

SHERWIN WILLIAMS CO
Form 10-Q
July 24, 2013

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

FORM 10-Q

(Mark One)

☒ Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the Period Ended June 30, 2013

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 1-04851

THE SHERWIN-WILLIAMS COMPANY
(Exact name of registrant as specified in its charter)

OHIO
(State or other jurisdiction of
incorporation or organization)

34-0526850
(I.R.S. Employer
Identification No.)

101 West Prospect Avenue,
Cleveland, Ohio
(Address of principal executive offices)
(216) 566-2000
(Registrant's telephone number including area code)

44115-1075
(Zip Code)

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

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

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

Large accelerated filer ☒ Accelerated filer ☐

Non-accelerated filer ☐ (Do not check if a smaller reporting company) Smaller reporting company ☐

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date.

Common Stock, \$1.00 Par Value – 102,683,128 shares as of June 30, 2013.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

THE SHERWIN-WILLIAMS COMPANY AND SUBSIDIARIES

STATEMENTS OF CONSOLIDATED INCOME (UNAUDITED)

Thousands of dollars, except per share data

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2013	2012	2013	2012
Net sales	\$2,713,889	\$2,573,022	\$4,881,057	\$4,709,366
Cost of goods sold	1,480,310	1,422,425	2,684,627	2,648,930
Gross profit	1,233,579	1,150,597	2,196,430	2,060,436
Percent to net sales	45.5	% 44.7	% 45.0	% 43.8
Selling, general and administrative expenses	837,124	810,207	1,615,803	1,567,886
Percent to net sales	30.8	% 31.5	% 33.1	% 33.3
Other general expense - net	485	3,086	4,432	8,123
Interest expense	15,069	10,230	30,380	20,567
Interest and net investment income	(698)) (625)) (1,447)) (1,167)
Other expense (income) - net	715	(104)) (2,006)) (5,091)
Income before income taxes	380,884	327,803	549,268	470,118
Income taxes	123,597	99,990	175,796	142,089
Net income	\$257,287	\$227,813	\$373,472	\$328,029
Net income per common share:				
Basic	\$2.51	\$2.23	\$3.65	\$3.20
Diluted	\$2.46	\$2.17	\$3.57	\$3.13
Average shares outstanding—basic	101,665,737	101,446,643	101,813,398	101,758,496
Average shares and equivalents outstanding—diluted	103,896,780	104,003,128	104,031,718	104,100,046
Comprehensive income	\$213,283	\$214,846	\$330,871	\$346,619

See notes to condensed consolidated financial statements.

THE SHERWIN-WILLIAMS COMPANY AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS (UNAUDITED)

Thousands of dollars

	June 30, 2013	December 31, 2012	June 30, 2012
Assets			
Current assets:			
Cash and cash equivalents	\$741,084	\$862,590	\$46,616
Accounts receivable, less allowance	1,299,679	1,032,508	1,237,832
Inventories:			
Finished goods	809,586	732,359	851,827
Work in process and raw materials	175,258	187,965	179,651
	984,844	920,324	1,031,478
Deferred income taxes	129,732	126,730	148,685
Other current assets	187,096	207,086	159,391
Total current assets	3,342,435	3,149,238	2,624,002
Goodwill	1,171,503	1,156,005	1,122,274
Intangible assets	311,947	347,553	314,913
Deferred pension assets	250,989	249,911	232,591
Other assets	379,439	366,134	394,200
Property, plant and equipment:			
Land	99,579	102,336	101,336
Buildings	718,015	677,944	665,162
Machinery and equipment	1,812,541	1,750,729	1,702,849
Construction in progress	39,087	56,582	47,588
	2,669,222	2,587,591	2,516,935
Less allowances for depreciation	1,717,031	1,621,695	1,578,540
	952,191	965,896	938,395
Total Assets	\$6,408,504	\$6,234,737	\$5,626,375
Liabilities and Shareholders' Equity			
Current liabilities:			
Short-term borrowings	\$50,664	\$69,035	\$604,985
Accounts payable	1,117,459	922,999	1,102,148
Compensation and taxes withheld	218,633	314,892	231,828
Accrued taxes	170,447	52,104	126,556
Current portion of long-term debt	2,632	3,689	4,246
Other accruals	407,670	513,717	462,040
Total current liabilities	1,967,505	1,876,436	2,531,803
Long-term debt	1,631,951	1,632,165	635,589
Postretirement benefits other than pensions	320,219	320,223	298,798
Other long-term liabilities	621,299	614,109	620,932
Shareholders' equity:			
Common stock—\$1.00 par value:			
102,683,128, 103,270,067 and 102,632,285 shares outstanding at June 30, 2013, December 31, 2012 and June 30, 2012, respectively	112,454	111,623	109,682
Preferred stock—convertible, no par value:			
68,049, 101,086 and 128,390 shares outstanding at June 30, 2013,			

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December 31, 2012 and June 30, 2012, respectively	68,049	101,086	128,390
Unearned ESOP compensation	(68,049) (101,086) (128,390)
Other capital	1,773,060	1,673,788	1,429,209
Retained earnings	1,496,639	1,226,467	1,003,693
Treasury stock, at cost	(1,101,633) (849,685) (654,043)
Cumulative other comprehensive loss	(412,990) (370,389) (349,288)
Total shareholders' equity	1,867,530	1,791,804	1,539,253
Total Liabilities and Shareholders' Equity	\$6,408,504	\$6,234,737	\$5,626,375

See notes to condensed consolidated financial statements.

THE SHERWIN-WILLIAMS COMPANY AND SUBSIDIARIES
CONDENSED STATEMENTS OF CONSOLIDATED CASH FLOWS (UNAUDITED)

Thousands of dollars

	Six Months Ended	
	June 30, 2013	June 30, 2012
OPERATING ACTIVITIES		
Net income	\$373,472	\$328,029
Adjustments to reconcile net income to net operating cash:		
Depreciation	78,301	75,507
Amortization of intangible assets	14,127	12,963
Stock-based compensation expense	23,977	21,945
Provisions for qualified exit costs	367	1,582
Provