakness in the industrial market. The industrial market performance decline was due to decreases in dewatering applications in the oil and gas market which more than offset increases in the balance of the industrial market.

From an application perspective, organic revenue grew in transport, treatment and test applications. The organic revenue growth from transport applications was predominately due to public utility strength in the emerging markets, the United States and in western Europe, partially offset by declines in industrial dewatering applications from weakness in the oil and gas market in Canada and the United States. The organic revenue growth from treatment applications was due to ozone and filtration projects in China and Australia which was somewhat offset by the lapping of a large project in Latin America in 2014 and general weakness in Europe. Organic revenue growth from test applications was driven by growth in China and India due to demand for new wastewater and river monitoring products.

Applied Water

Applied Water's revenue decreased $52 million, or 3.5% in 2015 (a 1.8% increase on a constant currency basis) compared to 2014. The growth on a constant currency basis is driven primarily by organic revenue growth of $38 million or 2.6% due to strength in the commercial, industrial water and residential end markets, partially offset by declines in the agriculture end market. This increase in the current year was partially offset by the absence of $11 million in revenue from the divested Wolverhampton valves business.

From an applications perspective, the increase in organic revenue was predominately due to continued growth in commercial building services from a recovering institutional building sector in the United States and strength in Asia. The industrial water application organic revenue grew from project strength in western Europe and the United States, which was partially offset by the aforementioned Wolverhampton divestiture. Residential building services organic revenue increased primarily in the United States due to improvements in the home construction market and market share gain. Irrigation applications organic revenue decline was largely impacted by severe flooding conditions in the southeast and southwest regions of the United States and the lapping of a strong fourth quarter in 2014.

Orders/Backlog

Orders received during 2015 decreased by $310 million, or 7.7% to $3,711 million (a 0.2% increase on a constant currency basis). Organic order growth increased $19 million or 0.5% for the year.

Water Infrastructure segment orders decreased $215 million, or 8.6% to $2,296 million (1.0% growth on a constant currency basis). Organic order growth of 1.0% was predominantly due to organic order increases for treatment applications due to large projects in the Middle East and Greater Asia. The organic orders for test applications were slightly up. Slightly offsetting these increases was a decline in organic orders for transport applications predominately due to decreases in the dewatering transport application due to weakness in the oil and gas market, which more than offset solid growth in the remainder of the transport applications.

Orders decreased in our Applied Water segment $95 million, or 6.3% to $1,415 million (1.0% decline on a constant currency basis). The order decline on a constant currency basis was due to the organic order volume decrease of 0.3%, due to market softness in the oil and gas and agricultural markets, as well as the absence of orders from our Wolverhampton valves divestiture.

Delivery schedules vary from customer to customer based upon their requirements. Typically, large projects require longer lead production cycles, and delays can occur from time to time. Total backlog was $716 million at December 31, 2015 and $740 million at December 31, 2014. This decrease is due to foreign currency translation impacts. We anticipate that approximately 81% of the backlog at December 31, 2015 will be recognized as revenue during 2016.

Gross Margin

Gross margins as a percentage of consolidated revenue declined to 38.4% in 2015 from 38.6% in 2014. The gross margin decline was primarily due to negative currency translation impacts. Excluding the negative currency translation impacts, gross margin was slightly higher as compared to 2014. Benefits realized from cost saving initiatives through global sourcing and lean six sigma, as well as increased volume, more than offset material and

labor inflation headwinds and unfavorable sales mix, primarily due to higher volume sold to the emerging markets.

Operating Expenses

| (in millions) | 2015 | | 2014 | | Change | |
|---|---|---|---|---|---|---|
| Selling, general and administrative expenses ("SG&A") | $854 | | $920 | | (7.2 | )% |
| SG&A as a % of revenue | 23.4 | % | 23.5 | % | (10 | )bp |
| Research and development expenses ("R&D") | 95 | | 104 | | (8.7 | )% |
| R&D as a % of revenue | 2.6 | % | 2.7 | % | (10 | )bp |
| Restructuring charges | 6 | | 26 | | (76.9 | )% |
| Operating expenses | $955 | | $1,050 | | (9.0 | )% |
| Expense to revenue ratio | 26.1 | % | 26.8 | % | (70 | )bp |

Selling, General and Administrative Expenses

SG&A decreased by $66 million or 7.2% to 23.4% of revenue in 2015, as compared to 23.5% of revenue in 2014. The decrease in SG&A expenses as a percentage of revenue was primarily due to currency translation impacts. Additionally, cost inflation was offset by cost savings from continuous improvement initiatives and restructuring actions as well as reduced realignment costs.

Research and Development Expenses

R&D spending decreased $9 million or 8.7% to 2.6% of revenue in 2015 as compared to 2.7% of revenue in 2014 primarily due to currency translation impacts.

Restructuring Charges

During 2015, we incurred restructuring costs of $5 million and $1 million in our Water Infrastructure and Applied Water segments, respectively. These charges were incurred primarily in an effort to realign our organizational structure in Europe and North America to optimize our cost structure. The charges relate to the reduction in structural costs, including a decrease in headcount and consolidation of facilities. During 2014, we recognized restructuring costs of $19 million, $6 million and $1 million in our Water Infrastructure and Applied Water segments, and Corporate and other, respectively. These charges were incurred primarily in an effort to realign our organizational structure in Europe and North America to optimize our cost structure. The charges relate to the reduction in structural costs, including a decrease in headcount and consolidation of facilities.

Total expected costs associated with actions that commenced during 2015 are approximately $5 million for Water Infrastructure and approximately $1 million for Applied Water. These costs primarily comprise severance charges. The Water Infrastructure actions are expected to continue through the second quarter of 2016. Substantially all of cost associated with the Applied Water actions have been incurred. As a result of these actions initiated in 2015, we achieved savings of approximately $2 million in 2015 and estimate annual future net savings beginning in 2016 of approximately $3 million, resulting in $1 million of incremental savings in 2016 from the 2015 actions.

Operating Income

We generated operating income of $449 million during 2015, a $14 million or 3.0% decrease from the prior year. Operating income as a percentage of revenue was 12.3% for 2015 versus 11.8% for 2014, an increase of 50 basis points. This increase in operating margin was primarily due to reduced restructuring and realignment costs, incremental cost savings from continuous improvement initiatives and slightly higher volume. Partially offsetting these actions were cost inflation, unfavorable mix and unfavorable foreign exchange translation impacts.

The following table illustrates operating income results for our business segments:

| (in millions) | 2015 | 2014 | Change |
|---|---|---|---|
| Water Infrastructure | $303 | $321 | (5.6)% |
| Applied Water | 190 | 193 | (1.6)% |
| Segment operating income | 493 | 514 | (4.1)% |
| Corporate and other | (44) | (51) | (13.7)% |
| Total operating income | $449 | $463 | (3.0)% |
| Operating margin | | | |
| Water Infrastructure | 13.6% | 13.1% | 50 bp |
| Applied Water | 13.4% | 13.1% | 30 bp |
| Total Xylem | 12.3% | 11.8% | 50 bp |

The table below provides a reconciliation of the total and each segment's operating income to adjusted operating income, and a calculation of the corresponding adjusted operating margin:

| (in millions) | 2015 | 2014 | Change |
|---|---|---|---|
| Water Infrastructure | | | |
| Operating income | $303 | $321 | (5.6)% |
| Restructuring and realignment costs | 13 | 29 | (55.2)% |
| Special charges | 1 | — | NM |
| Adjusted operating income | $317 | $350 | (9.4)% |
| Adjusted operating margin | 14.2% | 14.3% | (10)bp |
| Applied Water | | | |
| Operating income | $190 | $193 | (1.6)% |
| Restructuring and realignment costs | 7 | 13 | (46.2)% |
| Adjusted operating income | $197 | $206 | (4.4)% |
| Adjusted operating margin | 13.9% | 14.0% | (10)bp |
| Corporate and other | | | |
| Operating loss | $(44) | $(51) | (13.7)% |
| Restructuring and realignment costs | — | 1 | (100.0)% |
| Adjusted operating loss | $(44) | $(50) | (12.0)% |
| Total Xylem | | | |
| Operating income | $449 | $463 | (3.0)% |
| Restructuring and realignment costs | 20 | 43 | (53.5)% |
| Special charges | 1 | — | NM |
| Adjusted operating income | $470 | $506 | (7.1)% |
| Adjusted operating margin | 12.9% | 12.9% | — |

NM Not Meaningful

Water Infrastructure

Operating income for our Water Infrastructure segment decreased $18 million or 5.6% (decreased $33 million or 9.4% on an adjusted basis) compared to the prior year. On an adjusted basis the operating margin decreased from 14.3% to 14.2%. The reduction in operating margin was due to cost inflation and unfavorable mix resulting from the declines in our dewatering business driven by oil and gas weakness, and lower emerging market margins. This reduction was not quite offset by cost savings from procurement initiatives, lean six sigma initiatives and restructuring actions.

Applied Water

Operating income for our Applied Water segment decreased $3 million or 1.6% (decreased $9 million or 4.4% on an adjusted basis) compared to the prior year. On an adjusted basis the operating margin decreased from 14.0% to 13.9%. The reduction in operating margin was due to cost inflation, unfavorable mix and foreign exchange impacts, partially offset by cost reductions from procurement and lean six sigma initiatives and higher volume.

Corporate and other

Operating loss for corporate and other decreased $7 million or 13.7% (decreased $6 million or 12.0% on an adjusted basis) compared to the prior year. The reduction in adjusted operating loss was primarily due to reduced information technology and franchise tax costs.

Interest Expense

Interest expense was $55 million and $54 million for 2015 and 2014, respectively, primarily related to interest expense on $1.2 billion aggregate principal amount of our senior notes. Refer to Note 13, “Credit Facilities and Long-Term Debt,” for further details.

Income Tax Expense

The income tax provision for 2015 was $63 million at an effective tax rate of 15.6% compared to $84 million at an effective tax rate of 19.8% in 2014. The 2015 effective tax rate is lower than 2014 due primarily to geographic mix of earnings as well as a reduction in the amount of unrecognized tax benefits recorded.

Other Comprehensive (Loss) Income

Other comprehensive loss before tax of $130 million in 2015 as compared to $284 million loss in 2014 was primarily due to a $23 million net gain in postretirement benefit plans foreign currency in 2015 as compared to a net loss of $110 million for 2014. Further contributing to this decreased loss was a lower translation loss of $26 million primarily due to less weakening of the Euro against the U.S. Dollar largely offset by the additional weakening of the Swedish Krona against the U.S. Dollar. Additionally, there was a release of $8 million of currency translation gains out of Other comprehensive (loss) income recognized as part of the sale of a business.

2014 versus 2013

Revenue

Revenue generated for 2014 was $3,916 million, an increase of $79 million, or 2.1%, compared to $3,837 million in 2013. On a constant currency basis, revenue grew 3.3%. The following table illustrates the impact on 2014 revenue from organic growth, recent acquisitions, and fluctuations in foreign currency.

| (in millions) | $ Change | % Change |
|---|---|---|
| 2013 Revenue | $3,837 | |
| Organic Growth | 134 | 3.5 % |
| Acquisitions/(Divestitures) | (6) | (0.2)% |
| Constant Currency | 128 | 3.3 % |
| Foreign currency translation (a) | (49) | (1.3)% |
| Total change in revenue | 79 | 2.1 % |
| 2014 Revenue | $3,916 | |

(a) Foreign currency impact primarily due to weakness in the value of the Canadian Dollar, Australian Dollar, Argentine Peso, Swedish Krona and Norwegian Krone against the U.S. Dollar, partially offset by strength in the value of the British Pound against the U.S. Dollar.

The following table summarizes revenue by segment for 2014 and 2013:

| (in millions) | 2014 | 2013 | As Reported Change | Constant Currency Change |
|---|---|---|---|---|
| Water Infrastructure | $2,442 | $2,384 | 2.4 % | 4.4 % |
| Applied Water | 1,474 | 1,453 | 1.4 % | 1.6 % |
| Total | $3,916 | $3,837 | 2.1 % | 3.3 % |

Water Infrastructure

Water Infrastructure’s revenue increased $58 million, or 2.4% in 2014 (4.4% on a constant currency basis). The 4.4% constant currency increase reflects growth within the industrial water and public utility end markets and $6 million of incremental revenue from our 2013 acquisitions.

Organic revenue increased $99 million or 4.2% during the year, which was substantially due to higher volumes in transport, test and treatment applications. Revenue from transport applications grew primarily from increased industrial dewatering applications in the United States from oil and gas market-related rental activities. Transport

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also grew organically from public utility pump and aftermarket demand. Revenue from test applications increased due to significant strength in the United States from increased government spending coupled with the continued success of new products and cross-selling of our European technologies. Revenue from treatment applications grew from the delivery of several large projects in the emerging markets, particularly in Latin America, partially offset by lower deliverable project backlog in the United States and European markets.

Applied Water

Applied Water's revenue increased $21 million, or 1.4% in 2014 (a 1.6% increase on a constant currency basis). The growth on a constant currency basis is driven primarily by organic revenue growth of $35 million, or 2.4% versus the prior year due to strength in the commercial building services, industrial water and agriculture end markets, which more than offset declines in the residential building services. The increase in the current year was partially offset by the absence of revenue from our Wolverhampton valves business following its divestiture in the third quarter of 2014 as compared to $12 million of revenue for the comparative period in 2013.

Organic revenue increased $35 million or 2.4% for the year due primarily to commercial building recovery in the United States institutional building market, including distributor restocking and promotional activity. Also contributing to the organic growth was industrial water application strength across all regions, particularly from projects in the Middle East and Latin America. Irrigation application revenue also grew, driven by the timing of project shipments and increased demand for vertical turbines. A decline in European demand for residential applications partially offset organic growth.

Orders/Backlog

Orders received during 2014 increased by $109 million, or 2.8% to $4,021 million (a 3.9% increase on a constant currency basis). Organic order growth increased $153 million or 3.9% for the year.

Water Infrastructure segment orders increased $68 million, or 2.8% to $2,511 million (4.4% growth on a constant currency basis), including $8 million from acquisitions. Organic order growth of 4.1% was primarily due to higher industrial demand within transport for wastewater pumps in the United States and Europe as well as strength within the dewatering business for rental and equipment sales into oil and gas markets. Orders for test applications also bolstered the growth for the segment from large orders in the United States. The strength in transport and test offset declines in treatment from project delays in the United States and Europe.

Orders increased in our Applied Water segment $41 million, or 2.8% to $1,510 million (3.0% growth on a constant currency basis). Organic growth of 3.6% was driven by strong performance in the commercial building services and industrial water markets in the United States, as well as continued strength in China. The growth was partially offset by weakness in the residential markets of Europe.

Delivery schedules vary from customer to customer based upon their requirements. Typically, large projects require longer lead production cycles, and delays can occur from time to time. Total backlog was $740 million at December 31, 2014 and $707 million at December 31, 2013. We anticipate that more than 85% of the backlog at December 31, 2014 will be recognized as revenue during 2015.

Gross Margin

Gross margins as a percentage of consolidated revenue declined to 38.6% in 2014 from 39.1% in 2013. The decrease is primarily attributable to lower margin sales within the Water Infrastructure segment caused by higher mix sold to emerging markets, which have lower margins, in conjunction with foreign exchange headwinds as well as unfavorable product sales mix. These negative impacts were partially mitigated by benefits from restructuring savings and cost-saving initiatives through lean six sigma and global sourcing across both segments.

Operating Expenses

| (in millions) | 2014 | | 2013 | | Change | |
|---|---|---|---|---|---|---|
| Selling, General and Administrative (SG&A) | $920 | | $986 | | (6.7 | )% |
| SG&A as a % of revenue | 23.5 | % | 25.7 | % | (220 | )bp |
| Research and Development (R&D) | 104 | | 104 | | — | % |
| R&D as a % of revenue | 2.7 | % | 2.7 | % | — | bp |
| Restructuring and asset impairment charges | 26 | | 42 | | (38.1 | )% |
| Separation Costs | — | | 4 | | NM | |
| Operating expenses | $1,050 | | $1,136 | | (7.6 | )% |
| Expense to revenue ratio | 26.8 | % | 29.6 | % | (280 | )bp |

NM Not meaningful percentage change

Selling, General and Administrative Expenses

SG&A decreased by $66 million or 6.7% to $920 million, or 23.5% of revenue in 2014, as compared to $986 million or 25.7% of revenue in 2013. The decrease in SG&A expenses as a percentage of revenue is due primarily to savings from restructuring actions combined with lapping the impacts from non-recurring special charges in 2013 of $24 million, which comprise the legal settlement with Xylem Group LLC, costs incurred for the change in our chief executive officer, costs incurred for the contractual indemnification of federal tax obligations to ITT and costs associated with a legal judgment arising from a historical acquisition matter. The decrease was also driven by $7 million less realignment costs in 2014, which were costs incurred by the Company to reposition our European business in an effort to optimize our cost structure and improve our operational efficiency and effectiveness as well as implement our new organizational structure.

Research and Development Expenses

R&D spending was flat at $104 million or 2.7% of revenue in both 2014 and 2013.

Restructuring and Asset Impairment Charges

During 2014, we incurred restructuring costs of $19 million, $6 million and $1 million in our Water Infrastructure and Applied Water segments, and Corporate and other, respectively. These charges were incurred primarily in an effort to realign our organizational structure in Europe and North America to optimize our cost structure. The charges relate to the reduction in structural costs, including a decrease in headcount and consolidation of facilities. During 2013, we recognized restructuring costs of $31 million and $9 million in our Water Infrastructure and Applied Water segments, respectively. These charges were incurred primarily in an effort to realign our organizational structure in Europe and North America to address declines in sales volumes and optimize our cost structure. The charges relate to the reduction in structural costs, including a decrease in headcount and consolidation of facilities.

Total expected costs associated with actions that commenced during 2014 are approximately $19 million for Water Infrastructure, approximately $6 million for Applied Water and approximately $1 million for Corporate and other. These costs primarily comprise severance charges and the actions are substantially complete. As a result of these actions initiated in 2014, we achieved savings of approximately $13 million in 2014 and annual future net savings beginning in 2015 of approximately $26 million.

Total costs associated with actions that commenced during 2013 are approximately $32 million for Water Infrastructure and approximately $8 million for Applied Water. These costs primarily comprise severance charges. These actions are substantially complete. As a result of actions initiated during 2013, we achieved net savings of approximately $13 million in 2013 and annual future net savings beginning in 2014 of approximately $36 million. Additionally, in the fourth quarter of 2013, we recorded a $2 million impairment charge related to three trade names in our Water Infrastructure segment associated with acquired businesses within our Analytics operating unit, reflecting a decline in their value since being acquired. Refer to Note 4, “Restructuring and Asset Impairment Charges,” for additional information.

Operating Income

We generated operating income of $463 million during 2014, a $100 million or 27.5% increase from the prior year operating income of $363 million, primarily reflecting cost-saving initiatives and savings from restructuring actions. These benefits were partially offset by cost inflation combined with unfavorable impacts from our geographic and product sales mix described above. Another driving factor in the year-over-year improvement was the absence of the aforementioned special charges in 2013 within SG&A, which did not recur as well as lower restructuring and realignment costs. The following table illustrates operating income results by business segments for 2014 and 2013.

| (in millions) | 2014 | 2013 | Change |
|---|---|---|---|
| Water Infrastructure | $321 | $263 | 22.1 % |
| Applied Water | 193 | 175 | 10.3 % |
| Segment operating income | 514 | 438 | 17.4 % |
| Corporate and other | (51) | (75) | (32.0)% |
| Total operating income | $463 | $363 | 27.5 % |
| Operating margin | | | |
| Water Infrastructure | 13.1 % | 11.0 % | 210 bp |
| Applied Water | 13.1 % | 11.6 % | 150 bp |
| Total Xylem | 11.8 % | 9.5 % | 230 bp |

The table included below provides a reconciliation from segment operating income to adjusted operating income, and a calculation of the corresponding adjusted operating margin.

| (in millions) | 2014 | 2013 | Change |
|---|---|---|---|
| Water Infrastructure | | | |
| Operating income | $321 | $263 | 22.1 % |
| Restructuring and realignment costs | 29 | 48 | (39.6)% |
| Special charges | — | 4 | NM |
| Adjusted operating income | $350 | $315 | 11.1 % |
| Adjusted operating margin | 14.3 % | 13.2 % | 110 bp |
| Applied Water | | | |
| Operating income | $193 | $175 | 10.3 % |
| Restructuring and realignment costs | 13 | 16 | (18.8)% |
| Adjusted operating income | $206 | $191 | 7.9 % |
| Adjusted operating margin | 14.0 % | 13.1 % | 90 bp |
| Corporate and other | | | |
| Operating loss | $(51) | $(75) | (32.0)% |
| Restructuring and realignment costs | 1 | — | NM |
| Special charges | — | 20 | 100.0 % |
| Adjusted operating loss | $(50) | $(55) | (9.1)% |
| Total Xylem | | | |
| Operating income | $463 | $363 | 27.5 % |
| Restructuring and realignment costs | 43 | 64 | (32.8)% |
| Special charges | — | 24 | NM |
| Adjusted operating income | $506 | $451 | 12.2 % |
| Adjusted operating margin | 12.9 % | 11.8 % | 110 bp |

NM Not meaningful percentage change

Water Infrastructure

Operating income for our Water Infrastructure segment increased $58 million or 22.1% (increased $35 million or 11.1% on an adjusted basis) compared with the prior year. The 11.1% increase was primarily driven by higher volume, restructuring savings and cost reduction initiatives, such as global sourcing and lean six sigma. The increase was partially offset by cost inflation, unfavorable sales mix and price.

Applied Water

Operating income for our Applied Water segment increased $18 million or 10.3% (increased $15 million or 7.9% on an adjusted basis) compared to the prior year. The 7.9% increase was driven by lean six sigma initiatives, global sourcing and restructuring savings combined with modest price realization. The increase was partially offset by cost inflation and unfavorable foreign exchange headwinds.

Corporate and other

Operating loss for corporate and other decreased $24 million or 32.0% (decreased $5 million or 9.1% on an adjusted basis) compared to the prior year. The reduction in adjusted operating loss was primarily due to reduced stock based compensation expense and costs associated with the corporate headquarter move in 2013 that did not recur in 2014.

Interest Expense

Interest expense was $54 million and $55 million for 2014 and 2013, respectively, primarily related to interest expense on $1.2 billion aggregate principal amount of our senior notes. Refer to Note 13, “Credit Facilities and Long-Term Debt,” for further details.

Income Tax Expense

The income tax provision for 2014 was $84 million at an effective tax rate of 19.8% compared to $70 million at an effective tax rate of 23.5% in 2013. The 2014 effective tax rate is lower than 2013 due primarily to geographic mix of earnings.

Other Comprehensive (Loss) Income

Other comprehensive loss before tax of $284 million in 2014 as compared to income of $74 million in 2013 was primarily due to a $221 million foreign currency translation impact due to a weakening of the Euro, British Pound and Swedish Krona against the U.S. Dollar. Further contributing to the year-over-year decline was a $110 million net loss in postretirement benefit plans in 2014 as compared to a net gain of $34 million in 2013 due to a decrease in discount rates, partially mitigated by actual gains on plan assets in excess of the assumed long-term rate of return. The effective tax rate on other comprehensive income decreased as compared to 2013 due primarily to the shift in comprehensive earnings from foreign currency translation, which is not taxable, as well as from a change in the jurisdictional mix of net gains and losses from postretirement benefit plans.

Liquidity and Capital Resources

The following table summarizes our sources and uses of cash:

| | Year Ended December 31, | | |
|---|---|---|---|
| (in millions) | 2015 | 2014 | 2013 |
| Operating activities | $464 | $416 | $324 |
| Investing activities | (132) | (86) | (199) |
| Financing activities | (262) | (147) | (100) |
| Foreign exchange (a) | (53) | (53) | 4 |
| Total | $17 | $130 | $29 |

(a) 2015 and 2014 impact is primarily due to the weakness of the Euro against the U.S. Dollar.

Sources and Uses of Liquidity

Operating Activities

During 2015, net cash provided by operating activities was $464 million, compared to $416 million in 2014. The $48 million year-over-year increase was primarily driven by a decrease in the use of working capital from reduced inventory levels in 2015 and improved collections of receivables. Lower payments for restructuring and

postretirement benefit plans were more than offset by increased payments for foreign value-added taxes as compared to the prior year.

During 2014, net cash provided by operating activities was $416 million, compared to $324 million in 2013. The $92 million year-over-year increase was driven by an increase in income, as well as a modest improvement in working capital performance. Reductions in payments made for restructuring and postretirement plan contributions in 2014 were largely offset by an increase in tax payments. Also contributing to the increase was a refund of value-added tax in the current year that had been paid during 2013.

Investing Activities

Cash used in investing activities was $132 million for 2015, compared to $86 million in 2014. The increase of $46 million was primarily due to $18 million spent on an acquisition in 2015 as compared to nothing in 2014 as well as cash received in 2014 of $30 million for the sale of our Wolverhampton business.

Cash used in investing activities was $86 million in 2014 compared to $199 million in 2013. The decrease of $113 million was primarily driven by a decrease in acquisition activity as there were no acquisitions in 2014, whereas we spent $81 million for acquisitions during 2013. Also contributing to the decrease was the receipt of $30 million in 2014 for the sale of a business. Capital expenditures were also lower in 2014, with a $7 million reduction primarily due to a decrease in the spending on post Spin-off information technology investments and the relocation of our corporate headquarters.

Financing Activities

Cash used by financing activities was $262 million, $147 million and $100 million during 2015, 2014 and 2013, respectively. In 2015, the $115 million increase is primarily driven by an increase in share repurchase activity of $45 million and an increase of $8 million, or a 10% per share increase, in dividends paid to shareholders as well as a decrease in cash received from short-term debt borrowings under the European Investment Bank facility of $50 million. In 2014, the $47 million increase reflected cash used for share repurchase activity increasing $61 million and dividend payments increasing $7 million compared to 2013. These uses were partially offset by an increase in cash received from short-term debt borrowings under the European Investment Bank facility of $50 million in 2014 versus $38 million in 2013.

Funding and Liquidity Strategy

Our ability to fund our capital needs depends on our ongoing ability to generate cash from operations, and access to bank financing and the capital markets. Historically, we have generated operating cash flow sufficient to fund our primary cash needs centered on operating activities, working capital, capital expenditures, and strategic investments. If our cash flows from operations are less than we expect, we may need to incur debt or issue equity. From time to time, we may need to access the long-term and short-term capital markets to obtain financing. Our access to, and the availability of, financing on acceptable terms and conditions in the future will be impacted by many factors, including: (i) our credit ratings or absence of a credit rating, (ii) the liquidity of the overall capital markets, and (iii) the current state of the economy. There can be no assurance that such financing will be available to us on acceptable terms or that such financing will be available at all.

Our global funding requirements are continually monitored with appropriate strategies executed to ensure liquidity needs are met cost effectively. Based on our current global cash positions, cash flows from operations and access to the commercial paper markets, we believe there is sufficient liquidity to meet our funding requirements. In addition, our existing committed credit facilities and access to the public debt markets would provide further liquidity if required.

We anticipate that our present sources of funds, including funds from operations and additional borrowings, will provide us with sufficient liquidity and capital resources to meet our liquidity and capital needs in both the United States and outside of the United States over the next twelve months.

Senior Notes

On September 20, 2011, we issued 3.550% Senior Notes of $600 million aggregate principal amount due September 2016 (the "Senior Notes due 2016") and 4.875% Senior Notes of $600 million aggregate principal amount due October 2021 (the "Senior Notes due 2021" and together with the Senior Notes due 2016, the "Senior Notes").

The Senior Notes include covenants which restrict our ability, subject to exceptions, to incur debt secured by liens and engage in sale and leaseback transactions, as well as provide for customary events of default (subject, in certain cases,

to receipt of notice of default and/or customary grace and cure periods). We may redeem the Senior

Notes, as applicable, in whole or in part, at any time at a redemption price equal to the principal amount of the Senior Notes to be redeemed, plus a make-whole premium. If a change of control triggering event (as defined in the Senior Notes) occurs, we will be required to make an offer to purchase the Senior Notes at a price equal to 101% of their principal amount plus accrued and unpaid interest to the date of repurchase. As of December 31, 2015, we were in compliance with all covenants.

Interest on the Senior Notes due 2016 is payable on March 20 and September 20 of each year. Interest on the Senior Notes due 2021 is payable on April 1 and October 1 of each year.

As of December 31, 2015, we have classified $600 million of our Senior Notes due 2016 as long-term based on our current ability and intent to refinance the outstanding borrowings on a long-term basis.

Credit Facility

Effective March 27, 2015, Xylem entered into a Five-Year Revolving Credit Facility with Citibank, N.A., as administrative agent, and a syndicate of lenders. The Credit Facility provides for an aggregate principal amount of up to $600 million of: (i) revolving extensions of credit outstanding at any time and (ii) the issuance of letters of credit in a face amount not in excess of $100 million outstanding at any time. The Credit Facility provides for increases of up to $200 million for a possible maximum total of $800 million in aggregate principal amount at our request and with the consent of the institutions providing such increased commitments.

At our election, the interest rate per annum applicable to the revolving loans will be based on either (i) a Eurodollar rate determined by reference to LIBOR, adjusted for statutory reserve requirements, plus an applicable margin or (ii) a fluctuating rate of interest determined by reference to the greatest of: (a) the prime rate of Citibank, N.A., (b) the U.S. Federal funds effective rate plus 0.5% or (c) the Eurodollar rate determined by reference to LIBOR, adjusted for statutory reserve requirements, in each case, plus an applicable margin.

In accordance with the terms, we may not exceed a maximum leverage ratio of 3.50 to 1.00 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. The Credit Facility also contains limitations on, among other things, incurring secured debt, granting liens, entering into sale and leaseback transactions, mergers, consolidations, liquidations, dissolutions and sales of assets. In addition, the Credit Facility contains other terms and conditions such as customary representations and warranties, additional covenants and customary events of default. As of December 31, 2015, we were in compliance with all covenants.

As of December 31, 2015, the Credit Facility was undrawn.

Research and Development Facility Agreement

On December 3, 2015, the Company amended and restated its Risk Sharing Finance Facility Agreement (the "R&D Facility Agreement") with The European Investment Bank (the "EIB") to amend the maturity date. The facility provides an aggregate principal amount of up to €120 million (approximately $132 million) to finance research projects and infrastructure development in the European Union. The Company's wholly owned subsidiaries in Luxembourg, Xylem Holdings S.á r.l. and Xylem International S.á r.l., are the borrowers under the R&D Facility Agreement. The obligations of the borrowers under the R&D Facility Agreement are guaranteed by the Company under an Amended and Restated Deed of Guarantee, dated as of December 4, 2013, in favor of the EIB. The funds are available during the period from 2013 through 2016 at the Company's facilities in Sweden, Germany, Italy, the United Kingdom, Austria, Norway and Hungary.

Under the R&D Facility Agreement, the borrower can draw loans on or before March 31, 2016 with a maturity of no longer than 12 years. The R&D Facility Agreement provides for Fixed Rate loans and Floating Rate loans. The interest rate per annum applicable to Fixed Rate loans is at a fixed percentage rate per annum specified by the EIB which includes the applicable margin. The interest rate per annum applicable to Floating Rate loans is at the rate determined by reference to EURIBOR for loans drawn in Euros and LIBOR for loans drawn in Pounds Sterling or U.S. Dollars, plus an applicable spread specified by the EIB which includes the applicable margin. The applicable margin for both Fixed Rate loans and Floating Rate loans is determined by reference to the credit rating of the Company.

In accordance with the terms of the R&D Facility Agreement, we may not exceed a maximum leverage ratio of 3.50 to 1.00 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. The R&D Facility Agreement also contains limitations on, among other things, incurring debt, granting liens, and entering into sale and leaseback transactions. In addition, the R&D Facility Agreement contains other terms and

conditions, such as customary representations and warranties, additional covenants and customary events of default. As of December 31, 2015, we were in compliance with all covenants.

As of December 31, 2015 and 2014, $76 million and $84 million was outstanding, respectively, under the R&D Facility Agreement. Although the borrowing term for this arrangement is up to five years, we have classified it as short-term debt on our Consolidated Balance Sheet since we intend to repay this obligation in less than a year.

Non-U.S. Operations

For 2015 and 2014, we generated 59% and 62% of our revenue from non-U.S. operations, respectively. As we continue to grow our operations in the emerging markets and elsewhere outside of the United States, we expect to continue to generate significant revenue from non-U.S. operations and we expect our cash will be predominately held by our foreign subsidiaries. We expect to manage our worldwide cash requirements considering available funds among the many subsidiaries through which we conduct business and the cost effectiveness with which those funds can be accessed. We may transfer cash from certain international subsidiaries to the U.S. and other international subsidiaries when we believe it is cost effective to do so. We continually review our domestic and foreign cash profile, expected future cash generation and investment opportunities, which support our current designation of a portion of these funds as being indefinitely reinvested and reassess whether there is a demonstrated need to repatriate funds held internationally to support our U.S. operations. If, as a result of our review, it is determined that all or a portion of the funds may be needed for our operations in the United States, we may be required to accrue additional U.S. taxes. As of December 31, 2015, our foreign subsidiaries were holding $656 million in cash or marketable securities.

As of December 31, 2015, our excess of financial reporting over the tax basis of investments in certain foreign subsidiaries totaled $1.9 billion. We have not asserted that $41 million of our excess basis difference will be indefinitely reinvested and have therefore provided for U.S or additional foreign withholding taxes for that portion. Generally, such amounts become subject to U.S. taxation upon the remittance of dividends and under certain other circumstances.

Contractual Obligations

The following table summarizes our contractual commitments as of December 31, 2015:

| (in millions) | 2016 | 2017 - 2018 | 2019 - 2020 | Thereafter | Total |
|---|---|---|---|---|---|
| Debt and capital lease obligations (1) | $678 | $— | $— | $600 | $1,278 |
| Interest payments (1) (2) | 51 | 59 | 59 | 29 | 198 |
| Operating lease obligations | 55 | 76 | 40 | 19 | 190 |
| Purchase obligations (3) | 82 | 3 | — | — | 85 |
| Other long-term obligations reflected on the balance sheet | 3 | 6 | 5 | 8 | 22 |
| Total commitments | $869 | $144 | $104 | $656 | $1,773 |

In addition to the amounts presented in the table above, we have recorded liabilities for uncertain tax positions of $47 million, net investment hedges of $18 million and employee severance indemnity of $13 million. These amounts have been excluded from the contractual obligations table due to an inability to reasonably estimate the timing or amounts of such payments in individual years. Further, benefit payments which reflect expected future service related to the Company's pension and other postretirement employee benefit obligations are presented in Note 14, “Postretirement Benefit Plans” of the consolidated financial statements and not included in the above table. Finally, estimated environmental payments and workers' compensation and general liability reserves are excluded from the table above. We estimate, based on historical experience, that we will spend approximately $1 million to $2 million per year on environmental investigation and remediation and approximately $4 million to $5 million per year on workers' compensation and general liability. At December 31, 2015, we had estimated and accrued $4 million and $24 million related to environmental matters, and workers' compensation and general liability, respectively.

(1) Refer to Note 13, “Credit Facilities and Long-Term Debt,” of the consolidated financial statements for discussion of the use and availability of debt and revolving credit agreements. Amounts represent principal payments of long-term debt including current maturities and exclude unamortized discounts. As of December 31, 2015, we have classified $600 million of our Senior Notes due 2016 as long-term based on our current ability and intent to refinance the outstanding borrowings on a long-term basis, however, we cannot reasonably estimate the future debt terms and interest payments.

(2) Amounts represent estimates of future interest payments on long-term debt outstanding as of December 31, 2015.

(3)

Represents unconditional purchase agreements that are enforceable and legally binding and that specify all significant terms to purchase goods or services, including fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. Purchase agreements that are able to cancel without penalty have been excluded.

Off-Balance Sheet Arrangements

As of December 31, 2015, we have issued guarantees for the debt and other obligations of consolidated subsidiaries in the normal course of business. We have determined that none of these arrangements has a material current effect or is reasonably likely to have a material future effect on our consolidated financial statements, financial condition, changes in financial condition, revenues or expenses, liquidity, capital expenditures or capital resources.

We obtain certain stand-by letters of credit, bank guarantees and surety bonds from third-party financial institutions in the ordinary course of business when required under contracts or to satisfy insurance related requirements. As of December 31, 2015, the amount of stand-by letters of credit, bank guarantees and surety bonds was $161 million.

Critical Accounting Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses, and the disclosure of contingent liabilities. Management bases its estimates on historical experience and on various other assumptions that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources.

Significant accounting policies used in the preparation of the Consolidated Financial Statements are discussed in Note 1, “Summary of Significant Accounting Policies,” of the consolidated financial statements. Accounting estimates and assumptions discussed in this section are those that we consider most critical to an understanding of our financial statements because they are inherently uncertain, involve significant judgments, include areas where different estimates reasonably could have been used, and changes in the estimate that are reasonably possible could materially impact the financial statements. Management believes that the accounting estimates employed and the resulting balances are reasonable; however, actual results in these areas could differ from management’s estimates under different assumptions or conditions.

Revenue Recognition. We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collectability of the sales price is reasonably assured. For product sales, delivery does not occur until the products have been shipped, risk of loss has been transferred to the customer and the contractual terms have been fulfilled. In instances where contractual terms include a provision for customer acceptance, revenue is recognized when either (i) we have previously demonstrated that the product meets the specified criteria based on either seller- or customer-specified objective criteria or (ii) upon formal acceptance received from the customer where the product has not been previously demonstrated to meet customer-specified objective criteria. Revenue on service and repair contracts is recognized after services have been agreed to by the customer and rendered.

We enter into contracts to sell our products and services, and while the majority of our sales agreements contain standard terms and conditions, certain agreements contain multiple elements or non-standard terms and conditions. Where sales agreements contain multiple elements or non-standard terms and conditions, judgment is required to determine the appropriate accounting, including whether the deliverables specified in these agreements should be treated as separate units of accounting for revenue recognition purposes, and, if so, how the transaction price should be allocated among the elements and when to recognize revenue for each element. When a sale involves multiple deliverables, the total revenue from the arrangement is allocated to each unit of accounting based on the relative selling price of the deliverable to all other deliverables in the contract. Revenue for multiple element arrangements is recognized when the appropriate revenue recognition criteria for the individual deliverable have been satisfied. The allocation of sales price between elements may impact the timing of revenue recognition, but will not change the total revenue recognized on the arrangement. For delivered elements accounted for as separate units of accounting in a multiple element arrangement, revenue is recognized only when the delivered elements have standalone value, there are no uncertainties regarding customer acceptance and there are no customer-negotiated refund or return rights affecting the sales recognized.

Certain businesses enter into long-term construction-type sales contracts for which revenue is recognized under the percentage-of-completion method based upon percentage of costs incurred to total estimated costs.

We record a reduction in revenue at the time of sale for estimated product returns, rebates and other allowances, based on historical experience and known trends.

Income Taxes. Deferred tax assets and liabilities are determined based on temporary differences between the financial reporting and tax bases of assets and liabilities, applying enacted tax rates in effect for the year in which

we expect the differences will reverse. Based on the evaluation of available evidence, we recognize future tax benefits, such as net operating loss carryforwards, to the extent that we believe it is more likely than not we will realize these benefits. We periodically assess the likelihood that we will be able to recover our deferred tax assets and reflect any changes to our estimate of the amount we are more likely than not to realize in the valuation allowance, with a corresponding adjustment to earnings or other comprehensive income, as appropriate.

In assessing the need for a valuation allowance, we look to the future reversal of existing taxable temporary differences, taxable income in carryback years and the feasibility of tax planning strategies and estimated future taxable income. The valuation allowance can be affected by changes to tax laws, changes to statutory tax rates and changes to future taxable income estimates.

Our effective tax rate reflects the impact of certain undistributed foreign earnings for which we have not provided U.S. taxes because we plan to reinvest such earnings indefinitely outside the United States. We plan foreign earnings remittance amounts based on projected cash flow needs, as well as the working capital and long-term investment requirements of our foreign subsidiaries and our domestic operations. Based on these assumptions, we estimate the amount we will distribute to the United States and provide the U.S. federal taxes due on these amounts. Material changes in our estimates of cash, working capital and long-term investment requirements in the various jurisdictions in which we do business could impact our effective tax rate.

The calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax regulations in a multitude of jurisdictions across our global operations. We recognize potential liabilities and record tax liabilities for anticipated tax audit issues in the U.S. and other tax jurisdictions based on our estimate of whether, and to the extent to which, additional taxes will be due. Furthermore, we 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, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement.

We adjust our liability for uncertain tax positions in light of changing facts and circumstances; however, due to the complexity of some of these uncertainties, the ultimate resolution may result in a payment that is materially different from our current estimate of the tax liabilities. If our estimate of tax liabilities proves to be less than the ultimate assessment, an additional tax expense would result. If a payment of these amounts ultimately proves to be less than the recorded amounts, the reversal of the liabilities would result in tax benefits being recognized in the period when we determine the liabilities are no longer necessary.

Goodwill and Intangible Assets. We review goodwill and indefinite-lived intangible assets for impairment annually and whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. We also review the carrying value of our finite-lived intangible assets for potential impairment when impairment indicators arise. We conduct our annual impairment test as of the first day of the fourth quarter. We perform a two-step impairment test for goodwill. In the first step, we compare the estimated fair value of each reporting unit to its carrying value. If the estimated fair value of the reporting unit exceeds the carrying value of the net assets assigned to that reporting unit, goodwill is not impaired and we are not required to perform further testing. If the carrying value of the net assets assigned to the reporting unit exceeds its fair value, then we must perform the second step of the impairment test in order to measure the impairment loss to be recorded, if any. If the carrying value of a reporting unit’s goodwill exceeds its implied fair value, then we record an impairment loss equal to the difference. In our annual impairment test for indefinite-lived intangible assets, we compare the fair value of those assets to their carrying value. We recognize an impairment loss when the estimated fair value of the indefinite-lived intangible asset is less than its carrying value. We estimate the fair value of our reporting units and intangible assets with indefinite lives using an income approach. Under the income approach, we calculate fair value based on the present value of estimated future cash flows.

Determining the fair value of a reporting unit or an indefinite-lived intangible asset is judgmental in nature and involves the use of significant estimates and assumptions, particularly related to future operating results and cash flows. These estimates and assumptions include, but are not limited to, revenue growth rates and operating margins used to calculate projected future cash flows, risk-adjusted discount rates, assumed royalty rates, future economic and market conditions and identification of appropriate market comparable data. In addition, the identification of reporting

units and the allocation of assets and liabilities to the reporting units when determining the carrying value of each reporting unit also require judgment. Goodwill is tested for impairment at either the operating segment identified in Note 20, “Segment and Geographic Data,” of the consolidated financial statements, or one level below. The fair value of our reporting units and indefinite-lived intangible assets is based on estimates and assumptions that are believed to be reasonable. Significant changes to these estimates and assumptions could adversely impact our conclusions. Actual future results may differ from those estimates.

During the fourth quarter of 2015, we performed our annual impairment assessment and determined that the estimated fair values of our goodwill reporting units were substantially in excess of each of their carrying values. However, future goodwill impairment tests could result in a charge to earnings. We will continue to evaluate goodwill on an annual basis as of the beginning of our fourth quarter and whenever events and changes in circumstances indicate there may be a potential impairment. We determined that no impairment of the indefinite-lived intangibles existed as of the measurement date in 2015.

Contingent Liabilities. As discussed in Note 18, "Commitments and Contingencies" of the consolidated financial statements, the Company is, from time to time, subject to a variety of litigation, environmental liabilities, product liabilities, and similar contingent liabilities incidental to its business (or the business operations of previously owned entities). The Company recognizes a liability for any contingency that is known or probable of occurrence and reasonably estimable. These assessments require judgments concerning matters such as litigation developments and outcomes, the anticipated outcome of negotiations, the number of future claims and the cost of both pending and future claims. In addition, because most contingencies are resolved over long periods of time, liabilities may change in the future due to various factors, including those discussed in Note 18 of the consolidated financial statements. If the liabilities established by the Company with respect to these contingencies are inadequate, the Company would be required to incur an expense equal to the amount of the loss incurred in excess of the recorded liability, which would adversely affect the Company’s financial statements.

Receivables and Allowance for Doubtful Accounts and Discounts. Receivables primarily comprise uncollected amounts owed to us from transactions with customers and are presented net of allowances for doubtful accounts and early payment discounts.

We determine our allowance for doubtful accounts using a combination of factors to reduce our trade receivable balances to their estimated net realizable amount. We maintain an allowance for doubtful accounts based on a variety of factors, including the length of time receivables are past due, macroeconomic trends and conditions, significant one-time events, historical experience and the financial condition of customers. In addition, we record a specific reserve for individual accounts when we become aware of specific customer circumstances, such as in the case of bankruptcy filings or deterioration in the customer’s operating results or financial position. The past due or delinquency status of a receivable is based on the contractual payment terms of the receivable. If circumstances related to the specific customer change, we adjust estimates of the recoverability of receivables as appropriate. We determine our allowance for early payment discounts primarily based on historical experience with customers.

Credit risk with respect to accounts receivable is generally diversified due to the large number of entities comprising our customer base and their dispersion across many different geographical regions. We perform ongoing credit evaluations of the financial condition of our third-party distributors, resellers and other customers and require collateral, such as letters of credit and bank guarantees, in certain circumstances. As of December 31, 2015 and 2014 we do not believe we have any significant concentrations of credit risk.

Postretirement Plans. Company employees around the world participate in numerous defined benefit plans. The determination of projected benefit obligations and the recognition of expenses related to these plans are dependent on various assumptions. These major assumptions primarily relate to discount rates, expected long-term rates of return on plan assets, rate of future compensation increases, mortality, health care inflation and years of service (some of which are disclosed in Note 14, “Postretirement Benefit Plans,” of the consolidated financial statements) and other factors. Actual results that differ from our assumptions are accumulated and amortized on a straight-line basis only to the extent they exceed 10% of the higher of the market-related value or projected benefit obligation, over the average remaining service period of active plan participants, or for plans with all or substantially all inactive participants, over the average remaining life expectancy.

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Significant Assumptions

Management develops each assumption using relevant Company experience, in conjunction with market-related data for each individual country in which such plans exist. All assumptions are reviewed annually with third-party consultants and adjusted as necessary. The table included below provides the weighted average assumptions used to estimate our defined benefit pension obligations and costs as of and for the years ended 2015 and 2014.

| | 2015 | | | 2014 | | |
|---|---|---|---|---|---|---|
| | U.S. | | Int'l | U.S. | | Int'l |
| Benefit Obligation Assumptions | | | | | | |
| Discount rate | 4.27 | % | 3.44 % | 4.01 | % | 3.14 % |
| Rate of future compensation increase | NM | | 3.29 % | NM | | 3.34 % |
| Net Periodic Benefit Cost Assumptions | | | | | | |
| Discount rate | 4.01 | % | 3.14 % | 4.79 | % | 4.23 % |
| Expected long-term return on plan assets | 8.00 | % | 7.31 % | 8.00 | % | 7.30 % |
| Rate of future compensation increase | NM | | 3.34 % | NM | | 3.48 % |

NM Not meaningful. The pension benefits for future service for all the U.S. pension plans are based on years of service and not impacted by future compensation increases.

We determine the expected long-term rate of return on plan assets by evaluating both historical returns and estimates of future returns. Specifically, the Company analyzes the estimated future returns based on independent estimates of asset class returns and evaluates historical broad market returns over long-term timeframes based on the strategic asset allocation, which is detailed in Note 14, "Postretirement Benefit Plans," of the consolidated financial statements. Based on the approach described above, the chart below shows weighted average actual returns versus the weighted average expected long-term rates of return for our pension plans that were utilized in the calculation of the net periodic pension cost for each respective year.

| | 2015 | | 2014 | | 2013 | |
|---|---|---|---|---|---|---|
| Expected long-term rate of return on plan assets | 7.38 | % | 7.38 | % | 7.40 | % |
| Actual rate of return on plan assets | 3.51 | % | 18.13 | % | 10.17 | % |

For the recognition of net periodic pension cost, the calculation of the expected return on plan assets is generally derived by applying the expected long-term rate of return to the market-related value of plan assets. The market-related value of plan assets is based on average asset values at the measurement date over the last five years. The use of fair value, rather than a calculated value, could materially affect net periodic pension cost. The weighted average expected long-term rate of return for all of our plan assets to be used in determining net periodic benefit costs for 2016 is estimated at 7.32%. We estimate that every 25 basis point change in the expected return on plan assets impacts the expense by $1 million.

The discount rate reflects our expectation of the present value of expected future cash payments for benefits at the measurement date. A decrease in the discount rate increases the present value of benefit obligations and increases pension expense. We base the discount rate assumption on current investment yields of high-quality fixed income investments during the retirement benefits maturity period. The pension discount rate was determined by considering an interest rate yield curve comprising AAA/AA bonds, with maturities between zero and 30 years, developed by the plan's actuaries. Annual benefit payments are then discounted to present value using this yield curve to develop a single-point discount rate matching the plan's characteristics. Our weighted average discount rate for all pension plans effective January 1, 2016, is 3.53%. We estimate that every 25 basis point change in the discount rate impacts the expense by $1 million.

The rate of future compensation increase assumption reflects our long-term actual experience and future and near-term outlook. Effective January 1, 2016, our expected rate of future compensation is 3.29% for all pension plans. The estimated impact of a 25 basis point change in the expected rate of future compensation is less than $1 million.

The assumed rate of future increases in the per capita cost of health care (the health care trend rate) is 7.00% for 2016, decreasing ratably to 4.50% in 2027. An increase or decrease in the health care trend rates by one percent per year would impact the aggregate annual service and interest components by less than $1 million, and impact the benefit obligation by approximately $4 million.

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We currently anticipate making contributions to our pension and postretirement benefit plans in the range of $26 million to $36 million during 2016, of which $8 million is expected to be made in the first quarter.

Funded Status

Funded status is derived by subtracting the respective year-end values of the projected benefit obligations from the fair value of plan assets. We estimate that every 25 basis point change in the discount rate impacts the funded status by approximately $26 million.

Fair Value of Plan Assets

The plan assets of our pension plans comprise a broad range of investments, including domestic and foreign equity securities, interests in private equity and hedge funds, fixed income investments, insurance contracts, and cash and cash equivalents.

A portion of our pension benefit plan assets portfolio comprises investments in private equity and hedge funds. The private equity and hedge fund investments are generally measured at net asset value. However, in certain instances, the values reported by the asset managers were not current at the measurement date. Accordingly, we made estimate adjustments to the last reported value where necessary to measure the assets at fair value at the measurement date. These adjustments consider information received from the asset managers, as well as general market information. The adjustment recorded at December 31, 2015 and 2014 for these assets represented less than one percent of total plan assets in each respective year. Asset values for other positions were generally measured using market observable prices. We estimate that a 5% change in asset values will impact funded status by approximately $25 million.

New Accounting Pronouncements

See Note 2, “Recently Issued Accounting Pronouncements,” of the consolidated financial statements for a complete discussion of recent accounting pronouncements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to market risk, primarily related to foreign currency exchange rates and interest rates. These exposures are actively monitored by management. Our exposure to foreign exchange rate risk is due to certain costs, revenue and borrowings being denominated in currencies other than one of our subsidiaries functional currency. Similarly, we are exposed to market risk as the result of changes in interest rates which may affect the cost of our financing. It is our policy and practice to use derivative financial instruments only to the extent necessary to manage exposures.

Foreign Currency Exchange Rate Risk

We conduct approximately 59% of our business in various locations outside the United States.

Our economic foreign currency risk primarily relates to receipts from customers, payments to suppliers and intercompany transactions denominated in foreign currencies. We may use derivative financial instruments to offset risk related to receipts from customers and payments to suppliers, when it is believed that the exposure will not be limited by our normal operating and financing activities. We enter into currency forward contracts periodically in order to manage the exchange rate fluctuation risk on certain intercompany transactions associated with third party sales and purchases. These risks are also mitigated by natural hedges including the presence of manufacturing facilities outside the United States, global sourcing and other spending which occurs in foreign countries. Our principal foreign currency transaction exposures primarily relate to the Euro, Swedish Krona, Canadian Dollar, British Pound, Polish Zloty and Australian Dollar. We estimate that a hypothetical 10% movement in foreign currency exchange rates would not have a material economic impact to Xylem’s financial position and results of operations.

Additionally, we are subject to foreign exchange translation risk due to changes in the value of foreign currencies in relation to our reporting currency, the U.S. Dollar. The translation risk is primarily concentrated in the exchange rate between the U.S. Dollar and the Euro, British Pound, Chinese Yuan, Swedish Krona, Canadian Dollar and Australian Dollar. As the U.S. Dollar strengthens against other currencies in which we transact business, revenue and income will generally be negatively impacted, and if the U.S. Dollar weakens, revenue and income will generally be positively impacted. We estimate that a hypothetical 10% movement of the U.S. Dollar to the various foreign currency exchange rates we translate from, in the aggregate, could have approximately a 7% impact on Xylem's consolidated revenue and income as reported in U.S. Dollars. We expect to continue to generate significant revenue from non-U.S. operations and we expect our cash will be predominately held by our foreign subsidiaries. We expect to manage our worldwide cash requirements considering available funds among the many subsidiaries through which we conduct business and the cost effectiveness with which those funds can be accessed. We may transfer cash from certain international subsidiaries to the U.S. and other international subsidiaries when it is cost effective to do so, though our intent is to indefinitely reinvest most of these funds outside of the U.S. As such, we do not expect translation risk to have a material economic impact on our financial position and results of operations.

Interest Rate Risk

As of December 31, 2015, our debt portfolio is primarily comprised of two fixed-rate senior notes that total $1.2 billion. The $600 million senior note due 2021 is not exposed to interest rate risk as the bond is at a fixed-rate until maturity. The other $600 million senior note will mature on September 20th, 2016, and the company intends to refinance the debt with new debt instruments. Until the company closes the refinancing of the notes due, we are exposed to interest rate risk that can potentially impact the planned issuance of debt instruments. Based on current interest rate market we do not anticipate material risk associated with our debt refinancing within the target time-frame of completion.

Commodity Price Exposures

Portions of our business are exposed to volatility in the prices of certain commodities, such as copper, nickel and aluminum, among others. Our primary exposure to this volatility resides with the use of these materials in purchased component parts. We generally maintain long-term fixed price contracts on raw materials and component parts; however, we are prone to exposure as these contracts expire. We estimate that a hypothetical 10% adverse movement in prices for raw metal commodities would not be material to our financial position and results of operations.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA
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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Xylem Inc.
Rye Brook, New York

We have audited the accompanying consolidated balance sheets of Xylem Inc. and subsidiaries (the "Company") as of December 31, 2015 and 2014, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2015. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Xylem Inc. and subsidiaries as of December 31, 2015 and 2014, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2015, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2015, based on the criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 26, 2016 expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ Deloitte & Touche LLP
Stamford, Connecticut
February 26, 2016

XYLEM INC. AND SUBSIDIARIES
CONSOLIDATED INCOME STATEMENTS
(In Millions, except per share data)

| Year Ended December 31, | 2015 | 2014 | 2013 |
|---|---|---|---|
| Revenue | $3,653 | $3,916 | $3,837 |
| Cost of revenue | 2,249 | 2,403 | 2,338 |
| Gross profit | 1,404 | 1,513 | 1,499 |
| Selling, general and administrative expenses | 854 | 920 | 990 |
| Research and development expenses | 95 | 104 | 104 |
| Restructuring and asset impairment charges | 6 | 26 | 42 |
| Operating income | 449 | 463 | 363 |
| Interest expense | 55 | 54 | 55 |
| Other non-operating income (expense), net | — | 1 | (10) |
| Gain from sale of business | 9 | 11 | — |
| Income before taxes | 403 | 421 | 298 |
| Income tax expense | 63 | 84 | 70 |
| Net income | $340 | $337 | $228 |
| Earnings per share: | | | |
| Basic | $1.88 | $1.84 | $1.23 |
| Diluted | $1.87 | $1.83 | $1.22 |
| Weighted average number of shares: | | | |
| Basic | 180.9 | 183.1 | 185.2 |
| Diluted | 181.7 | 184.2 | 186.0 |
| Dividends declared per share | $0.5632 | $0.5120 | $0.4656 |

See accompanying notes to consolidated financial statements.

XYLEM INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In Millions)

| Year Ended December 31, | 2015 | 2014 | 2013 |
|---|---|---|---|
| Net income | $340 | $337 | $228 |
| Other comprehensive (loss) income, before tax: | | | |
| Foreign currency translation adjustment | (180) | (206) | 15 |
| Foreign currency gain reclassified into net income | (8) | — | — |
| Net change in derivative hedge agreements: | | | |
| Unrealized (losses) gains | (22) | (22) | 1 |
| Amount of loss reclassified into net income | 20 | 6 | — |
| Net change in postretirement benefit plans: | | | |
| Net gain (loss) | 23 | (110) | 34 |
| Prior service credit | 1 | 17 | 4 |
| Amortization of prior service (credit) cost | (3) | (1) | 1 |
| Amortization of net actuarial loss into net income | 18 | 11 | 17 |
| Settlement | — | 1 | — |
| Foreign currency translation adjustment | 21 | 20 | 2 |
| Other comprehensive (loss) income, before tax | (130) | (284) | 74 |
| Income tax expense (benefits) related to other comprehensive (loss) income | 9 | (18) | 22 |
| Other comprehensive (loss) income, net of tax | (139) | (266) | 52 |
| Comprehensive income | $201 | $71 | $280 |

See accompanying notes to consolidated financial statements.

XYLEM INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In Millions, except per share amounts)

| December 31, | 2015 | 2014 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $680 | $663 |
| Receivables, less allowances for discounts, returns and doubtful accounts of $33 and $34 in 2015 and 2014, respectively | 749 | 771 |
| Inventories | 433 | 486 |
| Prepaid and other current assets | 143 | 144 |
| Total current assets | 2,005 | 2,064 |
| Property, plant and equipment, net | 439 | 461 |
| Goodwill | 1,584 | 1,635 |
| Other intangible assets, net | 435 | 470 |
| Other non-current assets | 194 | 203 |
| Total assets | $4,657 | $4,833 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | $338 | $338 |
| Accrued and other current liabilities | 407 | 476 |
| Short-term borrowings and current maturities of long-term debt | 78 | 89 |
| Total current liabilities | 823 | 903 |
| Long-term debt | 1,196 | 1,195 |
| Accrued postretirement benefits | 335 | 388 |
| Deferred income tax liabilities | 118 | 136 |
| Other non-current accrued liabilities | 101 | 84 |
| Total liabilities | 2,573 | 2,706 |
| Commitment and Contingencies (Note 18) | | |
| Stockholders' equity: | | |
| Common Stock — par value $0.01 per share: | | |
| Authorized 750.0 shares, issued 190.2 and 188.9 shares in 2015 and 2014, respectively | 2 | 2 |
| Capital in excess of par value | 1,834 | 1,796 |
| Retained earnings | 885 | 648 |
| Treasury stock – at cost 11.8 shares and 6.6 shares in 2015 and 2014, respectively | (399) | (220) |
| Accumulated other comprehensive loss | (238) | (99) |
| Total stockholders' equity | 2,084 | 2,127 |
| Total liabilities and stockholders' equity | $4,657 | $4,833 |

See accompanying notes to consolidated financial statements.

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XYLEM INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In Millions)

| Year Ended December 31, | 2015 | 2014 | 2013 |
|---|---|---|---|
| Operating Activities | | | |
| Net income | $340 | $337 | $228 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation | 88 | 95 | 99 |
| Amortization | 45 | 47 | 51 |
| Deferred income taxes | (9) | (29) | (14) |
| Share-based compensation | 15 | 18 | 27 |
| Restructuring and asset impairment charges, net | 6 | 26 | 42 |
| Gain from sale of businesses | (9) | (11) | — |
| Other, net | 12 | 2 | 15 |
| Payments for restructuring | (14) | (26) | (35) |
| Contributions to postretirement benefit plans | (25) | (35) | (43) |
| Changes in assets and liabilities (net of acquisitions): | | | |
| Changes in receivables | (24) | (37) | (47) |
| Changes in inventories | 23 | (49) | (39) |
| Changes in accounts payable | 20 | 17 | 4 |
| Changes in accrued liabilities | (11) | 3 | 18 |
| Changes in accrued taxes | (3) | 25 | 20 |
| Net changes in other assets and liabilities | 10 | 33 | (2) |
| Net Cash — Operating activities | 464 | 416 | 324 |
| Investing Activities | | | |
| Capital expenditures | (117) | (119) | (126) |
| Proceeds from the sale of property, plant and equipment | — | 2 | 6 |
| Acquisitions of businesses and assets, net of cash acquired | (18) | — | (81) |
| Proceeds from sale of business | 1 | 30 | — |
| Other, net | 2 | 1 | 2 |
| Net Cash — Investing activities | (132) | (86) | (199) |
| Financing Activities | | | |
| (Repayment) issuance of short-term debt, net | (3) | 52 | 39 |
| Principal payments of debt and capital lease obligations | — | — | (2) |
| Repurchase of common stock | (179) | (134) | (73) |
| Proceeds from exercise of employee stock options | 21 | 26 | 22 |
| Excess tax benefit from share based compensation | 2 | 2 | 1 |
| Dividends paid | (102) | (94) | (87) |
| Other, net | (1) | 1 | — |
| Net Cash — Financing activities | (262) | (147) | (100) |
| Effect of exchange rate changes on cash | (53) | (53) | 4 |
| Net change in cash and cash equivalents | 17 | 130 | 29 |
| Cash and cash equivalents at beginning of year | 663 | 533 | 504 |
| Cash and cash equivalents at end of year | $680 | $663 | $533 |
| Supplemental disclosure of cash flow information: | | | |
| Cash paid during the year for: | | | |
| Interest | $52 | $51 | $51 |
| Income taxes (net of refunds received) | $75 | $81 | $65 |

See accompanying notes to consolidated financial statements.

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XYLEM INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(In Millions, except per share amounts)

| | Common Stock | Capital in Excess of Par Value | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total |
|---|---|---|---|---|---|---|
| Balance at December 31, 2012 | 2 | 1,706 | 264 | 115 | (13) | 2,074 |
| Net income | | | 228 | | | 228 |
| Other comprehensive loss, net | | | | 52 | | 52 |
| Dividends declared ($0.4656 per share) | | | (87) | | | (87) |
| Stock incentive plan activity | | 47 | | | | 47 |
| Repurchase of common stock | | | | | (73) | (73) |
| Balance at December 31, 2013 | $2 | $1,753 | $405 | $167 | $(86) | $2,241 |
| Net income | | | 337 | | | 337 |
| Other comprehensive income, net | | | | (266) | | (266) |
| Dividends declared ($0.5120 per share) | | | (94) | | | (94) |
| Stock incentive plan activity | | 43 | | | | 43 |
| Repurchase of common stock | | | | | (134) | (134) |
| Balance at December 31, 2014 | $2 | $1,796 | $648 | $(99) | $(220) | $2,127 |
| Net income | | | 340 | | | 340 |
| Other comprehensive income, net | | | | (139) | | (139) |
| Dividends declared ($0.5632 per share) | | | (103) | | | (103) |
| Stock incentive plan activity | | 38 | | | | 38 |
| Repurchase of common stock | | | | | (179) | (179) |
| Balance at December 31, 2015 | $2 | $1,834 | $885 | $(238) | $(399) | $2,084 |

See accompanying notes to consolidated financial statements.

XYLEM INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies

Xylem Inc. (“Xylem” or the “Company”) is a leading equipment and service provider for water and wastewater applications with a broad portfolio of products and services addressing the full cycle of water, from collection, distribution and use to the return of water to the environment. Xylem operates in two segments, Water Infrastructure and Applied Water. The Water Infrastructure segment focuses on the transportation, treatment and testing of water, offering a range of products including water and wastewater pumps, treatment and testing equipment, and controls and systems. The Applied Water segment serves many of the primary uses of water and focuses on the residential, commercial, industrial and agricultural markets. The Applied Water segment’s major products include pumps, valves, heat exchangers, controls and dispensing equipment.

On October 31, 2011 (the "Distribution Date"), ITT Corporation (“ITT”) completed the Spin-off (the “Spin-off”) of Xylem, formerly ITT’s water equipment and services businesses. The Spin-off was completed pursuant to the Distribution Agreement, dated as of October 25, 2011 (the “Distribution Agreement”), among ITT, Exelis Inc., acquired by Harris Inc. on May 29, 2015, (“Exelis”) and Xylem. Xylem Inc. was incorporated in Indiana on May 4, 2011 in connection with the Spin-off.

Hereinafter, except as otherwise indicated or unless the context otherwise requires, “Xylem,” “we,” “us,” “our” and “the Company” refer to Xylem Inc. and its subsidiaries. References in the notes to the consolidated financial statements to “ITT” or “ former parent” refers to ITT Corporation and its consolidated subsidiaries (other than Xylem Inc.).

Basis of Presentation

The consolidated financial statements reflect our financial position and results of operations in conformity with accounting principles generally accepted in the United States of America (“GAAP”). All intercompany transactions between our businesses have been eliminated. Certain prior year amounts have been reclassified to conform to the current year presentation.

In 2014, we implemented an organizational redesign to integrate our commercial teams within geographical regions. While this organizational redesign did not change our reportable segments, it had implications on how we manage our business. These changes and the related measurement system were effective in the fourth quarter 2014 and as a result, we commenced reporting our financial performance at such time based on the new organizational design.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Estimates are revised as additional information becomes available. Estimates and assumptions are used for, but not limited to, postretirement obligations and assets, revenue recognition, income tax contingency accruals and valuation allowances, goodwill and indefinite lived intangible impairment testing and contingent liabilities. Actual results could differ from these estimates.

Consolidation Principles

We consolidate companies in which we have a controlling financial interest or when Xylem is considered the primary beneficiary of a variable interest entity. We account for investments in companies over which we have the ability to exercise significant influence but do not hold a controlling financial interest under the equity method, and we record our proportionate share of income or losses in the Consolidated Income Statements. Equity method investments are reviewed for impairment when events or circumstances indicate the investment may be other than temporarily impaired. This requires significant judgment, including an assessment of the investee’s financial condition, the possibility of subsequent rounds of financing, and the investee’s historical and projected results of operations. If the actual results of operations for the investee are significantly different from projections, we may incur future charges for the impairment of these investments.

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Foreign Currency Translation

The national currencies of our foreign companies are generally the functional currencies. Balance sheet accounts are translated at the exchange rate in effect at the end of each period; income statement accounts are translated at the average rates of exchange prevailing during the period. Gains and losses on foreign currency translations are reflected in the cumulative translation adjustments component of stockholders' equity. Net gains or losses from foreign currency transactions are reported currently in selling, general and administrative expenses.

Revenue Recognition

Revenue is recognized when persuasive evidence of an arrangement exists, the price is fixed or determinable, collectability is reasonably assured and delivery has occurred or services have been rendered. For product sales, other than long-term construction-type contracts, we recognize revenue at the time title, and risks and rewards of ownership pass, which is generally when products are shipped. Certain contracts with customers require delivery, installation, testing, certification or other acceptance provisions to be satisfied before revenue is recognized. We recognize revenue on product sales to channel partners, including resellers, distributors or value-added solution providers at the time of sale when the channel partners have economic substance apart from Xylem and Xylem has completed its obligations related to the sale. Revenue from the rental of equipment is recognized over the rental period. Service revenue is recognized as services are performed.

For agreements that contain multiple deliverables, we recognize revenue based on the relative selling price if the deliverable has stand-alone value to the customer and, in arrangements that include a general right of return relative to the delivered element, performance of the undelivered element is considered probable and substantially in the Company's control. The selling price for a deliverable is based on vendor-specific objective evidence of selling price ("VSOE"), if available, third-party evidence of selling price ("TPE") if VSOE is not available, or best estimated selling price, if neither VSOE nor TPE is available.

The deliverables in our arrangements with multiple elements include various products and may include related services, such as installation and start-up services. We allocate arrangement consideration based on the relative selling prices of the separate units of accounting determined in accordance with the hierarchy described above. For deliverables that are sold separately, we establish VSOE based on the price when the deliverable is sold separately. We establish TPE, generally for services, based on prices similarly situated customers pay for similar services from third-party vendors. For those deliverables for which we are unable to establish VSOE or TPE, we estimate the selling price considering various factors including market and pricing trends, geography, product customization, and profit objectives. Revenue for multiple element arrangements is recognized when the appropriate revenue recognition criteria for the individual deliverable have been satisfied.

Certain businesses enter into long-term construction-type sales contracts for which revenue is recognized under the percentage-of-completion method based upon percentage of costs incurred to total estimated costs.

Shipping and Handling Costs

Shipping and handling costs are recorded as a component of cost of revenue.

Share-Based Compensation

Share-based awards issued to employees and members of the Board of Directors include non-qualified stock options, restricted stock awards and performance-based awards. Compensation costs resulting from share-based payment transactions are recognized primarily within selling, general and administrative expenses, at fair value over the requisite service period (typically three years) on a straight-line basis. The calculated compensation cost is adjusted based on an estimate of awards ultimately expected to vest. For performance-based awards, the calculated compensation cost is adjusted based on an estimate of awards ultimately expected to vest and our assessment of the probable outcome of the performance condition.The fair value of a non-qualified stock option is determined on the date of grant using a binomial lattice pricing model incorporating multiple and variable assumptions over time, including assumptions such as employee exercise patterns, stock price volatility and changes in dividends. The fair value of restricted stock awards is determined using the closing price of our common stock on date of grant. The fair value of performance-based share awards at 100% target is determined using the closing price of our common stock on date of grant.

Research and Development

We conduct research and development activities, which consist primarily of the development of new products, product applications, and manufacturing processes. These costs are charged to expense as incurred.

Exit and Disposal Costs

We periodically initiate management-approved restructuring activities to achieve cost savings through reduced operational redundancies and to position ourselves strategically in the market in response to prevailing economic conditions and associated customer demand. Costs associated with restructuring actions can include severance, infrastructure charges to vacate facilities or consolidate operations, contract termination costs and other related charges. For involuntary separation plans, a liability is recognized when it is probable and reasonably estimable. For voluntary separation plans, a liability is recognized when the employee irrevocably accepts the voluntary termination. For one-time termination benefits, such as additional severance pay or benefit payouts, and other exit costs, such as lease termination costs, the liability is measured and recognized initially at fair value in the period in which the liability is incurred, with subsequent changes to the liability recognized as adjustments in the period of change.

Deferred Financing Costs

Deferred financing costs represent costs incurred in conjunction with our debt financing activities and are capitalized in long-term debt and amortized over the life of the related financing arrangements. If the debt is retired early, the related unamortized deferred financing costs are written off in the period the debt is retired and are recorded in the results of operations under the caption “interest expense.”

Income Taxes

Income taxes are calculated using the asset and liability method. Deferred tax assets and liabilities are determined based on the estimated future tax effects of temporary differences between the financial statement carrying amounts and the tax bases of assets and liabilities, as measured by the current enacted tax rates.

We maintain valuation allowances when it is more likely than not that all or a portion of a deferred asset will not be realized. The valuation allowance is intended in part to provide for the uncertainty regarding the ultimate utilization of our U.S. capital loss carryforwards, U.S. foreign tax credit carryovers, and foreign net operating loss carryforwards. In determining whether a valuation allowance is warranted, we consider all positive and negative evidence and all sources of taxable income such as prior earnings history, expected future earnings, carryback and carryforward periods and tax strategies to estimate if sufficient future taxable income will be generated to realize the deferred tax asset. The assessment of the adequacy of our valuation allowance is based on our estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. In the event that actual results differ from these estimates, or we adjust these estimates in future periods for current trends or expected changes in our estimating assumptions, we may need to modify the level of valuation allowance that could materially impact our business, financial condition and results of operations.

Our effective tax rate reflects the impact of certain undistributed foreign earnings for which we have not provided U.S. taxes because we plan to reinvest such earnings indefinitely outside the United States. We plan foreign earnings remittance amounts based on projected cash flow needs, as well as the working capital and long-term investment requirements of our foreign subsidiaries and our domestic operations. Based on these assumptions, we estimate the amount we will distribute to the United States and provide the U.S. federal taxes due on these amounts. Material changes in our estimates of cash, working capital and long-term investment requirements in the various jurisdictions in which we do business could impact our effective tax rate.

Tax benefits are recognized for an uncertain tax position when, in management’s judgment, it is more likely than not that the position will be sustained upon examination by a taxing authority. For a tax position that meets the more-likely-than-not recognition threshold, the tax benefit is measured as the largest amount that is judged to have a greater than 50% likelihood of being realized upon ultimate settlement with a taxing authority. The liability associated with unrecognized tax benefits is adjusted periodically due to changing circumstances and when new information becomes available. Such adjustments are recognized in the period in which they are identified. The effective tax rate includes the net impact of changes in the liability for unrecognized tax benefits and subsequent adjustments as considered appropriate by management. While it is often difficult to predict the final outcome or the timing of resolution of any particular tax matter, we believe our liability for unrecognized tax benefits is adequate. We classify interest relating to unrecognized tax benefits as a component of other non-operating (expense) income, net and tax penalties as a component of income tax expense in our Consolidated Income Statements.

Earnings Per Share

We present two calculations of earnings per share (“EPS”). “Basic” EPS equals net income divided by weighted average shares outstanding during the period. “Diluted” EPS equals net income divided by the sum of weighted average common shares outstanding during the period plus potentially dilutive shares. Potentially dilutive common shares that are anti-dilutive are excluded from diluted EPS.

Cash Equivalents

We consider all liquid investments purchased with an original maturity of three months or less to be cash equivalents.

Receivables and Allowance for Doubtful Accounts and Discounts

Receivables primarily comprise uncollected amounts owed to us from transactions with customers and are presented net of allowances for doubtful accounts and early payment discounts.

We determine our allowance for doubtful accounts using a combination of factors to reduce our trade receivable balances to their estimated net realizable amount. We maintain an allowance for doubtful accounts based on a variety of factors, including the length of time receivables are past due, macroeconomic trends and conditions, significant one-time events, historical experience and the financial condition of customers. In addition, we record a specific reserve for individual accounts when we become aware of specific customer circumstances, such as in the case of bankruptcy filings or deterioration in the customer's operating results or financial position. The past due or delinquency status of a receivable is based on the contractual payment terms of the receivable. If circumstances related to the specific customer change, we adjust estimates of the recoverability of receivables as appropriate. We determine our allowance for early payment discounts primarily based on historical experience with customers.

Credit risk with respect to accounts receivable is generally diversified due to the large number of entities comprising our customer base and their dispersion across many different geographical regions. We perform ongoing credit evaluations of the financial condition of our third-party distributors, resellers and other customers and require collateral, such as letters of credit and bank guarantees, in certain circumstances. As of December 31, 2015 and 2014 we do not believe we have any significant concentrations of credit risk.

Inventories

Inventories, which include the costs of material, labor and overhead, are stated at the lower of cost or market using the first in, first out ("FIFO") method. Estimated losses from obsolete and slow-moving inventories are recorded to reduce inventory values to their estimated net realizable value. Our manufacturing operations recognize costs of sales using standard costs with full overhead absorption, which generally approximates actual cost.

Property, Plant and Equipment

These assets are recorded at historical cost and are depreciated using the straight-line method of depreciation over the estimated useful lives as follows:

| | Estimated Life |
|---|---|
| Buildings and improvements | 5 to 40 years |
| Machinery and equipment | 2 to 10 years |
| Furniture and fixtures | 3 to 7 years |
| Equipment held for lease or rental | 2 to 10 years |

Leasehold improvements are depreciated over the shorter of their estimated useful life or the term of the lease. Costs related to maintenance and repairs that do not prolong the assets' useful lives are expensed as incurred.

Goodwill and Intangible Assets

Goodwill represents purchase consideration paid in a business combination that exceeds the values assigned to the net assets of acquired businesses. Intangible assets include customer relationships, proprietary technology, brands and trademarks, patents, software and other intangible assets. Intangible assets with a finite life are amortized on a straight-line basis over an estimated economic useful life which ranges from 1 to 20 years and is included in selling, general and administrative expense. Certain of our intangible assets, namely certain brands and trademarks, have an indefinite life and are not amortized.

Long-Lived Asset Impairment

Long-lived assets, including intangible assets with finite lives, are amortized and tested for impairment whenever events or changes in circumstances indicate their carrying value may not be recoverable. We assess the recoverability of long-lived assets based on the undiscounted future cash flow the assets are expected to generate and recognize an impairment loss when estimated undiscounted future cash flows expected to result from the use of the asset plus net proceeds expected from disposition of the asset, if any, are less than the carrying value of the asset. When an impairment is identified, we reduce the carrying amount of the asset to its estimated fair value based on a discounted cash flow approach or, when available and appropriate, to comparable market values.

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Goodwill and indefinite-lived intangible assets are not amortized, but rather are tested for impairment annually (or more frequently if impairment indicators arise, such as changes to the reporting unit structure, significant adverse changes in the business climate or an adverse action or assessment by a regulator). We conduct our annual impairment testing on the first day of our fourth quarter. For goodwill, the impairment test is a two-step test. In the first step, the estimated fair value of each reporting unit is compared to the carrying value of the net assets assigned to that reporting unit. If the estimated fair value of the reporting unit exceeds its carrying value, goodwill is not impaired and the second step of the impairment test is not performed. If the carrying value of the reporting unit exceeds its estimated fair value, then the second step of the impairment test is performed in order to measure the impairment loss to be recorded, if any. If the carrying value of a reporting unit's goodwill exceeds its implied fair value, then we record an impairment loss equal to the difference. We estimate the fair value of our reporting units and indefinite-lived intangible assets using an income approach. Under the income approach, we estimate fair value based on the present value of estimated future cash flows.

Product Warranties

We accrue for the estimated cost of product warranties at the time revenue is recognized and record it as a component of cost of revenue. Our product warranty liability reflects our best estimate of probable liability under the terms and conditions of our product warranties offered to customers. We estimate the liability based on our standard warranty terms, the historical frequency of claims and the cost to replace or repair our products under warranty. Factors that impact our warranty liability include the number of units sold, the length of warranty term, historical and anticipated rates of warranty claims and cost per claim. We also record a warranty liability for specific matters. We assess the adequacy of our recorded warranty liabilities quarterly and adjust amounts as necessary.

Postretirement Benefit Plans

The determination of defined benefit pension and postretirement plan obligations and their associated costs requires the use of actuarial computations to estimate participant plan benefits to which the employees will be entitled. The significant assumptions primarily relate to discount rates, expected long-term rates of return on plan assets, rate of future compensation increases, mortality, years of service and other factors. We develop each assumption using relevant company experience in conjunction with market-related data for each individual country in which such plans exist. All actuarial assumptions are reviewed annually with third-party consultants and adjusted as necessary. For the recognition of net periodic postretirement cost, the calculation of the expected return on plan assets is generally derived by applying the expected long-term rate of return on the market-related value of plan assets. The market-related value of plan assets is based on average asset values at the measurement date over the last five years. Actual results that differ from our assumptions are accumulated and amortized on a straight-line basis only to the extent they exceed 10% of the higher of the market-related value or the projected benefit obligation, over the average remaining service period of active participants, or for plans with all or substantially all inactive participants, over the average remaining life expectancy. The fair value of plan assets is determined based on market prices or estimated fair value at the measurement date.

We consider changes to a plan's benefit formula that eliminate the accrual for future service but continue to allow for future salary increases (i.e. "soft freeze") a curtailment.

Business Combinations

We allocate the purchase price of acquisitions to the tangible and intangible assets acquired, liabilities assumed, and non-controlling interests in the acquiree based on their estimated fair value at the acquisition date. The excess of the acquisition price over those estimated fair values is recorded as goodwill. Changes to the acquisition date provisional fair values prior to the expiration of the measurement period, a period not to exceed 12 months from date of acquisition, are recorded as an adjustment to the associated goodwill. Changes to the acquisition date fair values after expiration of the measurement period are recorded in earnings. Acquisition-related expenses and restructuring costs, if any, are recognized separately from the business combination and are expensed as incurred.

Derivative Financial Instruments

We record all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on whether we have elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm

commitment attributable to a particular risk are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, including forecasted transactions, are considered cash flow hedges. Derivatives may also be designated as hedges of the foreign currency exposure of a net investment in a foreign operation. Hedge accounting generally provides for the

matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. We may enter into derivative contracts that are intended to hedge certain risks economically, even though hedge accounting does not apply or we elect not to apply hedge accounting.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges of foreign exchange risk is recorded in other comprehensive income ("OCI") and is subsequently reclassified into either revenue or cost of revenue (hedge of sales classified into revenue and hedge of purchases classified into cost of revenue) in the period that the hedged forecasted transaction affects earnings. Any ineffective portion of the change in fair value of the derivative is recognized directly in selling, general and administrative expenses. Our policy is to de-designate cash flow hedges at the time forecasted transactions are recognized as assets or liabilities on a business unit’s balance sheet and report subsequent changes in fair value through selling, general and administrative expenses where the gain or loss due to movements in currency rates on the underlying asset or liability is revalued. If it becomes probable that the originally forecasted transaction will not occur, the gain or loss related to the hedge recorded within accumulated other comprehensive income is immediately recognized into net income.

The effective portion of changes in the fair value of derivatives designated and that qualify as net investment hedges of foreign exchange risk is recorded in OCI. Amounts in OCI are reclassified into earnings at the time the hedged net investment is sold or substantially liquidated. Effectiveness of derivatives designated as net investment hedges is assessed using the forward method. Any ineffective portion of the change in fair value of the derivative is recognized directly in selling, general and administrative expenses.

Commitments and Contingencies

We record accruals for commitments and loss contingencies for those which are both probable and for which the amount can be reasonably estimated. In addition, legal fees are accrued for cases where a loss is probable and the related fees can be reasonably estimated. Significant judgment is required to determine both probability and the estimated amount of loss. We review these accruals quarterly and adjust the accruals to reflect the impact of negotiations, settlements, rulings, advice of legal counsel, and other current information.

Accruals for environmental matters are recorded on a site-by-site basis when it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated, based on current law and existing technologies. Our estimated liability is reduced to reflect the anticipated participation of other potentially responsible parties in those instances where it is probable that such parties are legally responsible and financially capable of paying their respective shares of the relevant costs. These accruals are reviewed quarterly and are adjusted as assessment and remediation efforts progress or as additional technical or legal information becomes available. Actual costs to be incurred at identified sites in future periods may vary from the estimates, given inherent uncertainties in evaluating environmental exposures. Accruals for environmental liabilities are primarily included in other non-current liabilities at undiscounted amounts and exclude claims for recoveries from insurance companies or other third parties.

Concentrations of Credit Risk

Financial instruments that potentially subject us to significant concentrations of credit risk consist principally of cash and cash equivalents, and accounts receivable from trade customers. We maintain cash and cash equivalents and derivative contracts with various financial institutions. These financial institutions are located in many different geographical regions, and our policy is designed to limit exposure with any one institution. As part of our cash and risk management processes, we perform periodic evaluations of the relative credit standing of the financial institutions. We have not sustained any material credit losses during the previous three years from instruments held at financial institutions. We may utilize forward contracts to protect against the effects of foreign currency fluctuations. Such contracts involve the risk of non-performance by the counterparty. Credit risk with respect to accounts receivable is generally diversified due to the large number of entities comprising our customer base and their dispersion across many different industries and geographic regions. We perform ongoing credit evaluations of the financial condition of our third-party distributors, resellers and other customers and require collateral, such as letters of credit and bank guarantees, in certain circumstances.

Substantially all of the cash and cash equivalents, including foreign cash balances, at December 31, 2015 and 2014 were uninsured. Foreign cash balances at December 31, 2015 and 2014 were $656 million and $537 million,

respectively.

Fair Value Measurements

We determine fair value 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. We use a hierarchical structure to prioritize the inputs to valuation techniques used to measure fair value into three broad levels defined as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2 inputs are other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include quoted prices (in non-active markets or in active markets for similar assets or liabilities), inputs other than quoted prices that are observable, and inputs that are derived principally from or corroborated by observable market data by correlation or other means.
- Level 3 inputs are unobservable inputs for the assets or liabilities.

The fair value hierarchy is based on maximizing the use of observable inputs and minimizing the use of unobservable inputs when measuring fair value. Classification within the fair value hierarchy is based on the lowest level input that is significant to the fair value measurement.

NAV Practical Expedient is the measurement of fair value using the net asset value ("NAV") per share (or its equivalent) practical expedient as an alternative to the fair value hierarchy as discussed above.

Note 2. Recently Issued Accounting Pronouncements

Pronouncements Not Yet Adopted

In February 2016, the Financial Accounting Standards Board (“FASB”) issued guidance amending the accounting for leases. Specifically, the amended guidance requires all lessees to record a lease liability at lease inception, with a corresponding right of use asset, except for short-term leases. Lessor accounting is not fundamentally changed. This amended guidance is effective for interim and annual periods beginning after December 15, 2018 using a modified retrospective approach. Early adoption is permitted. We are evaluating the impact of the guidance on our financial condition and results of operations.

In January 2016, the FASB issued guidance amending the classification and measurement of financial instruments. Specifically, the amended guidance (1) requires equity securities with readily determinable fair values to be measured at fair value with changes in fair value recognized through net income (2) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative impairment assessment at each reporting period and requiring any impaired investment be measured at fair value (3) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or accompanying notes to the financial statements and (4) eliminates the requirement to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at cost on the balance sheet. This amended guidance is effective for interim and annual periods beginning after December 15, 2017 by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the year of adoption. Early adoption is permitted for fiscal years or interim periods for which the applicable financial statements have not been issued. We are evaluating the impact of the guidance on our financial condition and results of operations.

In July 2015, the FASB issued guidance regarding simplifying the measurement of inventory. Under prior guidance, inventory is measured at the lower of cost or market, where market is defined as replacement cost, with a ceiling of net realizable value and a floor of net realizable value less a normal profit margin. The amended guidance requires the measurement of inventory at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. This guidance is effective prospectively for interim and annual periods beginning after December 15, 2016 and early application is permitted. We are evaluating the impact of the guidance on our financial condition and results of operations.

In May 2014, the FASB issued guidance on recognizing revenue from contracts with customers. The guidance outlines a single comprehensive model to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The core principle of the model is that an entity recognizes revenue to portray the transfer of goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The standard also expands disclosure requirements regarding revenue recognition. This guidance is effective for interim

and annual reporting periods beginning after December 15, 2017 and may be applied retrospectively to each prior period presented or with the cumulative effect recognized as of the date of initial

application. Early adoption is permitted for interim and annual reporting periods beginning after December 15, 2016. We are evaluating the impact of the guidance on our financial condition and results of operations.

Recently Adopted Pronouncements

In November 2015, the FASB issued guidance that changes the presentation of deferred income taxes. Under prior accounting guidance deferred income tax liabilities and assets are separated into current and noncurrent amounts in an entity's balance sheet. The guidance requires that deferred income tax liabilities and assets be classified as noncurrent in an entity's balance sheet. This guidance may be applied prospectively or retrospectively to all deferred income tax balances. We elected to early adopt this guidance effective the fourth quarter of 2015 on a retrospective basis. Accordingly, $71 million and $118 million are reflected in noncurrent deferred tax assets and noncurrent deferred tax liabilities, respectively as of December 31, 2015. Additionally, $38 million of current deferred tax assets and $5 million of current deferred tax liabilities were reclassified to noncurrent deferred tax assets and liabilities as of December 31, 2014 resulting in total noncurrent deferred tax assets and noncurrent deferred tax liabilities of $90 million and $136 million, respectively.

In September 2015, the FASB issued guidance regarding simplifying the accounting for measurement-period adjustments attributable to an acquisition. Under prior guidance, adjustments to provisional amounts during the measurement period that arise due to new information regarding acquisition date circumstances must be made retrospectively with a corresponding adjustment to goodwill. The amended guidance requires an acquirer to record adjustments to provisional amounts made during the measurement period in the period that the adjustment is determined. The adjustments should reflect the impact on earnings of changes in depreciation, amortization, or other income effects, if any, as if the accounting had been completed as of the acquisition date. Additionally, amounts recorded in the current period that would have been reflected in prior reporting periods if the adjustments had been recognized as of the acquisition date must be disclosed either on the face of the income statement or in the notes to financial statements. This guidance is effective prospectively for interim and annual periods beginning after December 15, 2015. We elected to early adopt this guidance effective the fourth quarter of 2015. Our adoption of this guidance did not have any impact on our financial condition or results of operations.

In May 2015, the FASB issued guidance regarding the disclosure of investments which are valued at fair value using the net asset value ("NAV") per share practical expedient. Investments measured at NAV per share using the practical expedient will be presented as a reconciling item between the fair value hierarchy disclosure and the balance sheet. The amended guidance removes the requirement to categorize such investments within the fair value hierarchy. The amendment also removes the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the NAV per share practical expedient, instead limiting such disclosures to those investments measured at fair value using the NAV practical expedient. This guidance is effective for interim and annual periods beginning after December 15, 2015. The guidance must be applied retrospectively and early adoption is permitted. We elected to early adopt this guidance effective the fourth quarter of 2015. Adoption of this guidance did not have an impact on our financial condition and results of operations.

In April 2015, the FASB issued guidance which changes the presentation of debt issuance costs in the balance sheet. Under prior guidance, debt issuance costs are reflected on the balance sheet as an asset. This amendment requires such costs to be reflected as a direct deduction to the related debt liability, with retrospective application upon adoption. Subsequently, in August 2015, the FASB issued additional guidance indicating that debt issuance costs associated with line-of-credit arrangements may be presented as an asset and amortized over the term of the line-of-credit arrangement. We elected to early adopt these standards effective the first and third quarter of 2015, respectively. Accordingly, $4 million of debt issuance costs were reflected within long-term debt as of December 31, 2015 and December 31, 2014. These costs were previously recorded within other non-current assets.

In April 2015, the FASB issued guidance regarding whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license then the software license element of the arrangement should be accounted for in a manner that is consistent with accounting for the acquisition of other software licenses. If a cloud computing arrangement does not include a software license then the arrangement should be accounted for as a service contract. This guidance is effective for interim and annual periods beginning after December 15, 2015. The guidance may be applied (1) retrospectively or (2) prospectively to arrangements entered into, or materially modified after the effective date. Early adoption is permitted. We elected to early adopt this

standard effective in the second quarter of 2015 with retrospective application. Our adoption of this guidance did not have any impact on our financial condition or results of operations.

In February 2015, the FASB issued guidance which amends the requirements to determine whether a company needs to consolidate certain legal entities into its reported financial statements. Specifically, the amendment: (1) modifies the evaluation of whether limited partnerships and similar legal entities are variable interest entities

("VIEs") or voting interest entities, (2) eliminates the presumption that a general partner should consolidate a limited partnership and (3) affects the consolidation analysis of reporting entities that are involved with VIEs. This guidance is effective for interim and annual reporting periods beginning after December 15, 2015 and may be applied retrospectively to each prior period presented or with the cumulative effect recognized as of the date of initial application. We elected to early adopt this standard effective in the second quarter of 2015 with retrospective application. Our adoption of this guidance did not have any impact on our financial condition or results of operations.

In January 2015, the FASB issued guidance which eliminates from GAAP the concept of an extraordinary item. Under prior guidance, an event or transaction must be unusual in nature and must occur infrequently to be considered an extraordinary item. Additionally, under prior guidance extraordinary items are separately presented in a company's income statement and disclosed in the footnotes to the company's financial statements. As a result of the new guidance regarding extraordinary items, a company will no longer (1) segregate an extraordinary item from the results of ordinary operations, (2) separately present an extraordinary item on its income statement, and (3) disclose income taxes and earnings-per-share data applicable to an extraordinary item. We elected to early adopt this standard effective in the first quarter of 2015 with retrospective application. Our adoption of this guidance did not have any impact on our financial condition or results of operations.

In June 2014, as a result of inconsistency in practice, the FASB issued guidance related to the recognition of compensation on employee share-based payments in which the terms of the award provide that a performance target that affects vesting could be achieved after the requisite service period. The standard states that the performance target should not be reflected in estimating the grant date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the periods for which the service has already been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost should be recognized prospectively over the remaining requisite service period. We elected to early adopt this guidance effective in the first quarter of 2015 with retrospective application. Our adoption of this guidance did not have any impact on our financial condition or results of operations as we were using the accounting prescribed in the new guidance.

In April 2014, the FASB issued guidance related to the reporting of discontinued operations. The guidance states that the disposal of a business or operation is required to be reported as discontinued operations if the disposal represents a strategic shift that will have a major effect on an entity's operations and financial results. The guidance also expands disclosures about discontinued operations and the disposal of significant businesses that did not qualify for discontinued operations presentation. This standard is effective prospectively, for disposals (or businesses that qualify as "held for sale") that occur within annual periods beginning on or after December 15, 2014 and interim periods within those years. Our adoption of this guidance effective in the first quarter of 2015 did not have any impact on our financial condition or results of operations.

In January 2014, the FASB issued guidance related to service concession arrangements. A service concession arrangement is an arrangement between a public-sector entity grantor and an operating entity under which the operating entity operates the grantor's infrastructure (for example, airports, roads and bridges). The guidance states that service concession arrangements should not be accounted for under the guidance of Accounting Standards Codification Topic 840, Leases, but rather other guidance as deemed appropriate. This guidance is effective for interim and reporting periods beginning on or after December 15, 2014. The guidance requires opening retained earnings in the year of adoption to reflect the cumulative historical impact of any arrangements existing at the date of adoption, and the new guidance to be applied to the financial statements on a prospective basis. Our adoption of this guidance effective in the first quarter of 2015 did not have any impact on our financial condition or results of operations.

Note 3. Acquisitions and Divestitures

2015 Acquisition and Divestitures

Hypack

On October 22, 2015, we acquired substantially all of the assets of Hypack, Inc. ("Hypack"), a leading provider of hydrographic software worldwide, for approximately $18 million. Hypack, a privately-owned company headquartered in Middletown, Connecticut, has approximately 30 employees and annual revenue of approximately $8

million. Our consolidated financial statements include Hypack's results of operations prospectively from October 22, 2015 within the Water Infrastructure segment.

During 2015, we divested two businesses within our Water Infrastructure segment for $1 million, which were not material, individually or in the aggregate, to our results of operations or financial position. The sales resulted in a gain of $9 million, reflected in gain from sale of businesses in our Consolidated Income Statement.

2014 Divestiture

On July 2, 2014, we divested our Wolverhampton, U.K.-based pneumatic and hydraulic valves business for approximately $30 million. The sale resulted in a gain of $11 million, reflected in gain from sale of business in our Consolidated Income Statement. The business, which was part of our Applied Water segment, provided a wide range of products, primarily to industrial original equipment manufacturer customers in the oil and gas sector. The business reported 2013 annual revenue of approximately $25 million.

2013 Acquisitions

During 2013, we spent $84 million ($81 million, net of cash acquired) on acquisitions. As the acquisitions were not material, individually or in the aggregate, to results of operations, pro forma results of operations reflecting results prior to the acquisitions and certain other disclosure items have not been presented.

MultiTrode

On March 1, 2013 we acquired MultiTrode Pty Ltd ("MultiTrode"), a water and wastewater technology and services company based in Australia, for approximately $26 million. MultiTrode offers advanced monitoring and control technologies to municipal and private water and waste water authorities as well as industrial clients. The company had approximately 60 employees and generated revenue of approximately $13 million in its fiscal year ended June 30, 2012. Our consolidated financial statements include MultiTrode's results of operations prospectively from March 1, 2013 within the Water Infrastructure segment.

PIMS

On February 5, 2013 we acquired PIMS Group ("PIMS"), a wastewater services company based in the United Kingdom, for approximately $57 million, including a cash payment of $55 million and the assumption of certain liabilities. PIMS is a supplier of wastewater installation and maintenance services for the private sector, municipal and industrial markets. The company had approximately 220 employees and generated revenue of approximately $38 million for its fiscal year ended April 30, 2012. Our consolidated financial statements include PIMS' results of operations prospectively from February 5, 2013 within the Water Infrastructure segment.

Note 4. Restructuring and Asset Impairment Charges

From time to time, the Company will incur costs related to restructuring actions in order to optimize our cost base and more strategically position ourselves based on the economic environment and customer demand. During 2015, 2014 and 2013, the costs incurred primarily relate to the reduction in structural costs, including the elimination of headcount and consolidation of facilities primarily within our Water Infrastructure and Applied Water segments. The components of restructuring and asset impairment charges incurred during each of the previous three years ended are presented below.

| | Year Ended December 31, | | |
|---|---|---|---|
| (in millions) | 2015 | 2014 | 2013 |
| By component: | | | |
| Severance and other charges | $7 | $26 | $38 |
| Lease related charges | — | 1 | 2 |
| Reversal of restructuring accruals | (1) | (1) | — |
| Total restructuring charges | 6 | 26 | 40 |
| Asset impairment | — | — | 2 |
| Total restructuring and asset impairment charges | $6 | $26 | $42 |
| | | | |
| By segment: | | | |
| Water Infrastructure | $5 | $19 | $33 |
| Applied Water | 1 | 6 | 9 |
| Corporate and other | — | 1 | — |

Restructuring

The following table displays a rollforward of the restructuring accruals, presented on our Consolidated Balance Sheet within accrued and other current liabilities, for the years ended December 31, 2015 and 2014.

| (in millions) | 2015 | 2014 |
|---|---|---|
| Restructuring accruals - January 1 | $12 | $13 |
| Restructuring charges | 6 | 26 |
| Cash payments | (14) | (26) |
| Foreign currency and other | (1) | (1) |
| Restructuring accruals - December 31 | $3 | $12 |
| | | |
| By segment: | | |
| Water Infrastructure | $1 | $5 |
| Applied Water | 1 | 3 |
| Regional selling locations (a) | 1 | 3 |
| Corporate and other | — | 1 |

(a) Regional selling locations consist primarily of selling and marketing organizations that incurred restructuring expense which was allocated to the segments. The liabilities associated with restructuring expense were not allocated to the segments.

The following is a rollforward of employee position eliminations associated with restructuring activities for the years ended December 31, 2015 and 2014.

| | 2015 | 2014 |
|---|---|---|
| Planned reductions - January 1 | 133 | 51 |
| Additional planned reductions | 87 | 320 |
| Actual reductions | (138) | (238) |
| Planned reductions - December 31 | 82 | 133 |

Total expected costs associated with actions for Water Infrastructure that commenced during 2015 are approximately $5 million. These costs primarily consist of severance charges. Approximately $4 million of the expected cost was incurred in 2015. We currently expect activity related to these actions to continue through the second quarter of 2016.

Total expected costs associated with actions for Applied Water that commenced during 2015 are approximately $1 million. These costs primarily consist of severance charges. Substantially all of the costs associated with these actions have been incurred in 2015.

Total expected costs associated with actions for Water Infrastructure that commenced during 2014 are approximately $19 million. The actions are substantially complete with approximately $18 million of the expected cost was incurred in 2014 and $1 million was incurred during 2015. Total expected costs associated with actions for Applied Water that commenced during 2014 are approximately $6 million. Substantially all of the costs associated with these actions have been incurred in 2014.

Total expected costs associated with actions for Water Infrastructure that commenced during 2013 are approximately $32 million. The actions are substantially complete with approximately $31 million of the expected cost was incurred in 2013 and $1 million was incurred during 2014. Total expected costs associated with actions for Applied Water that commenced during 2013 are approximately $8 million. Substantially all of the costs associated with these actions have been incurred in 2013.

Asset Impairment Charges

During the fourth quarter of 2013 we performed our annual impairment test of our indefinite-lived intangibles assets, which resulted in an impairment charge of $2 million related to trade names within our Water Infrastructure segment. The charge was calculated using an income approach, which is considered a Level 3 input for fair value measurement, and is reflected in “Restructuring and asset impairment charges” in our Consolidated Income Statement.

Note 5. Other Non-Operating Income (Expense), Net

The components of other non-operating income (expense), net are as follows:

| | Year Ended December 31, | | |
|---|---|---|---|
| (in millions) | 2015 | 2014 | 2013 |
| Interest income | $2 | $2 | $3 |
| Income from joint ventures | 3 | 2 | 2 |
| Other expense – net (a) | (5) | (3) | (15) |
| Total other non-operating income (expense), net | $— | $1 | $(10) |

(a) 2013 includes $10 million of expense incurred under the Tax Matters Agreement with ITT. Refer to Note 6 "Income Taxes" for additional information regarding the Tax Matters Agreement.

Note 6. Income Taxes

The source of pre-tax income and the components of income tax expense are as follows:

| | Year Ended December 31, | | |
|---|---|---|---|
| (in millions) | 2015 | 2014 | 2013 |
| Income components: | | | |
| Domestic | $116 | $118 | $49 |
| Foreign | 287 | 303 | 249 |
| Total pre-tax income | $403 | $421 | $298 |
| Income tax expense components: | | | |
| Current: | | | |
| Domestic – federal | $32 | $44 | $37 |
| Domestic – state and local | 6 | 7 | 1 |
| Foreign | 34 | 62 | 46 |
| Total Current | 72 | 113 | 84 |
| Deferred: | | | |
| Domestic – federal | $1 | $(14) | $(6) |
| Domestic – state and local | 1 | — | — |
| Foreign | (11) | (15) | (8) |
| Total Deferred | (9) | (29) | (14) |
| Total income tax provision | $63 | $84 | $70 |
| Effective income tax rate | 15.6% | 19.8% | 23.5% |

Reconciliations between taxes at the U.S. federal income tax rate and taxes at our effective income tax rate on earnings before income taxes are as follows:

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2015 | 2014 | 2013 |
| Tax provision at U.S. statutory rate | 35.0% | 35.0% | 35.0% |
| Increase (decrease) in tax rate resulting from: | | | |
| State income taxes | 1.0 | 1.0 | 0.7 |
| Settlements of tax examinations | 0.5 | 0.4 | — |
| Valuation allowance | 8.6 | 22.9 | 39.4 |
| Tax exempt interest | (13.1) | (26.3) | (43.0) |
| Foreign tax rate differential | (7.2) | (4.2) | (4.1) |
| Repatriation of foreign earnings, net of foreign tax credits | 0.2 | (1.7) | 5.1 |
| Tax incentives | (7.8) | (6.2) | (8.1) |
| Other – net | (1.6) | (1.1) | (1.5) |
| Effective income tax rate | 15.6% | 19.8% | 23.5% |

We operate under tax incentives, which are effective January 2013 through December 2023 and may be extended if certain additional requirements are satisfied. The tax incentives are conditional upon our meeting and maintaining certain employment thresholds. The inability to meet the thresholds would have a prospective impact and at this time we continue to believe we will meet the requirements.

Deferred tax assets and liabilities are determined based on temporary differences between the financial reporting and tax bases of assets and liabilities, applying enacted tax rates in effect for the year in which we expect the differences will reverse.

The following is a summary of the components of the net deferred tax assets and liabilities recognized in the Consolidated Balance Sheets:

| | December 31, | |
|---|---|---|
| (in millions) | 2015 | 2014 |
| Deferred tax assets: | | |
| Employee benefits | $106 | $124 |
| Accrued expenses | 24 | 25 |
| Loss and other tax credit carryforwards | 285 | 456 |
| Inventory | 7 | 6 |
| Other | 3 | 3 |
| | 425 | 614 |
| Valuation allowance | (248) | (427) |
| Net deferred tax asset | $177 | $187 |
| Deferred tax liabilities: | | |
| Intangibles | $168 | $173 |
| Investment in foreign subsidiaries | 4 | 8 |
| Property, plant, and equipment | 17 | 22 |
| Other | 35 | 30 |
| Total deferred tax liabilities | $224 | $233 |

Management assesses the available positive and negative evidence to estimate if sufficient future taxable income will be generated to realize existing deferred tax assets. On the basis of this evaluation, as of December 31, 2015, a valuation allowance of $248 million has been established to reduce the deferred income tax asset related to certain U.S. and foreign net operating losses, and U.S. and foreign capital loss carryforwards.

A reconciliation of our valuation allowance on deferred tax assets is as follows:

| (in millions) | 2015 | 2014 | 2013 |
|---|---|---|---|
| Valuation allowance — January 1 | $427 | $349 | $229 |
| Change in assessment | (5) | (4) | — |
| Current year operations | 39 | 100 | 118 |
| Foreign currency and other (a) | (213) | (18) | 2 |
| Valuation allowance — December 31 | $248 | $427 | $349 |

(a) Included in foreign currency and other in 2015 is the reduction of a net operating loss that was subject to a valuation allowance of $176 million.

Deferred taxes are classified net of unrecognized tax benefits in the Consolidated Balance Sheets as follow

| | December 31, | |
|---|---|---|
| (in millions) | 2015 | 2014 |
| Non-current assets | $71 | $90 |
| Non-current liabilities | (118) | (136) |
| Total net deferred tax liabilities | $(47) | $(46) |

Tax attributes available to reduce future taxable income begin to expire as follows:

| (in millions) | December 31, 2015 | First Year of Expiration |
|---|---|---|
| U.S. net operating loss | $8 | December 31, 2024 |
| State net operating loss | 53 | December 31, 2016 |
| U.S. tax credits | 43 | December 31, 2020 |
| Foreign net operating loss | 897 | December 31, 2018 |

The foreign tax credit for financial statement purposes differs from the amount for tax return purposes due to unrecognized tax benefits.

As of December 31, 2015, we have provided a deferred tax liability of $4 million on the excess of $41 million of financial reporting over the tax basis of investments in certain foreign subsidiaries that has not been indefinitely reinvested. However, we have not provided for deferred taxes on the excess of financial reporting over the tax basis of investments in certain foreign subsidiaries in the amount of $1.9 billion because we plan to reinvest such amounts indefinitely outside the U.S. The determination of the amount of federal and state income taxes is not practicable because of complexities of the hypothetical calculation.

Unrecognized Tax Benefits

We recognize tax benefits from uncertain tax positions only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the consolidated financial statements from such positions are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows:

| (in millions) | 2015 | 2014 | 2013 |
|---|---|---|---|
| Unrecognized tax benefits — January 1 | $44 | $30 | $8 |
| Additions for: | | | |
| Current year tax positions | 4 | 9 | 23 |
| Prior year tax positions | 1 | 7 | — |
| Reductions for: | | | |
| Settlements | (2) | (2) | (1) |
| Unrecognized tax benefits — December 31 | $47 | $44 | $30 |

The amount of unrecognized tax benefits at December 31, 2015 was $47 million which, if ultimately recognized, will reduce our annual effective tax rate. We believe that it is reasonably possible that the unrecognized tax benefits will be reduced by $22 million within the next twelve months.

In many cases, unrecognized tax benefits are related to tax years that remain subject to examination by the relevant taxing authorities. By virtue of previously filed separate company tax returns including tax returns filed by ITT, we are routinely under audit by federal, state, local and foreign taxing authorities. These audits include questioning the timing and the amount of deductions and the allocation of income among various tax jurisdictions. Income taxes payable include amounts considered sufficient to pay assessments that may result from examination of prior year returns; however, the amount paid upon resolution of issues raised may differ from the amount provided. Differences between the reserves for tax contingencies and the amounts owed by the company are recorded in the period they become known. Under the Tax Matters Agreement, as discussed below, ITT assumes all consolidated tax liabilities and related interest and penalties for the pre-spin period.

The following table summarizes our earliest open tax years by major jurisdiction:

| Jurisdiction | Earliest Open Year |
|---|---|
| Germany | 2009 |
| Italy | 2010 |
| Luxembourg | 2011 |
| Sweden | 2010 |
| Switzerland | 2011 |
| United Kingdom | 2011 |
| United States | 2012 |

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We classify interest relating to unrecognized tax benefits as a component of other non-operating (expense) income, net and tax penalties as a component of income tax expense in our Consolidated Income Statements. The amount of accrued interest relating to unrecognized tax benefits as of December 31, 2015 and 2014 was $1 million.

Tax Matters Agreement

In connection with the Spin-off, Xylem, ITT and Exelis entered into a Tax Matters Agreement. Under the agreement, we may be obligated to make payments to ITT and Exelis under certain conditions. These conditions include a payment to ITT in the event audit settlement payments exceed amounts specified in the agreement.

During 2015, ITT effectively settled the Federal income tax audit for the period including the year of the Spin-Off which resulted in a closing of the Federal Tax Audit portion of the Tax Matters Agreement. In connection with that, Xylem has accrued a liability of $9 million. While the U.S. State Income Tax Audit and Non U.S. Audit portion of the Tax Matters Agreement remain operational, we have not accrued a liability.

Note 7. Earnings Per Share

The following is a reconciliation of the shares used in calculating basic and diluted net earnings per share.

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2015 | 2014 | 2013 |
| Net Income (in millions) | $340 | $337 | $228 |
| Shares (in thousands): | | | |
| Weighted average common shares outstanding | 180,854 | 183,030 | 185,082 |
| Add: Participating securities (a) | 39 | 47 | 134 |
| Weighted average common shares outstanding — Basic | 180,893 | 183,077 | 185,216 |
| Plus incremental shares from assumed conversions: (b) | | | |
| Dilutive effect of stock options | 465 | 643 | 264 |
| Dilutive effect of restricted stock | 379 | 529 | 558 |
| Weighted average common shares outstanding — Diluted | 181,737 | 184,249 | 186,038 |
| Basic earnings per share | $1.88 | $1.84 | $1.23 |
| Diluted earnings per share | $1.87 | $1.83 | $1.22 |

(a) Restricted stock awards containing rights to non-forfeitable dividends that participate in undistributed earnings with common shareholders are considered participating securities for purposes of computing earnings per share.

(b) Incremental shares from stock options, restricted stock and performance share units are computed by the treasury stock method. The weighted average shares listed below were not included in the computation of diluted earnings per share because to do so would have been anti-dilutive for the periods presented or were otherwise excluded under the treasury stock method. The treasury stock method calculates dilution assuming the exercise of all in-the-money options and vesting of restricted stock and performance share awards, reduced by the repurchase of shares with the proceeds from the assumed exercises, unrecognized compensation expense for outstanding awards and the estimated tax benefit of the assumed exercises. Performance share units will be included in the treasury stock calculation of diluted earnings per share upon achievement of underlying performance conditions. See Note 15, "Stock-Based Compensation Plans" for further detail on the performance share units.

| | Year Ended December 31, | | |
|---|---|---|---|
| (in thousands) | 2015 | 2014 | 2013 |
| Stock options | 2,616 | 2,720 | 4,126 |
| Restricted shares | 723 | 525 | 703 |
| Performance shares | 181 | 119 | 80 |

Note 8. Inventories

The components of total inventories are summarized as follows:

| | December 31, | |
|---|---|---|
| (in millions) | 2015 | 2014 |
| Finished goods | $213 | $194 |
| Work in process | 32 | 42 |
| Raw materials | 188 | 250 |
| Total inventories | $433 | $486 |

Note 9. Property, Plant and Equipment

The components of total property, plant and equipment, net are as follows:

| | December 31, | |
|---|---|---|
| (in millions) | 2015 | 2014 |
| Land, buildings and improvements | $240 | $252 |
| Machinery and equipment | 650 | 655 |
| Equipment held for lease or rental | 205 | 207 |
| Furniture and fixtures | 79 | 87 |
| Construction work in progress | 46 | 41 |
| Other | 19 | 23 |
| Total property, plant and equipment, gross | 1,239 | 1,265 |
| Less accumulated depreciation | 800 | 804 |
| Total property, plant and equipment, net | $439 | $461 |

Depreciation expense was $88 million, $95 million, and $99 million for 2015, 2014, and 2013, respectively.

Note 10. Goodwill and Other Intangible Assets

Changes in the carrying value of goodwill by operating segment during the years ended December 31, 2015 and 2014 are as follows:

| (in millions) | Water Infrastructure | Applied Water | Total |
|---|---|---|---|
| Balance as of December 31, 2013 | $1,149 | $569 | $1,718 |
| Activity in 2014 | | | |
| Divestiture (a) | — | (6) | (6) |
| Foreign currency and other | (51) | (26) | (77) |
| Balance as of December 31, 2014 | $1,098 | $537 | $1,635 |
| Activity in 2015 | | | |
| Acquired (a) | 10 | — | 10 |
| Foreign currency and other | (42) | (19) | (61) |
| Balance as of December 31, 2015 | $1,066 | $518 | $1,584 |

(a) On July 2, 2014, we divested our Wolverhampton, U.K.-based pneumatic and hydraulic valves business which had $6 million of goodwill associated with the business. On October 22, 2015, we acquired substantially all of the assets of Hypack, Inc. and recorded $10 million of goodwill. Refer to Note 3, "Acquisitions and Divestitures" for additional information.

During the fourth quarter of 2015, we performed our annual impairment assessment and determined that the estimated fair values of our goodwill reporting units were in excess of each of their carrying values. However, future goodwill impairment tests could result in a charge to earnings. We will continue to evaluate goodwill on an annual basis as of the beginning of our fourth quarter and whenever events and changes in circumstances indicate there may be a potential impairment.

Other Intangible Assets

Information regarding our other intangible assets is as follows:

| (in millions) | December 31, 2015 | | | December 31, 2014 | | |
|---|---|---|---|---|---|---|
| | Carrying Amount | Accumulated Amortization | Net Intangibles | Carrying Amount | Accumulated Amortization | Net Intangibles |
| Customer and distributor relationships | $320 | $(140) | $180 | $331 | $(122) | $209 |
| Proprietary technology and patents | 116 | (54) | 62 | 116 | (49) | 67 |
| Trademarks | 35 | (19) | 16 | 36 | (17) | 19 |
| Software (a) | 155 | (110) | 45 | 145 | (106) | 39 |
| Other | 8 | (8) | — | 9 | (9) | — |
| Indefinite-lived intangibles | 132 | — | 132 | 136 | — | 136 |
| Other intangibles | $766 | $(331) | $435 | $773 | $(303) | $470 |

(a) The December 31, 2014 carrying amount of software was previously included within other non-current assets on the Consolidated Balance Sheets and is now being reflected within other intangible assets to conform to a current period change in balance sheet presentation.

We determined that no impairment of the indefinite-lived intangibles existed as of the measurement date of our annual impairment assessment in 2015 or 2014. Future impairment tests could result in a charge to earnings. We will continue to evaluate the indefinite-lived intangible assets on an annual basis as of the beginning of our fourth quarter and whenever events and changes in circumstances indicate there may be a potential impairment.

Customer and distributor relationships, proprietary technology and patents, trademarks, software and other are amortized over weighted average lives of approximately 13 years, 19 years, 16 years, 5 years and 6 years, respectively.

Total amortization expense for intangible assets was $45 million, $47 million, and $51 million for 2015, 2014 and 2013, respectively.

Estimated amortization expense for each of the five succeeding years is as follows:

| (in millions) | |
|---|---|
| 2016 | $44 |
| 2017 | 43 |
| 2018 | 40 |
| 2019 | 36 |
| 2020 | 34 |

Note 11. Derivative Financial Instruments

Risk Management Objective of Using Derivatives

We are exposed to certain risks arising from both our business operations and economic conditions, and principally manage our exposures to these risks through management of our core business activities. Certain of our foreign operations expose us to fluctuations of foreign interest rates and exchange rates that may impact revenue, expenses, cash receipts, cash payments, and the value of our stockholders' equity. We enter into derivative financial instruments to protect the value or fix the amount of certain cash flows in terms of the functional currency of the business unit with that exposure and reduce the volatility in stockholders' equity.

Cash Flow Hedges of Foreign Exchange Risk

We are exposed to fluctuations in various foreign currencies against our functional currencies. We use foreign currency derivatives, including currency forward agreements, to manage our exposure to fluctuations in the various exchange rates. Currency forward agreements involve fixing the foreign currency exchange rate for delivery of a specified amount of foreign currency on a specified date.

Certain business units with exposure to foreign currency exchange risks have designated certain currency forward agreements as cash flow hedges of forecasted intercompany inventory purchases and sales. Our principal currency exposures relate to the Euro, Swedish Krona, British Pound, Canadian Dollar, Polish Zloty, Australian Dollar and Hungarian Forint. We held forward foreign exchange contracts with purchase notional amounts totaling $94 million and $355 million as of December 31, 2015 and 2014, respectively. As of December 31, 2015, our most significant foreign currency derivatives include contracts to purchase Swedish Krona and sell Euro, sell U.S. Dollar and purchase Euro, and to sell British Pound and purchase Euro. The purchased notional amounts associated with these currency derivatives are $51 million, $24 million and $12 million, respectively. As of December 31, 2014, our most significant foreign currency derivatives include contracts to purchase Swedish Krona and sell Euro, sell U.S. Dollar and purchase Euro, and to sell British Pound and purchase Euro. The purchase notional amounts associated with these currency derivatives were $140 million, $85 million and $51 million, respectively.

Hedges of Net Investments in Foreign Operations

We are exposed to changes in foreign currencies impacting our net investments held in foreign subsidiaries. Beginning in 2015, we entered into cross currency swaps to manage our exposure to fluctuations in the Euro-U.S. Dollar exchange rate. The total notional amount of derivative instruments designated as net investment hedges was $411 million as of December 31, 2015.

The table below presents the effect of our derivative financial instruments on the Consolidated Income Statements and Statements of Comprehensive Income.

| | Year Ended December 31, | | |
|---|---|---|---|
| (in millions) | 2015 | 2014 | 2013 |
| Derivatives in Cash Flow Hedges | | | |
| Foreign Exchange Contracts | | | |
| Amount of (loss) gain recognized in OCI (a) | $(5) | $(22) | $1 |
| Amount of loss (gain) reclassified from OCI into revenue (a) | 19 | 5 | (2) |
| Amount of loss reclassified from OCI into cost of revenue (a) | 1 | 1 | 2 |
| | | | |
| Derivatives in Net Investment Hedges | | | |
| Amount of (loss) recognized in OCI (a) | $(17) | $— | $— |

(a) Effective portion

As of December 31, 2015, $1 million of the net gains on cash flow hedges is expected to be reclassified into earnings in the next 12 months. The ineffective portion of the change in fair value of a cash flow hedge is excluded from effectiveness testing and is recognized immediately in selling, general and administrative expenses in the Consolidated Income Statements and was not material for 2015, 2014, and 2013.

As of December 31, 2015, no gains or losses on the net investment hedges are expected to be reclassified into earnings over the next 12 months. The net investment hedges did not experience any ineffectiveness for 2015.

The fair values of our derivative assets and liabilities are measured on a recurring basis using Level 2 inputs and are determined through the use of models that consider various assumptions including yield curves, time value and other measurements.

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The fair values of our derivative contracts currently included in our hedging program were as follows:

| | December 31, | |
|---|---|---|
| (in millions) | 2015 | 2014 |
| Derivatives designated as hedging instruments | | |
| Assets | | |
| Cash Flow Hedges | | |
| Other current assets | $2 | $1 |
| Liabilities | | |
| Cash Flow Hedges | | |
| Other current liabilities | — | (13) |
| Net Investment Hedges | | |
| Other non-current liabilities | (18) | — |

Note 12. Accrued and Other Current Liabilities

| | December 31, | |
|---|---|---|
| (in millions) | 2015 | 2014 |
| Compensation and other employee-benefits | $156 | $186 |
| Customer-related liabilities | 64 | 66 |
| Accrued warranty costs | 33 | 31 |
| Accrued taxes | 64 | 77 |
| Other accrued liabilities | 90 | 116 |
| Total accrued and other current liabilities | $407 | $476 |

Note 13. Credit Facilities and Long-Term Debt

Total debt outstanding is summarized as follows:

| | December 31, | |
|---|---|---|
| (in millions) | 2015 | 2014 |
| 3.550% Senior Notes due 2016 (a) | $600 | $600 |
| 4.875% Senior Notes due 2021 (a) | 600 | 600 |
| Research and Development Facility Agreement | 76 | 84 |
| Other | 2 | 5 |
| Debt issuance costs and unamortized discount (b) | (4) | (5) |
| Total debt | 1,274 | 1,284 |
| Less: short-term borrowings and current maturities of long-term debt | 78 | 89 |
| Total long-term debt | $1,196 | $1,195 |

(a) The fair value of our Senior Notes (as defined below) was determined using quoted prices in active markets for identical securities, which are considered Level 1 inputs. The fair value of our Senior Notes due 2016 (as defined below) was $607 million and $621 million as of December 31, 2015 and 2014, respectively. The fair value of our Senior Notes due 2021 (as defined below) was $640 million and $653 million as of December 31, 2015 and 2014, respectively.

(b) The debt issuance costs and unamortized discount is recognized as a reduction in the carrying value of the Senior Notes in the Consolidated Balance Sheets and is being amortized to interest expense in our Consolidated Income Statements over the expected remaining terms of the Senior Notes.

Senior Notes

On September 20, 2011, we issued 3.550% Senior Notes of $600 million aggregate principal amount due September 2016 (the "Senior Notes due 2016") and 4.875% Senior Notes of $600 million aggregate principal amount due October 2021 (the "Senior Notes due 2021" and together with the Senior Notes due 2016, the “Senior Notes”).

The Senior Notes include covenants which restrict our ability, subject to exceptions, to incur debt secured by liens and engage in sale and leaseback transactions, as well as provide for customary events of default (subject, in certain cases, to receipt of notice of default and/or customary grace and cure periods). We may redeem the Senior Notes, as applicable, in whole or in part, at any time at a redemption price equal to the principal amount of the Senior Notes to be redeemed, plus a make-whole premium. If a change of control triggering event (as defined in the Senior Notes indenture) occurs, we will be required to make an offer to purchase the Senior Notes at a price equal to 101% of their principal amount plus accrued and unpaid interest to the date of repurchase. As of December 31, 2015, we were in compliance with all covenants.

Interest on the Senior Notes due 2016 is payable on March 20 and September 20 of each year. Interest on the Senior Notes due 2021 is payable on April 1 and October 1 of each year.

As of December 31, 2015, we have classified $600 million of our Senior Notes due 2016 as long-term based on our current ability and intent to refinance the outstanding borrowings on a long-term basis.

Five-Year Revolving Credit Facility

Effective March 27, 2015, Xylem entered into a Five-Year Revolving Credit Facility (the "Credit Facility") with Citibank, N.A., as administrative agent, and a syndicate of lenders. The Credit Facility provides for an aggregate principal amount of up to $600 million of: (i) revolving extensions of credit (the "revolving loans") outstanding at any time and (ii) the issuance of letters of credit in a face amount not in excess of $100 million outstanding at any time. The Credit Facility provides for increases of up to $200 million for a possible maximum total of $800 million in aggregate principal amount at our request and with the consent of the institutions providing such increased commitments.

At our election, the interest rate per annum applicable to the revolving loans will be based on either (i) a Eurodollar rate determined by reference to LIBOR, adjusted for statutory reserve requirements, plus an applicable margin or (ii) a fluctuating rate of interest determined by reference to the greatest of: (a) the prime rate of Citibank, N.A., (b) the U.S. Federal funds effective rate plus 0.5% or (c) the Eurodollar rate determined by reference to LIBOR, adjusted for statutory reserve requirements, in each case, plus an applicable margin.

In accordance with the terms, we may not exceed a maximum leverage ratio of 3.50 to 1.00 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. The Credit Facility also contains limitations on, among other things, incurring secured debt, granting liens, entering into sale and leaseback transactions, mergers, consolidations, liquidations, dissolutions and sales of assets. In addition, the Credit Facility contains other terms and conditions such as customary representations and warranties, additional covenants and customary events of default. As of December 31, 2015, we were in compliance with all covenants.

As of December 31, 2015, the Credit Facility was undrawn.

Research and Development Facility Agreement

On December 3, 2015, the Company amended and restated its Risk Sharing Finance Facility Agreement (the "R&D Facility Agreement") with The European Investment Bank (the "EIB") to amend the maturity date. The facility provides an aggregate principal amount of up to €120 million (approximately $132 million) to finance research projects and infrastructure development in the European Union. The Company's wholly owned subsidiaries in Luxembourg, Xylem Holdings S.á r.l. and Xylem International S.á r.l., are the borrowers under the R&D Facility Agreement. The obligations of the borrowers under the R&D Facility Agreement are guaranteed by the Company under an Amended and Restated Deed of Guarantee, dated as of December 4, 2013, in favor of the EIB. The funds are available during the period from 2013 through 2016 at the Company's facilities in Sweden, Germany, Italy, the United Kingdom, Austria, Norway and Hungary.

Under the R&D Facility Agreement, the borrower can draw loans on or before March 31, 2016 with a maturity of no longer than 12 years. The R&D Facility Agreement provides for Fixed Rate loans and Floating Rate loans. The interest rate per annum applicable to Fixed Rate loans is at a fixed percentage rate per annum specified by the EIB which includes the applicable margin. The interest rate per annum applicable to Floating Rate loans is at the rate determined by reference to EURIBOR for loans drawn in Euros and LIBOR for loans drawn in Pounds Sterling or U.S. Dollars, plus an applicable spread specified by the EIB which includes the applicable margin. The applicable margin for both Fixed Rate loans and Floating Rate loans is determined by reference to the credit rating of the Company.

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In accordance with the terms of the R&D Facility Agreement, we may not exceed a maximum leverage ratio of 3.50 to 1.00 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. The R&D Facility Agreement also contains limitations on, among other things, incurring debt, granting liens, and entering into sale and leaseback transactions. In addition, the R&D Facility Agreement contains other terms and conditions, such as customary representations and warranties, additional covenants and customary events of default. As of December 31, 2015, we were in compliance with all covenants.

As of December 31, 2015 and 2014, $76 million and $84 million was outstanding, respectively, under the R&D Facility Agreement. Although the borrowing term for this arrangement is up to five years, we have classified it as short-term debt on our Consolidated Balance Sheet since we intend to repay this obligation in less than a year.

Note 14. Postretirement Benefit Plans

Defined contribution plans – Xylem and certain of our subsidiaries maintain various defined contribution savings plans, which allow employees to contribute a portion of their pre-tax and/or after-tax income in accordance with specified guidelines. Several of the plans require us to match a percentage of the employee contributions up to certain limits, generally between 3.0% – 7.0% of employee base pay. Xylem's U.S. plan also provides for transition credits for eligible U.S. employees for the first five years after the Spin-off to supplement retirement benefits in the absence of a defined benefit plan. Age plus years of eligible service greater than or equal to 60, entitles an employee to transition credits. The liability for transition credits was approximately $2 million and $2 million at December 31, 2015 and 2014, respectively. Matching obligations, the majority of which were funded in cash in connection with the plans, along with transition credits and other company contributions are as follows:

| (in millions) | Defined Contribution |
|---|---|
| 2015 | $32 |
| 2014 | 36 |
| 2013 | 35 |

The Xylem Stock Fund, an investment option under the defined contribution plan in which Company employees participate is considered an Employee Stock Ownership Plan. As a result, participants in the Xylem Stock Fund may receive dividends in cash or may reinvest such dividends into the Xylem Stock Fund. Company employees held approximately 414 thousand and 415 thousand shares of Xylem Inc. common stock in the Xylem Stock Fund at December 31, 2015 and 2014, respectively.

Defined benefit pension plans and other postretirement plans – We historically have maintained qualified and nonqualified defined benefit retirement plans covering certain current and former employees, including hourly and union plans as well as salaried plans, which generally require up to 5 years of service to be vested and for which the benefits are determined based on years of credited service and either specified rates, final pay, or final average pay. The other postretirement benefit plans are all unfunded plans in the U.S. and Canada.

During 2015, we made several amendments to plans that had no material impact to the Company's financial statements.

During the third quarter 2014, we amended one of our international pension plans as well as one of our domestic other postretirement plans. The pension plan amendment froze the accrual of benefits and closed the plan to new entrants. The other postretirement plan amendment modified the accrual of benefits and closed the plan to new entrants. The overall impact of these changes was a $10 million increase to funded status. This included a net loss of $3 million ($1 million net of tax) and a prior service credit of $13 million ($8 million net of tax) recognized in other comprehensive income.

Effective October 1, 2013, the Xylem Canada Company Pension Plan for Salaried Employees was amended to close the plan to new entrants and implemented a soft freeze, where benefits earned to date are based on frozen service but the future average earnings will continue to be recognized. The impact of the curtailment on the Company's financial statements was immaterial. However, the participants are now considered inactive and actuarial gains and losses will be amortized over 25 years which represents the expected weighted-average remaining lives of the plan participants.

Effective October 14, 2013, an amendment to one of the Company's U.S. business unit's pension plans for its hourly workers modified the benefit formula. Pension benefits for future service will be based only on years of service. The remeasurement at year end resulted in a $4 million prior service credit, which will be amortized into net periodic pension cost over approximately 11 years.

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Amounts recognized in the Consolidated Balance Sheets for pension and other employee-related benefit plans (collectively, postretirement plans) reflect the funded status of the postretirement benefit plans. The following table provides a summary of the funded status of our postretirement plans, the presentation of such balances and a summary of amounts recorded within accumulated other comprehensive income.

| (in millions) | December 31, 2015 | | | December 31, 2014 | | |
|---|---|---|---|---|---|---|
| | Pension | Other | Total | Pension | Other | Total |
| Fair value of plan assets | $559 | $— | $559 | $584 | $— | $584 |
| Projected benefit obligation | (779) | (61) | (840) | (872) | (58) | (930) |
| Funded status | $(220) | $(61) | $(281) | $(288) | $(58) | $(346) |
| Amounts recognized in the balance sheet | | | | | | |
| Other non-current assets | $68 | $— | $68 | $55 | $— | $55 |
| Accrued and other current liabilities | (10) | (4) | (14) | (10) | (3) | (13) |
| Accrued postretirement benefits | (278) | (57) | (335) | (333) | (55) | (388) |
| Net amount recognized | $(220) | $(61) | $(281) | $(288) | $(58) | $(346) |
| Accumulated other comprehensive income (loss): | | | | | | |
| Net actuarial losses | $(234) | $(31) | $(265) | $(297) | $(30) | $(327) |
| Prior service credit | — | 15 | 15 | — | 17 | 17 |
| Total | $(234) | $(16) | $(250) | $(297) | $(13) | $(310) |

The unrecognized amounts recorded in accumulated other comprehensive income will be subsequently recognized as expense on a straight-line basis only to the extent they exceed 10% of the higher of the market-related value or the projected benefit obligation, over the average remaining service period of active participants, or for plans with all or substantially all inactive participants, over the average remaining life expectancy. Actuarial gains and losses incurred in future periods and not recognized as expense in those periods will be recognized as increases or decreases in other comprehensive income, net of tax.

The net actuarial loss included in accumulated other comprehensive income at the end of 2015 and expected to be recognized in net periodic benefit cost during 2016 is $14 million ($10 million, net of tax). The prior service credit included in accumulated other comprehensive income to be recognized in 2016 is $3 million ($2 million, net of tax).

The benefit obligation, fair value of plan assets, funded status, and amounts recognized in the consolidated financial statements for our defined benefit domestic and international pension plans were:

| | Domestic Plans December 31, | | International Plans December 31, | |
|---|---|---|---|---|
| (in millions) | 2015 | 2014 | 2015 | 2014 |
| Change in benefit obligation: | | | | |
| Benefit obligation at beginning of year | $88 | $74 | $784 | $703 |
| Service cost | 3 | 2 | 12 | 12 |
| Interest cost | 4 | 3 | 22 | 27 |
| Benefits paid | (4) | (3) | (29) | (30) |
| Actuarial (gain) loss | (5) | 13 | (39) | 144 |
| Plan amendments, settlements and curtailments | 1 | — | (1) | (2) |
| Foreign currency translation/other | (1) | (1) | (56) | (70) |
| Benefit obligation at end of year | $86 | $88 | $693 | $784 |
| Change in plan assets: | | | | |
| Fair value of plan assets at beginning of year | $60 | 58 | $524 | $466 |
| Employer contributions | 3 | 4 | 19 | 28 |
| Actual return on plan assets | (2) | 3 | 22 | 92 |
| Benefits paid | (4) | (3) | (29) | (30) |
| Plan amendments, settlements and curtailments | — | — | — | (2) |
| Foreign currency translation/other | — | (2) | (34) | (30) |
| Fair value of plan assets at end of year | $57 | $60 | $502 | $524 |
| Unfunded status of the plans | $(29) | $(28) | $(191) | $(260) |

The following table provides a rollforward of the projected benefit obligation for the other postretirement employee benefit plans:

| (in millions) | 2015 | 2014 |
|---|---|---|
| Change in benefit obligation: | | |
| Benefit obligation at beginning of year | $58 | $63 |
| Service cost | 1 | 1 |
| Interest cost | 2 | 3 |
| Benefits paid | (3) | (3) |
| Actuarial loss | 4 | 12 |
| Plan amendment | (1) | (18) |
| Benefit obligation at the end of year | $61 | $58 |

The accumulated benefit obligation (“ABO”) for all the defined benefit pension plans was $746 million and $830 million at December 31, 2015 and 2014, respectively. For defined benefit pension plans in which the ABO was in excess of the fair value of the plans’ assets, the projected benefit obligation, ABO and fair value of the plans’ assets were as follows:

| | December 31, | |
|---|---|---|
| (in millions) | 2015 | 2014 |
| Projected benefit obligation | $392 | $453 |
| Accumulated benefit obligation | 365 | 419 |
| Fair value of plan assets | 106 | 110 |

The components of net periodic benefit cost for our defined benefit pension plans are as follows:

| | Year Ended December 31, | | |
|---|---|---|---|
| (in millions) | 2015 | 2014 | 2013 |
| Domestic defined benefit pension plans: | | | |
| Service cost | $3 | $2 | $3 |
| Interest cost | 4 | 3 | 3 |
| Expected return on plan assets | (5) | (4) | (4) |
| Amortization of prior service cost | — | — | 1 |
| Amortization of net actuarial loss | 2 | 2 | 2 |
| Net periodic benefit cost | $4 | $3 | $5 |
| International defined benefit pension plans: | | | |
| Service cost | $12 | $12 | $14 |
| Interest cost | 22 | 27 | 28 |
| Expected return on plan assets | (32) | (32) | (31) |
| Amortization of net actuarial loss | 13 | 7 | 13 |
| Settlement | — | 1 | — |
| Net periodic benefit cost | $15 | $15 | $24 |
| Total net periodic benefit cost | $19 | $18 | $29 |

Other changes in assets and benefit obligations recognized in other comprehensive (loss) income, as they pertain to our defined benefit pension plans are as follows:

| | Year Ended December 31, | | |
|---|---|---|---|
| (in millions) | 2015 | 2014 | 2013 |
| Domestic defined benefit pension plans: | | | |
| Net loss (gain) | $2 | $14 | $(11) |
| Prior service cost (credit) | — | 1 | (4) |
| Amortization of prior service cost | — | — | (1) |
| Amortization of net actuarial loss | (2) | (2) | (2) |
| Losses (gains) recognized in other comprehensive (loss) income | $— | $13 | $(18) |
| International defined benefit pension plans: | | | |
| Net (gain) loss | $(29) | $84 | $(21) |
| Amortization of net actuarial loss | (13) | (7) | (13) |
| Settlement | — | (1) | — |
| Foreign currency translation/other | (21) | (20) | (2) |
| (Gains) losses recognized in other comprehensive (loss) income | $(63) | $56 | $(36) |
| Total (gains) losses recognized in other comprehensive (loss) income | $(63) | $69 | $(54) |
| Total (gains) losses recognized in comprehensive income | $(44) | $87 | $(25) |

The components of net periodic benefit cost for other postretirement employee benefit plans are as follows:

| | Year Ended December 31, | | |
|---|---|---|---|
| (in millions) | 2015 | 2014 | 2013 |
| Service cost | $1 | $1 | $1 |
| Interest cost | 2 | 3 | 3 |
| Amortization of prior service credit | (3) | (1) | — |
| Amortization of net actuarial loss | 3 | 2 | 2 |
| Net periodic benefit cost | $3 | $5 | $6 |

Other changes in benefit obligations recognized in other comprehensive (loss) income, as they pertain to other postretirement employee benefit plans are as follows:

| | Year Ended December 31, | | |
|---|---|---|---|
| (in millions) | 2015 | 2014 | 2013 |
| Net loss (gain) | $4 | $12 | $(2) |
| Prior service credit | (1) | (18) | — |
| Amortization of prior service credit | 3 | 1 | — |
| Amortization of net actuarial loss | (3) | (2) | (2) |
| Losses (gains) recognized in other comprehensive (loss) income | $3 | $(7) | $(4) |
| Total losses (gains) recognized in comprehensive income | $6 | $(2) | $2 |

Assumptions

The following table provides the weighted-average assumptions used to determine projected benefit obligations and net periodic benefit cost, as they pertain to our pension plans.

| | 2015 | | 2014 | | 2013 | |
|---|---|---|---|---|---|---|
| | U.S. | Int'l | U.S. | Int'l | U.S. | Int'l |
| Benefit Obligation Assumptions | | | | | | |
| Discount rate | 4.27% | 3.44% | 4.01% | 3.14% | 4.79% | 4.23% |
| Rate of future compensation increase | NM | 3.29% | NM | 3.34% | NM | 3.48% |
| Net Periodic Benefit Cost Assumptions | | | | | | |
| Discount rate | 4.01% | 3.14% | 4.79% | 4.23% | 4.13% | 4.04% |
| Expected long-term return on plan assets | 8.00% | 7.31% | 8.00% | 7.30% | 8.00% | 7.33% |
| Rate of future compensation increase | NM | 3.34% | NM | 3.48% | 4.50% | 3.50% |

NM Not meaningful. The pension benefits for future service for all the U.S. pension plans are based on years of service and not impacted by future compensation increases.

Management develops each assumption using relevant company experience in conjunction with market-related data for each individual country in which plans exist. Assumptions are reviewed annually and adjusted as necessary.

The expected long-term rate of return on assets reflects the expected returns for each major asset class in which the plans hold investments, the weight of each asset class in the target mix, the correlations among asset classes and their expected volatilities. The assets of the pension plans are held by a number of independent trustees, managed by several investment institutions and are accounted for separately in the Company's pension funds.

Our expected return on plan assets is estimated by evaluating both historical returns and estimates of future returns. Specifically, we analyze the plans' actual historical annual return on assets, net of fees, over the past 15, 20 and 25 years; estimate future returns based on independent estimates of asset class returns; and evaluate historical broad market returns over long-term timeframes based on our asset allocation range. For the U.S. Master Trust which has only existed since 2011, historical returns were estimated using a constructed portfolio that reflects the Company's strategic asset allocation and the historical compound geometric returns of each asset class for the longest time period available. Based on this approach, the weighted average expected long-term rate of return for all of our plan assets to be used in determining net periodic benefit costs for 2016 is estimated at 7.32%.

The table below provides the weighted average actual rate of return generated on all of our plan assets during each of the years presented as compared to the weighted average expected long-term rates of return utilized in calculating the net periodic benefit costs.

| | 2015 | | 2014 | | 2013 | |
|---|---|---|---|---|---|---|
| Expected long-term rate of return on plan assets | 7.38 | % | 7.38 | % | 7.40 | % |
| Actual rate of return on plan assets | 3.51 | % | 18.13 | % | 10.17 | % |

The assumed rate of future increases in the per capita cost of health care (the health care trend rate) is 7.00% for 2016, decreasing ratably to 4.50% in 2027. An increase or decrease in the health care trend rates by one percent per year would impact the aggregate annual service and interest components by less than $1 million, and impact the benefit obligation by approximately $4 million.

Investment Policy

The investment strategy for managing worldwide postretirement benefit plan assets is to seek an optimal rate of return relative to an appropriate level of risk for each plan. Investment strategies vary by plan, depending on the specific characteristics of the plan, such as plan size and design, funded status, liability profile and legal requirements. In general, the plans are managed closely to their strategic allocations.

The following table provides the actual asset allocations of plan assets as of December 31, 2015 and 2014, and the related asset target allocation ranges by asset category.

| | 2015 | | 2014 | | Target Allocation Ranges |
|---|---|---|---|---|---|
| Equity securities | 22.5 | % | 28.8 | % | 20-40% |
| Fixed income | 31.5 | % | 37.3 | % | 20-60% |
| Hedge funds | 34.0 | % | 25.0 | % | 20-60% |
| Private equity | 3.1 | % | 3.2 | % | 0-15% |
| Insurance contracts and other | 8.9 | % | 5.7 | % | 0-30% |

Fair Value of Plan Assets

In measuring plan assets at fair value, the fair value hierarchy is applied which categorizes and prioritizes the inputs used to estimate fair value into three levels. See Note 1 "Summary of Significant Accounting Policies" for further detail on fair value hierarchy.

In certain instances, fair value is estimated using quoted market prices obtained from external pricing services. In obtaining such data from the pricing service, we have evaluated the methodologies used to develop the estimate of fair value in order to assess whether such valuations are representative of fair value, including net asset value ("NAV"). Additionally, in certain circumstances, the NAV reported by an asset manager may be adjusted when sufficient evidence indicates NAV is not representative of fair value.

The following is a description of the valuation methodologies and inputs used to measure fair value for major categories of investments.

- Equity securities — Equities (including common and preferred shares, domestic listed and foreign listed, closed end mutual funds and exchange traded funds) are generally valued at the closing price reported on the major market on which the individual securities are traded at the measurement date. Equity securities held by the Company that are publicly traded in active markets are classified within Level 1 of the fair value hierarchy. Those equities that are held in proprietary funds pooled with other investor accounts measured at fair value using the NAV per share practical expedient are not classified in the fair value hierarchy.
- Fixed income — United States government securities are generally valued using quoted prices of securities with similar characteristics. Corporate bonds and notes are generally valued by using pricing models (e.g. discounted cash flows), quoted prices of securities with similar characteristics or broker quotes. Fixed income securities listed on active markets are classified in Level 1. Fixed income held in proprietary funds pooled with other investor accounts measured at fair value using the NAV per share practical expedient are not classified in the fair value hierarchy.

- Hedge funds — Hedge funds are pooled funds that employ a range of investment strategies including equity and fixed income, credit driven, macro and multi oriented strategies. The valuation of limited partnership interests in hedge funds may require significant management judgment. Generally, hedge funds are valued using the NAV reported by the asset manager, and are adjusted when it is determined that NAV is not representative of fair value. In making such an assessment, a variety of factors is reviewed, including, but not limited to, the timeliness of NAV as reported by the asset manager and changes in general economic and market conditions subsequent to the last NAV reported by the asset manager. $158 million (83%) of the hedge funds have no lockup or gate, and a redemption period of 90 days or less. Hedge funds have unfunded commitments of $6 million at both December 31, 2015 and 2014.
- Private equity — Private equity includes a diversified range of strategies, including buyout funds, distressed funds, venture and growth equity funds and mezzanine funds with long-term commitments, and redemptions beginning no earlier than 2018. The valuation of limited partnership interests in private equity funds may require significant management judgment. Generally, private equity is valued using the NAV reported by the asset manager, and is adjusted when it is determined that NAV is not representative of fair value. In making such an assessment, a variety of factors is reviewed, including, but not limited to, the timeliness of NAV as reported by the asset manager and changes in general economic and market conditions subsequent to the last NAV reported by the asset manager. Private equity is not liquid and has unfunded commitments of $4 million and $5 million at December 31, 2015 and 2014, respectively.
- Insurance contracts and other — Primarily comprised of insurance contracts and cash. Insurance contracts are valued at book value, which approximates fair value, and is calculated using the prior year balance adjusted for investment returns and cash flows and are generally classified as Level 3. Insurance contracts are held by certain foreign pension plans. Cash and cash equivalents are held in accounts with brokers or custodians for liquidity and investment collateral and are classified as Level 1.

The following table provides the fair value of plan assets held by our pension benefit plans by asset class.

| | 2015 | | | | | 2014 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| (in millions) | Level 1 | Level 2 | Level 3 | NAV Practical Expedient | Total | Level 1 | Level 2 | Level 3 | NAV Practical Expedient | Total |
| Equity securities | | | | | | | | | | |
| Global stock funds/securities | $79 | $— | $— | $4 | $83 | $112 | $— | $— | $11 | $123 |
| Index funds | 6 | — | — | 34 | 40 | 4 | — | — | 38 | 42 |
| Emerging market funds | 3 | — | — | — | 3 | 3 | — | — | — | 3 |
| Fixed income | | | | | | | | | | |
| Corporate bonds | 34 | 4 | — | 11 | 49 | 53 | 4 | — | 22 | 79 |
| Government bonds | 99 | 18 | — | 10 | 127 | 87 | 42 | — | 10 | 139 |
| Hedge funds | 9 | — | — | 181 | 190 | 11 | — | — | 135 | 146 |
| Private equity | — | — | — | 17 | 17 | — | — | — | 19 | 19 |
| Insurance contracts and other | 25 | — | 25 | — | 50 | 16 | — | 17 | — | 33 |
| Total plan assets subject to leveling | $255 | $22 | $25 | $257 | $559 | $286 | $46 | $17 | $235 | $584 |

The following table presents a reconciliation of the beginning and ending balances of fair value measurement within our pension plans using significant unobservable inputs (Level 3).

| (in millions) | Insurance Contracts and Other |
|---|---|
| Balance, December 31, 2014 (a) | $17 |
| Purchases, sales, settlements | 2 |
| Net transfers | 7 |
| Currency impact | (1) |
| Balance, December 31, 2015 | $25 |

(a) There were no material changes to Level 3 assets during 2014.

Contributions and Estimated Future Benefit Payments

Funding requirements under governmental regulations are a major consideration in making contributions to our postretirement plans. We made contributions of $25 million and $35 million to our pension and postretirement defined benefit plans during 2015 and 2014, respectively. We currently anticipate making contributions to our pension and postretirement defined benefit plans in the range of $26 million to $36 million during 2016, of which approximately $8 million is expected to be made in the first quarter.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid as follows:

| (in millions) | Pension | Other Benefits |
|---|---|---|
| 2016 | $32 | $4 |
| 2017 | 33 | 4 |
| 2018 | 33 | 4 |
| 2019 | 34 | 4 |
| 2020 | 35 | 4 |
| Years 2021 - 2025 | 187 | 22 |

Note 15. Stock-Based Compensation Plans

Our stock-based compensation program is a broad-based program designed to attract and retain employees while also aligning employees' interests with the interests of our shareholders. In addition, members of our Board of Directors participate in our stock-based compensation program in connection with their service on our board. Share-based awards issued to employees include non-qualified stock options, restricted stock awards and performance-based awards. Under the 2011 Omnibus Incentive Plan, the number of shares initially available for awards was 18 million. As of December 31, 2015, there were approximately 9 million shares of common stock available for future grants.

Total share-based compensation costs recognized for 2015, 2014 and 2013 were $15 million, $18 million, and $27 million, respectively. The unamortized compensation expense at December 31, 2015 related to our stock options, restricted shares and performance-based shares was $5 million, $19 million and $3 million, respectively, and is expected to be recognized over a weighted average period of 1.8, 1.9 and 1.9 years, respectively.

The amount of cash received from the exercise of stock options was $21 million for 2015 with a tax benefit of $8 million realized associated with stock option exercises and vesting of restricted stock. We classify as a financing activity the cash flows attributable to excess tax benefits arising from stock option exercises and restricted stock vestings.

Stock Option Grants

Options are awarded with a contractual term of ten years and generally vest over or at the conclusion of a three-year period and are exercisable in seven to ten-year periods, except in certain instances of death, retirement or disability. The exercise price per share is the fair market value of the underlying common stock on the date each option is granted. At December 31, 2015, there were options to purchase an aggregate of 2.6 million shares of common stock. The following is a summary of the changes in outstanding stock options for 2015:

| (shares in thousands) | Shares | Weighted Average Exercise Price / Share | Weighted Average Remaining Contractual Term (Years) |
|---|---|---|---|
| Outstanding at January 1, 2015 | 2,989 | $28.60 | 6.5 |
| Granted | 708 | $35.88 | 9.2 |
| Exercised | (840) | $24.86 | 4.5 |
| Forfeited and expired | (296) | $34.76 | 8.6 |
| Outstanding at December 31, 2015 | 2,561 | $31.16 | 6.8 |
| Options exercisable at December 31, 2015 | 1,608 | $28.49 | 5.7 |
| Vested and non-vested expected to vest as of December 31, 2015 | 2,480 | $31.00 | 6.7 |

The amount of non-vested options outstanding was 1.0 million, 1.0 million and 1.5 million at a weighted average grant date fair value of $35.65, $32.45 and $26.90 as of December 31, 2015, 2014 and 2013, respectively. The aggregate intrinsic value of the outstanding, exercisable, and vested and non-vested stock options expected to vest at December 31, 2015 was $15 million, $13 million and $15 million respectively. The total intrinsic value of options exercised (which is the amount by which the stock price exceeded the exercise price of the options on the date of exercise) during 2015, 2014 and 2013 was $9 million, $10 million and $7 million, respectively.

The fair value of each option grant was estimated on the date of grant using the binomial lattice pricing model which incorporates multiple and variable assumptions over time, including assumptions such as employee exercise patterns, stock price volatility and changes in dividends. The following are weighted-average assumptions used for 2015, 2014, and 2013:

| | 2015 | 2014 | 2013 |
|---|---|---|---|
| Dividend yield | 1.57% | 1.34% | 1.69% |
| Volatility | 27.77% | 28.49% | 31.10% |
| Risk-free interest rate | 1.64% | 1.82% | 1.28% |
| Expected term (in years) | 5.58 | 5.60 | 6.62 |
| Weighted-average fair value per share | $8.49 | $9.71 | $7.58 |

Expected volatility is calculated based on a weighted analysis of historic and implied volatility measures for a set of peer companies and Xylem. We use historical data to estimate option exercise and employee termination behavior within the valuation model. Employee groups and option characteristics are considered separately for valuation purposes. The expected term represents an estimate of the period of time options are expected to remain outstanding. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of option grant.

Restricted Stock Grants

Restricted shares granted to employees generally become fully vested upon the third anniversary of the date of grant. Prior to the time a restricted share becomes fully vested, the awardees cannot transfer, pledge, hypothecate or encumber such shares. Prior to the time a restricted share is fully vested, the awardees do not have certain rights of a stockholder, such as the right to vote and receive dividends; however, dividends accrue during the vesting period and are paid upon vesting. If an employee leaves prior to vesting, whether through resignation or termination for cause, the restricted stock and related accrued dividends are forfeited. If an employee retires, a pro rata portion of the restricted stock may vest in accordance with the terms of the grant agreements. Restricted shares granted to Board members become fully vested upon the day prior to the next annual meeting. Our restricted stock activity was as follows for 2015:

| (shares in thousands) | Shares | Weighted Average Grant Date Fair Value / Share |
|---|---|---|
| Outstanding at January 1, 2015 | 1,171 | $31.80 |
| Granted | 426 | $35.87 |
| Vested | (426) | $28.85 |
| Forfeited | (158) | $32.75 |
| Outstanding at December 31, 2015 | 1,013 | $34.52 |

Performance-Based Share Grants

As part of the annual grants under the long-term incentive plan, performance-based shares were granted to all executive officers of the Company. The performance-based shares vest based upon performance by the Company over a three-year period against targets approved by the compensation committee of the Company's Board of Directors prior to the grant date. For the performance periods, the performance-based shares were granted at a target of 100% with actual payout contingent upon the achievement of a pre-set, three-year adjusted Return on Invested Capital and cumulative adjusted net income performance target. The calculated compensation cost is adjusted based on an estimate of awards ultimately expected to vest and our assessment of the probable outcome of the performance condition. The fair value of performance-based share awards at 100% target is determined using the closing price of our common stock on date of grant. Our performance-based share activity was as follows for 2015:

| (shares in thousands) | Shares | Weighted Average Grant Date Fair Value / Share |
|---|---|---|
| Outstanding at January 1, 2015 | 124 | $33.95 |
| Granted | 103 | $35.91 |
| Forfeited | (67) | $33.21 |
| Outstanding at December 31, 2015 | 160 | $35.48 |

Note 16. Capital Stock

The Company has the authority to issue an aggregate of 750 million shares of common stock having a par value of $0.01 per share. The stockholders of Xylem common stock are entitled to receive dividends as declared by the Xylem Board of Directors. Dividends declared were $0.5632, $0.5120 and $0.4656 during 2015, 2014 and 2013, respectively.

The changes in common stock outstanding for the three years ended December 31 are as follows:

| (in thousands of shares) | 2015 | 2014 | 2013 |
|---|---|---|---|
| Beginning Balance, January 1 | 182,300 | 184,557 | 185,658 |
| Stock incentive plan net activity | 1,280 | 1,226 | 1,203 |
| Repurchase of common stock | (5,203) | (3,483) | (2,304) |
| Ending Balance, December 31 | 178,377 | 182,300 | 184,557 |

On August 24, 2015, our Board of Directors authorized the repurchase of up to $500 million in shares with no expiration date. The program's objective is to deploy our capital in a manner that benefits our shareholders and maintains our focus on growth. During 2015, we repurchased 2.3 million shares for $80 million under this program. There are up to $420 million in shares that may still be purchased under this plan as of December 31, 2015.

On August 20, 2013, our Board of Directors authorized the repurchase of up to $250 million in shares with no expiration date. The program's objective was to deploy our capital in a manner that benefited our shareholders and maintain our focus on growth. During 2015 and 2014, we repurchased 2.0 million shares and 3.4 million shares for $70 million and $130 million, respectively, under this program. As of December 31, 2015, we have exhausted the authorized amount to repurchase shares under this plan.

On August 18, 2012, the Board of Directors authorized the repurchase of up to 2.0 million shares of common stock with no expiration date. The program's objective is to offset dilution associated with various Xylem employee stock plans by acquiring shares in the open market from time to time. During 2015 we repurchased 0.8 million shares for $25 million. There are up to 0.3 million shares (approximately $9 million in value) that may still be purchased under this plan as of December 31, 2015. There were no shares repurchased under this plan during 2014.

Aside from the aforementioned repurchase programs, we repurchased 0.1 million and 0.2 million shares for $4 million and $4 million during 2015 and 2014, respectively in relation to settlement of employee tax withholding obligations due as a result of the vesting of restricted stock. These repurchases are included in the stock incentive plan net activity in the above table.

Note 17. Accumulated Other Comprehensive Income (Loss)

The following table provides the components of accumulated other comprehensive income (loss) for 2015, 2014 and 2013:

| (in millions) | Foreign Currency Translation | Postretirement Benefit Plans | Derivative Instruments | Total |
|---|---|---|---|---|
| Balance at January 1, 2013 | $336 | $(222) | $1 | $115 |
| Foreign currency translation adjustment | 15 | | | 15 |
| Changes in postretirement benefit plans | | 40 | | 40 |
| Income tax expense on changes in postretirement benefit plans | | (17) | | (17) |
| Amortization of prior service cost and net actuarial loss on postretirement benefit plans into: | | | | |
| Cost of revenue | | 7 | | 7 |
| Selling, general and administrative expenses | | 7 | | 7 |
| Research and development expenses | | 1 | | 1 |
| Other non-operating (expense) income, net | | 3 | | 3 |
| Income tax impact on amortization of postretirement benefit plan items | | (5) | | (5) |
| Unrealized gain on derivative hedge agreements | | | 1 | 1 |
| Reclassification of unrealized gain on derivative hedge agreements into revenue | | | (2) | (2) |
| Reclassification of unrealized loss on derivative hedge agreements into cost of revenue | | | 2 | 2 |
| Balance at December 31, 2013 | $351 | $(186) | $2 | $167 |
| Foreign currency translation adjustment | (206) | | | (206) |
| Changes in postretirement benefit plans | | (92) | | (92) |
| Income tax expense on changes in postretirement benefit plans | | 20 | | 20 |
| Foreign currency translation adjustment for postretirement benefit plans | | 20 | | 20 |
| Amortization of prior service cost and net actuarial loss on postretirement benefit plans into: | | | | |
| Cost of revenue | | 4 | | 4 |
| Selling, general and administrative expenses | | 5 | | 5 |
| Other non-operating (expense) income, net | | 1 | | 1 |
| Income tax impact on amortization of postretirement benefit plan items | | (3) | | (3) |
| Unrealized loss on derivative hedge agreements | | | (22) | (22) |
| Income tax benefit on unrealized loss on derivative hedge agreements | | | 1 | 1 |
| Reclassification of unrealized loss on derivative hedge agreements into revenue | | | 5 | 5 |
| Reclassification of unrealized loss on derivative hedge agreements into cost of revenue | | | 1 | 1 |
| Balance at December 31, 2014 | $145 | $(231) | $(13) | $(99) |

| (in millions) | Foreign Currency Translation | Postretirement Benefit Plans | Derivative Instruments | Total |
|---|---|---|---|---|
| Balance at January 1, 2015 | $145 | $(231) | $(13) | $(99) |
| Foreign currency translation adjustment | (180) | | | (180) |
| Foreign currency gain reclassified into gain on sale of businesses | (8) | | | (8) |
| Changes in postretirement benefit plans | | 24 | | 24 |
| Income tax expense on changes in postretirement benefit plans | | (10) | | (10) |
| Foreign currency translation adjustment for postretirement benefit plans | | 21 | | 21 |
| Amortization of prior service cost and net actuarial loss on postretirement benefit plans into: | | | | |
| Cost of revenue | | 4 | | 4 |
| Selling, general and administrative expenses | | 9 | | 9 |
| Research and development expenses | | 1 | | 1 |
| Other non-operating income (expense), net | | 1 | | 1 |
| Income tax impact on amortization of postretirement benefit plan items | | (4) | | (4) |
| Unrealized loss on derivative hedge agreements | | | (22) | (22) |
| Income tax benefit on unrealized loss on derivative hedge agreements | | | 6 | 6 |
| Reclassification of unrealized loss on derivative hedge agreements into revenue | | | 19 | 19 |
| Reclassification of unrealized loss on derivative hedge agreements into cost of revenue | | | 1 | 1 |
| Income tax benefit on reclassification of unrealized loss on derivative hedge agreements | | | (1) | (1) |
| Balance at December 31, 2015 | $(43) | $(185) | $(10) | $(238) |

Note 18. Commitments and Contingencies

Legal Proceedings

From time to time, we are involved in legal proceedings that are incidental to the operation of our businesses, including acquisitions and divestitures, intellectual property matters, product liability and personal injury claims, employment and pension matters, government and commercial contract disputes.

On December 17, 2014, the Korea Fair Trade Commission (“KFTC”) issued a written decision regarding an investigation into bid-rigging allegations against Xylem Water Solutions South Korea Co., Ltd. (“Xylem South Korea”), a subsidiary of Xylem Inc. The KFTC found that certain employees of Xylem South Korea had participated in activities that violated Korea’s antitrust laws. Xylem South Korea was assessed a fine of approximately $1.6 million, and following criminal prosecution a minimal criminal penalty was imposed. In January 2015, Xylem South Korea paid the fine and filed an appeal of the KFTC’s decision with the Seoul High Court.

In connection with the KFTC matter, the Company commenced an internal investigation relating to the allegations against Xylem South Korea. In late 2014, the Company broadened this internal investigation to assess related allegations made by certain employees of Xylem South Korea during the investigation into the KFTC matter. The broadened investigation includes a review of compliance by Xylem South Korea and its employees with the requirements of the Foreign Corrupt Practices Act. The Company engaged independent outside counsel to assist with its investigation and an independent professional services firm to provide forensic accounting assistance. In late January 2015, the Company voluntarily contacted the SEC and the Department of Justice ("DOJ") to advise both agencies of this internal investigation. The SEC has informed the Company that it will not bring an enforcement

action against the Company in connection with the events at Xylem South Korea and the DOJ has informed the Company that it has declined to prosecute the Company in connection with the events at Xylem South

Korea. Xylem South Korea's revenue is less than one percent of the Company's total revenue. Although the Company currently cannot reasonably estimate the potential liability, if any, related to the investigation, we currently believe that these matters will not have a material adverse effect on the Company's business, financial condition or results of operations.

On October 1, 2014, there was a court approved settlement agreement with respect to a purchase price dispute with the minority shareholders arising from one of our historical acquisitions. All outstanding claims have been settled and court proceedings have been terminated. The outstanding balance of the settlement is reflected in the 2015 Consolidated Balance Sheet.

On or about February 17, 2009, following a statement submitted to the Spanish Competition Authority (Comision Nacional de la Competencia, "CNC") by Grupo Industrial Ercole Marelli, S.A. regarding an anti-competitive agreement in which it said it had been participating, the CNC conducted an investigation at ITT Water & Wastewater España S.A. (now named Xylem Water Solutions España S.A.), at the Spanish Association of Fluid Pump Manufacturers (the "Association"), and at the offices of other members of the Association. On September 16, 2009, the Directorate of Investigation of the CNC commenced formal proceedings for alleged restrictive practices, such as several exchanges of information and a recommendation on general terms and conditions of sale, allegedly prohibited under applicable law. Following the conclusion of the formal proceedings, the CNC Council imposed fines on the Association and nineteen Spanish manufacturers and distributors of fluid pumps, including a fine of Euro 2,373,675 applied to ITT Water & Wastewater España S.A. and ITT Corporation. In March 2012, the Company appealed the CNC's decision to the Audiencia Nacional (the "High Court") and in March 2013, the High Court upheld the determination of the CNC and the fine previously assessed. In June 2013, the Company appealed the decision to the Tribunal Supremo, the Supreme Court of Spain, and in November 2015 the Tribunal Supremo upheld the determination and the fine previously assessed. The outstanding balance of the fine is reflected in the 2015 Consolidated Balance Sheet. The Company petitioned the Spanish Constitutional Court and the Council of the CNC in December 2015 and January 2016, respectively, for review of certain aspects relevant to the fine determination, and is awaiting decisions.

From time to time claims may be asserted against Xylem alleging injury caused by any our products resulting from asbestos exposure. We believe there are numerous legal defenses available for such claims and would defend ourselves vigorously. Pursuant to the Distribution Agreement among ITT, Exelis and Xylem, ITT has an obligation to indemnify, defend and hold Xylem harmless for asbestos product liability matters, including settlements, judgments, and legal defense costs associated with all pending and future claims that may arise from past sales of ITT's legacy products. We believe ITT remains a substantial entity with sufficient financial resources to honor its obligations to us. Although the ultimate outcome of any legal matter cannot be predicted with certainty, based on present information, including our assessment of the merits of the particular claims, we do not expect that any asserted or unasserted legal claims or proceedings, individually or in aggregate, will have a material adverse effect on our results of operations, or financial condition. We have estimated and accrued $6 million and $9 million as of December 31, 2015 and 2014, respectively for these general legal matters.

Indemnifications

As part of our 2011 spin-off from our former parent, ITT, Exelis Inc. and Xylem will indemnify, defend and hold harmless each of the other parties with respect to such parties' assumed or retained liabilities under the Distribution Agreement and breaches of the Distribution Agreement or related spin agreements. The former parent's indemnification obligations include asserted and unasserted asbestos and silica liability claims that relate to the presence or alleged presence of asbestos or silica in products manufactured, repaired or sold prior to October 31, 2011, the Distribution Date, subject to limited exceptions with respect to certain employee claims, or in the structure or material of any building or facility, subject to exceptions with respect to employee claims relating to Xylem buildings or facilities. The indemnification associated with pending and future asbestos claims does not expire. Xylem has not recorded a liability for material matters for which we expect to be indemnified by the former parent or Exelis Inc. through the Distribution Agreement and we are not aware of any claims or other circumstances that would give rise to material payments from us under such indemnifications. On May 29, 2015, Harris Inc. acquired Exelis. As the parent of Exelis, Harris Inc. is responsible for Exelis's indemnification obligations under the Distribution Agreement.

Guarantees

We obtain certain stand-by letters of credit, bank guarantees and surety bonds from third-party financial institutions

in the ordinary course of business when required under contracts or to satisfy insurance related requirements. As of December 31, 2015, the amount of stand-by letters of credit, bank guarantees and surety bonds was $161 million.

Environmental

In the ordinary course of business, we are subject to federal, state, local, and foreign environmental laws and regulations. We are responsible, or are alleged to be responsible, for ongoing environmental investigation and remediation of sites in various countries. These sites are in various stages of investigation and/or remediation and in many of these proceedings our liability is considered de minimis. We have received notification from the U.S. Environmental Protection Agency, and from similar state and foreign environmental agencies, that a number of sites formerly or currently owned and/or operated by Xylem or for which we are responsible under the Distribution Agreement, and other properties or water supplies that may be or have been impacted from those operations, contain disposed or recycled materials or wastes and require environmental investigation and/or remediation. These sites include instances where we have been identified as a potentially responsible party under federal and state environmental laws and regulations.

Accruals for environmental matters are recorded on a site-by-site basis when it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated, based on current law and existing technologies. Our accrued liabilities for these environmental matters represent the best estimates related to the investigation and remediation of environmental media such as water, soil, soil vapor, air and structures, as well as related legal fees. These estimates, and related accruals, are reviewed quarterly and updated for progress of investigation and remediation efforts and changes in facts and legal circumstances. Liabilities for these environmental expenditures are recorded on an undiscounted basis. We have estimated and accrued $4 million and $5 million as of December 31, 2015 and 2014, respectively, for environmental matters.

It is difficult to estimate the final costs of investigation and remediation due to various factors, including incomplete information regarding particular sites and other potentially responsible parties, uncertainty regarding the extent of investigation or remediation and our share, if any, of liability for such conditions, the selection of alternative remedial approaches, and changes in environmental standards and regulatory requirements. We believe the total amount accrued is reasonable based on existing facts and circumstances.

Operating Leases

We lease certain offices, manufacturing buildings, machinery, computers and other equipment. Such leases expire at various dates through 2047 and may include renewal and payment escalation clauses. We often pay maintenance, insurance and tax expense related to leased assets. Total rent expense for the three years ended December 31, 2015 was as follows:

| (in millions) | Total |
|---|---|
| 2015 | $59 |
| 2014 | 73 |
| 2013 | 77 |

At December 31, 2015, we are obligated to make minimum rental payments under operating leases which are as follows:

| (in millions) | 2016 | 2017 | 2018 | 2019 | 2020 | Thereafter |
|---|---|---|---|---|---|---|
| Minimum rental payments | $55 | $43 | $33 | $23 | $17 | $19 |

Warranties

We warrant numerous products, the terms of which vary widely. In general, we warrant products against defect and specific non-performance. Warranty expense was $32 million, $27 million, and $34 million for 2015, 2014 and 2013, respectively. The table below provides changes in the product warranty accrual over each period.

| (in millions) | 2015 | 2014 |
|---|---|---|
| Warranty accrual – January 1 | $31 | $37 |
| Net charges for product warranties in the period | 32 | 27 |
| Settlement of warranty claims | (29) | (31) |
| Foreign currency and other | (1) | (2) |
| Warranty accrual – December 31 | $33 | $31 |

Note 19. Related Party Transactions

Sales to and purchases from unconsolidated joint ventures for 2015, 2014 and 2013 are as follows:

| (in millions) | 2015 | 2014 | 2013 |
|---|---|---|---|
| Sales to unconsolidated affiliates | $11 | $16 | $15 |
| Purchases from unconsolidated affiliates | 19 | 18 | 20 |

Note 20. Segment and Geographic Data

Our business has two reportable segments: Water Infrastructure and Applied Water. The Water Infrastructure segment, focuses on the transportation, treatment and testing of water, offering a range of products including water and wastewater pumps, treatment and testing equipment, and controls and systems. The Applied Water segment, encompasses the uses of water and focuses on the residential, commercial, industrial and agricultural markets offering a wide range of products, including pumps, valves and heat exchangers. Our Regional selling locations consist primarily of selling and marketing organizations and related support that offer products and services across both of our reportable segments. Corporate and other consists of corporate office expenses including compensation, benefits, occupancy, depreciation, and other administrative costs, as well as charges related to certain matters, such as environmental matters that are managed at a corporate level and are not included in the business segments in evaluating performance or allocating resources.

The accounting policies of each segment are the same as those described in the summary of significant accounting policies (see Note 1). The following tables contain financial information for each reportable segment:

| | Year Ended December 31, | | |
|---|---|---|---|
| (in millions) | 2015 | 2014 | 2013 |
| Revenue: | | | |
| Water Infrastructure | $2,231 | $2,442 | $2,384 |
| Applied Water | 1,422 | 1,474 | 1,453 |
| Total | $3,653 | $3,916 | $3,837 |
| Operating income: | | | |
| Water Infrastructure | $303 | $321 | $263 |
| Applied Water | 190 | 193 | 175 |
| Corporate and other | (44) | (51) | (75) |
| Total operating income | 449 | 463 | 363 |
| Interest expense | 55 | 54 | 55 |
| Other non-operating income (expense) | — | 1 | (10) |
| Gain from sale of businesses | 9 | 11 | — |
| Income before taxes | $403 | $421 | $298 |
| Depreciation and amortization: | | | |
| Water Infrastructure | $88 | $100 | $104 |
| Applied Water | 26 | 25 | 26 |
| Regional selling locations (a) | 12 | 12 | 13 |
| Corporate and other | 7 | 5 | 7 |
| Total | $133 | $142 | $150 |
| Capital expenditures: | | | |
| Water Infrastructure | $67 | $73 | $67 |
| Applied Water | 22 | 28 | 31 |
| Regional selling locations (b) | 23 | 10 | 12 |
| Corporate and other | 5 | 8 | 16 |
| Total | $117 | $119 | $126 |

(a) Depreciation and amortization expense incurred by the Regional selling locations was included in an overall allocation of Regional selling location costs to the segments; however, a certain portion of that expense was not specifically identified to a segment. That is the expense captured in this Regional selling location line.

(b) Represents capital expenditures incurred by the Regional selling locations not allocated to the segments.

The following table illustrates revenue by product category, net of intercompany revenue.

| | Year Ended December 31, | | |
|---|---|---|---|
| (in millions) | 2015 | 2014 | 2013 |
| Pumps, accessories, parts and service | $2,917 | $3,094 | $3,076 |
| Other (a) | 736 | 822 | 761 |
| Total | $3,653 | $3,916 | $3,837 |

(a) Other includes treatment equipment, analytical instrumentation, heat exchangers, valves and controls.

The following table contains the total assets for each reportable segment as of December 31, 2015, 2014 and 2013.

| | Total Assets | | |
|---|---|---|---|
| (in millions) | 2015 | 2014 | 2013 (c) |
| Water Infrastructure | $2,024 | $2,128 | $2,224 |
| Applied Water | 1,054 | 1,114 | 1,122 |
| Regional selling locations (a) | 905 | 961 | 983 |
| Corporate and other (b) | 674 | 630 | 528 |
| Total | $4,657 | $4,833 | $4,857 |

(a) The Regional selling locations have assets that consist primarily of cash, accounts receivable and inventory which are not allocated to the segments.

(b) Corporate and other consists of items pertaining to our corporate headquarters function, which principally consist of cash, deferred tax assets, pension assets and certain, plant and equipment.

(c) In 2013, debt issuance costs of $6 million were reclassified to long-term debt from other non-current assets and deferred tax assets of $33 million were reclassified to deferred tax liabilities within the Consolidated Balance Sheet. See Note 2, “Recently Issued Accounting Pronouncements,” of the consolidated financial statements.

Geographical Information

Revenue is attributed to countries based upon the location of the customer. Property, Plant & Equipment is attributed to countries based upon the location of the assets.

| | Revenue | | |
|---|---|---|---|
| | Year Ended December 31, | | |
| (in millions) | 2015 | 2014 | 2013 |
| United States | $1,490 | $1,477 | $1,434 |
| Europe | 1,179 | 1,379 | 1,387 |
| Asia Pacific | 482 | 478 | 467 |
| Other | 502 | 582 | 549 |
| Total | $3,653 | $3,916 | $3,837 |

| | Property, Plant & Equipment | | |
|---|---|---|---|
| | December 31, | | |
| (in millions) | 2015 | 2014 | 2013 |
| United States | $168 | $180 | $186 |
| Europe | 189 | 206 | 225 |
| Asia Pacific | 56 | 53 | 45 |
| Other | 26 | 22 | 32 |
| Total | $439 | $461 | $488 |

Note 21. Valuation and Qualifying Accounts

The table below provides changes in the allowance for doubtful accounts over each period.

| (in millions) | 2015 | 2014 | 2013 |
|---|---|---|---|
| Balance at beginning of year | $24 | $22 | $25 |
| Additions charged to expense | 4 | 9 | 8 |
| Deductions/other | (6) | (7) | (11) |
| Balance at end of year | $22 | $24 | $22 |

Note 22. Quarterly Financial Data (Unaudited)

Our quarterly financial periods end on the Saturday closest to the last day of the calendar quarter, except for the fourth quarter which ends on December 31.

| | 2015 Quarter Ended | | | |
|---|---|---|---|---|
| (in millions, except per share amounts) | Dec. 31 | Sept. 30 | June 30 | Mar. 31 |
| Revenue | $994 | $902 | $920 | $837 |
| Gross profit | 390 | 351 | 348 | 315 |
| Operating income | 142 | 120 | 104 | 83 |
| Net income | $114 | $88 | $74 | $64 |
| Earnings per share: | | | | |
| Basic | $0.64 | $0.48 | $0.41 | $0.35 |
| Diluted | $0.63 | $0.48 | $0.41 | $0.35 |
| | 2014 Quarter Ended | | | |
| (in millions, except per share amounts) | Dec. 31 | Sept. 30 | June 30 | Mar. 31 |
| Revenue | $1,042 | $963 | $1,005 | $906 |
| Gross profit | 407 | 376 | 388 | 342 |
| Operating income | 141 | 130 | 116 | 76 |
| Net income | $96 | $106 | $86 | $49 |
| Earnings per share: | | | | |
| Basic | $0.53 | $0.58 | $0.47 | $0.27 |
| Diluted | $0.52 | $0.58 | $0.47 | $0.27 |

Note 23. Subsequent Events

On February 1, 2016, we acquired Tideland Signal Corporation (“Tideland”), a leading producer of analytics solutions in the coastal and ocean management sectors, for approximately $69 million. Tideland, a privately-owned company headquartered in Texas, has approximately 160 employees and annual revenue of approximately $48 million.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the Chief Executive Officer ("CEO") and Interim Chief Financial Officer ("CFO") of the Company, has evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the year ended December 31, 2015 pursuant to Rule 13a-15(b) and 15d-15(e) of the Securities Exchange Act of 1934 (“the Exchange Act”). Based upon that evaluation, our CEO and our CFO concluded that our disclosure controls and procedures as of the year ended December 31, 2015 were effective, in all material respects, and designed to provide reasonable assurance that the information required to be disclosed by us in the reports we file or submit under the Exchange Act is (1) recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms and (2) accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosures.

Management's Annual Report on Internal Control Over Financial Reporting

As required by the SEC's rules and regulations for the implementation of Section 404 of the Sarbanes-Oxley Act, the Company's management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. The Company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

The Company's management, including the CEO and CFO, conducted an assessment of the effectiveness of our internal control over financial reporting as of December 31, 2015 based on the framework established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organization of the Treadway Commission (2013). This assessment included an evaluation of the design of our internal control over financial reporting and testing of the operational effectiveness of those controls. Based on our assessment, the Company's management has concluded that our internal control over financial reporting was effective as of December 31, 2015.

The effectiveness of the Company's internal control over financial reporting as of December 31, 2015 has been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report which appears following Item 9B of this Annual Report on Form 10-K.

Changes in Internal Control Over Financial Reporting

There were no changes in the Company's internal control over financial reporting that occurred during the quarter ended December 31, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Xylem Inc.
Rye Brook, New York

We have audited the internal control over financial reporting of Xylem Inc. and subsidiaries (the "Company") as of December 31, 2015, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2015, based on the criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2015 of the Company and our report dated February 26, 2016 expressed an unqualified opinion on those financial statements.

/s/ Deloitte & Touche LLP

Stamford, Connecticut
February 26, 2016

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this Item is incorporated herein by reference to the information in our Definitive Proxy Statement to be filed with the SEC in connection with our 2016 Annual Meeting of Shareholders (the “2016 Proxy Statement”) under the captions “Proposal 1 - Election of Directors,” "Identifying and Evaluating Director Nominees," "Board Committees - Audit Committee" and “Section 16(a) Beneficial Ownership Reporting Compliance.”

The information called for by Item 10 with respect to executive officers is set forth in Part I of this Report under the caption “Executive Officers of the Registrant” and is incorporated by reference in this section.

We have adopted corporate governance principles and charters for each of our board committees. The principles address director qualification standards, responsibilities, access to management and independent advisors, compensation, orientation and continuing education, succession planning and board and committee self-evaluation. The corporate governance principles and board committee charters are available on the Company’s website at www.investors.xyleminc.com. A copy of the corporate governance principles and board committee charters are also available to any shareholder who requests a copy from the Company’s Corporate Secretary at our Principal Executive Offices.

We have also adopted a written code of conduct which is applicable to all our directors, officers and employees, including the Company’s Chief Executive Officer and Interim Chief Financial Officer and other executive officers identified pursuant to this Item 10. In accordance with the SEC’s rules and regulations, a copy of the Code of Conduct has been posted to our website and it is also available to any shareholder who requests a copy from our Corporate Secretary. We intend to disclose any changes in our Code of Conduct and waivers of the Code of Conduct on our website at www.xyleminc.com within four business days following the date of the amendment or waiver.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated herein by reference to the information in our 2016 Proxy Statement set forth under captions “Executive Compensation," "Director Compensation", "Board Committees - Leadership Development and Compensation Committee" and “Leadership Development and Compensation Committee Report.”

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this Item is incorporated herein by reference to the information in our 2016 Proxy Statement set forth under the captions “Stock Ownership of Directors, Executive Officers and Certain Beneficial Owners” and "Equity Compensation Plan Information."

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this Item is incorporated herein by reference to the information in our 2016 Proxy Statement set forth under the captions "Governance - Director Independence" and “Governance - Related Party Transactions.”

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by this Item is incorporated herein by reference to the information in our 2016 Proxy Statement set forth under the captions “Fees of Audit and Other Services Fees” and "Pre-Approval of Audit and Non-Audit Services."

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) (1) The Index to Consolidated Financial Statements of the Registrant under Item 8 of this Report is incorporated herein by reference as the list of Financial Statements required as part of this Report.

(2) Financial Statement Schedules — All financial statement schedules have been omitted because they are not applicable or the required information is shown in the financial statements or notes thereto.

(3) Exhibits — The exhibit list in the Exhibit Index is incorporated by reference as the list of exhibits required as part of this Report.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized.

XYLEM INC.
(Registrant)

/s/ John P. Connolly
John P. Connolly
Vice President, Controller and Chief Accounting Officer
(Principal Accounting Officer and Duly Authorized Officer)

February 26, 2016

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated:

| | |
|---|---|
| February 26, 2016 | /s/ Patrick K. Decker<br>Patrick K. Decker<br>President and Chief Executive Officer<br>(Principal Executive Officer) |
| February 26, 2016 | /s/ Shashank Patel<br>Shashank Patel<br>Interim Chief Financial Officer<br>(Principal Financial Officer) |
| February 26, 2016 | /s/ Markos I. Tambakeras<br>Markos I. Tambakeras, Chairman |
| February 26, 2016 | /s/ Curtis J. Crawford<br>Curtis J. Crawford, Director |
| February 26, 2016 | /s/ Robert F. Friel<br>Robert F. Friel, Director |
| February 26, 2016 | /s/ Victoria D. Harker<br>Victoria D. Harker, Director |
| February 26, 2016 | /s/ Sten E. Jakobsson<br>Sten E. Jakobsson, Director |
| February 26, 2016 | /s/ Steven R. Loranger<br>Steven R. Loranger, Director |
| February 26, 2016 | /s/ Edward J. Ludwig<br>Edward J. Ludwig, Director |
| February 26, 2016 | /s/ Surya N. Mohapatra<br>Surya N. Mohapatra, Director |
| February 26, 2016 | /s/ Jerome A. Peribere<br>Jerome A. Peribere, Director |

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EXHIBIT INDEX

| Exhibit Number | Description | Location |
|---|---|---|
| (2.1) | Distribution Agreement, dated as of October 25, 2011, among ITT Corporation, Exelis Inc. and Xylem Inc. | Incorporated by reference to Exhibit 10.1 of ITT Corporation's Form 10-Q Quarterly Report filed on October 28, 2011 (CIK No. 216228, File No. 1-5672). |
| (3.1) | Third Amended and Restated Articles of Incorporation of Xylem Inc. | Incorporated by reference to Exhibit 3.1 of Xylem Inc.'s Form 10-Q filed on July 29, 2014 (CIK No. 131190969, File No. 1-35229). |
| (3.2) | Amended and Restated By-laws of Xylem Inc. | Incorporated by reference to Exhibit 3.1 of Xylem Inc.'s Form 8-K filed on February 25, 2016 (CIK No. 1524472, File No. 1-35229). |
| (4.1) | Indenture, dated as of September 20, 2011, between Xylem Inc., ITT Corporation, as initial guarantor, and Union Bank, N.A., as trustee | Incorporated by reference to Exhibit 4.2 of ITT Corporation's Form 8-K Current Report filed on September 21, 2011 (CIK No. 216228, File No. 1-5672). |
| (4.2) | Form of Xylem Inc. 3.550% Senior Notes due 2016 | Incorporated by reference to Exhibit 4.5 of Xylem Inc.'s Form S-4 Registration Statement filed on May 24, 2012 (CIK No. 1524472, File No. 333-181643). |
| (4.3) | Form of Xylem Inc. 4.875% Senior Notes due 2021 | Incorporated by reference to Exhibit 4.6 of Xylem Inc.'s Form S-4 Registration Statement filed on May 24, 2012 (CIK No. 1524472, File No. 333-181643). |
| (10.1) | Form of Xylem 2011 Omnibus Incentive Plan Non-Qualified Stock Option Award Agreement (2015) | Incorporated by reference to Exhibit 10.1 of Xylem Inc.'s Form 10-K Annual Report filed on February 26, 2015 (CIK No. 1524472, File No. 1-35229). |
| (10.2) | Benefits and Compensation Matters Agreement, dated as of October 25, 2011, among ITT Corporation, Exelis Inc. and Xylem Inc. | Incorporated by reference to Exhibit 10.2 of ITT Corporation's Form 10-Q Quarterly Report filed on October 28, 2011 (CIK No. 216228, File No. 1-5672). |
| (10.3) | Tax Matters Agreement, dated as of October 25, 2011, among ITT Corporation, Exelis Inc. and Xylem Inc. | Incorporated by reference to Exhibit 10.3 of ITT Corporation's Form 10-Q Quarterly Report filed on October 28, 2011 (CIK No. 216228, File No. 1-5672). |
| (10.4) | Master Transition Services Agreement, dated as of October 25, 2011, among ITT Corporation, Exelis Inc. and Xylem Inc. | Incorporated by reference to Exhibit 10.4 of ITT Corporation's Form 10-Q Quarterly |

| | | |
|---|---|---|
| | | Report filed on October 28, 2011 (CIK No. 216228, File No. 1-5672). |
| (10.5) | Five-Year Revolving Credit Facility Agreement, dated as of March 27, 2015, among Xylem Inc., the Lenders Named Therein, Citibank, N.A., as Administrative Agent and J.P. Morgan Chase Bank, N.A., as Syndication Agent. | Incorporated by reference to Exhibit 10.1 of Xylem Inc.'s Form 8-K filed on March 31, 2015 (CIK No. 1524472, File No. 1-35229). |
| (10.6) | Xylem 2011 Omnibus Incentive Plan (Amended as of February 24, 2016) | Filed herewith. |
| (10.7) | Form of Xylem Non-Qualified Stock Option Award Agreement (Amended as of February 24, 2016) | Filed herewith. |
| (10.8) | Form of Xylem Restricted Stock Unit Agreement (Amended as of February 24, 2016) | Filed herewith. |

| Exhibit Number | Description | Location |
|---|---|---|
| (10.9) | Form of Xylem Performance Share Unit Agreement (Amended as of February 24, 2016) | Filed herewith. |
| (10.10) | Xylem Retirement Savings Plan | Incorporated by reference to Exhibit 10.1 of Xylem Inc.'s Form 10-Q filed on July 30, 2013 (CIK No. 1524472, File No. 1-35229). |
| (10.11) | Xylem Supplemental Retirement Savings Plan | Incorporated by reference to Exhibit 10.11 of Xylem Inc.'s Form 10-Q Quarterly Report filed on November 21, 2011 (CIK No. 1524472, File No. 1-35229). |
| (10.12) | Xylem Deferred Compensation Plan | Incorporated by reference to Exhibit 4.5 of Xylem Inc.'s Registration Statement on Form S-8 filed on October 28, 2011 (CIK No. 1524472, File No. 333-177607). |
| (10.13) | Xylem Deferred Compensation Plan for Non-Employee Directors | Incorporated by reference to Exhibit 10.13 of Xylem Inc.'s Form 10-Q Quarterly Report filed on November 21, 2011 (CIK No. 1524472, File No. 1-35229). |
| (10.14) | Form of Non-Employee Director Restricted Stock Unit Award Agreement | Incorporated by reference to Exhibit 10.1 of Xylem Inc.'s Form 10-Q Quarterly Report filed on July 30, 2015 (CIK No. 1524472, File No. 1-35229). |
| (10.15) | Xylem Special Senior Executive Severance Pay Plan (Amended as of February 24, 2016) | Filed herewith. |
| (10.16) | Xylem Senior Executive Severance Pay Plan (Amended as of February 24, 2016) | Filed herewith. |
| (10.17) | Form of Xylem 2011 Omnibus Incentive Plan 2011 Non-Qualified Stock Option Award Agreement — Founders Grant | Incorporated by reference to Exhibit 10.17 of Xylem Inc.'s Form 10-Q Quarterly Report filed on November 21, 2011 (CIK No. 1524472, File No. 1-35229). |
| (10.18) | Form of Xylem 2011 Omnibus Incentive Plan Non-Qualified Stock Option Award Agreement — General Grant | Incorporated by reference to Exhibit 10.18 of Xylem Inc.'s Form 10-Q Quarterly Report filed on November 21, 2011 (CIK No. 1524472, File No. 1-35229). |
| (10.19) | Xylem Annual Incentive Plan for Executive Officers (Amended as of February 24, 2016) | Filed herewith. |
| (10.20) | Form of Director's Indemnification Agreement | Filed herewith. |

| | | |
|---|---|---|
| (10.21) | Form of Xylem 2011 Omnibus Incentive Plan Non-Qualified Stock Option Award Agreement (2013) | Incorporated by reference to Exhibit 10.1 of Xylem Inc.'s Form 10-Q Quarterly Report filed on April 30, 2013 (CIK No. 1524472, File No. 1-35229). |
| (10.22) | Letter Agreement between Xylem Inc. and Patrick K. Decker | Incorporated by reference to Exhibit 10.1 of Xylem Inc.'s Form 10-Q Quarterly Report filed on April 29, 2014 (CIK No. 1524472, File No. 1-35229). |
| (10.23) | Restricted Stock Unit Grant Agreement between Xylem Inc. and Patrick K. Decker | Incorporated by reference to Exhibit 10.1 of Xylem Inc.'s Form 8-K Current Report filed on March 20, 2014 (CIK No. 1524472, File No. 1-35229). |

| Exhibit Number | Description | Location |
|---|---|---|
| (10.24) | Research and Development Facility Agreement - Xylem Water Technologies Risk-Sharing Financing Facility First Amended and Restated Finance Contract, dated December 4, 2013, among the European Investment Bank, Xylem Holdings S.a.r.l. and Xylem International S.a.r.l., as borrowers, and Xylem Inc., as guarantor. | Incorporated by reference to Exhibit 10.30 of Xylem Inc.'s Form 10-K Annual Report filed on February 27, 2014 (CIK No. 1524472, File No. 1-35229). |
| (10.25) | Agreement dated May 4, 2015, Amending the Research and Development Facility Agreement - Xylem Water Technologies Risk-Sharing Financing Facility First Amended and Restated Finance Contract, dated June 28, 2014, among the European Investment Bank, Xylem Holdings S.á r.l. and Xylem International S.á r.l., as borrowers, and Xylem Inc., as guarantor. | Incorporated by reference to Exhibit 10.2 of Xylem Inc.'s Form 10-Q Quarterly Report filed on July 30, 2015 (CIK No. 1524472, File No. 1-35229). |
| (10.26) | Agreement dated December 3, 2015, Amending the Research and Development Facility Agreement - Xylem Water Technologies Risk-Sharing Financing Facility First Amended and Restated Finance Contract, dated June 28, 2014, among the European Investment Bank, Xylem Holdings S.á r.l. and Xylem International S.á r.l., as borrowers, and Xylem Inc., as guarantor. | Filed herewith. |
| (11.0) | Statement re computation of per share earnings | Information required to be presented in Exhibit 11 is provided under "Earnings Per Share" in Note 7 of the consolidated financial statements in Part II, Item 8. "Financial Statements and Supplementary Data" of this Annual Report on Form 10-K in accordance with the provisions of Financial Accounting Standards Board Accounting Standards Codification 260, Earnings Per Share. |
| (12.0) | Statements re computation of ratios | Filed herewith. |
| (21.0) | Subsidiaries of the Registrant | Filed herewith. |
| (23.1) | Consent of Independent Registered Public Accounting Firm | Filed herewith. |
| (31.1) | Certification pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | Filed herewith. |
| (31.2) | Certification pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 | Filed herewith. |
| (32.1) | Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | This Exhibit is intended to be furnished in accordance with Regulation S-K Item 601(b) |

(32) (ii) and shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934 or incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except as shall be expressly set forth by specific reference.

| Exhibit Number | Description | Location |
|---|---|---|
| (32.2) | Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | This Exhibit is intended to be furnished in accordance with Regulation S-K Item 601(b) (32) (ii) and shall not be deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934 or incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except as shall be expressly set forth by specific reference. |
| (101) | The following materials from Xylem Inc.'s Annual Report on Form 10-K for the year ended December 31, 2015, formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Income Statements, (ii) Consolidated Statements of Comprehensive Income, (iii) Consolidated Balance Sheets, (iv) Consolidated Statements of Cash Flows and (v) Notes to Consolidated Financial Statements | Submitted electronically with this report. |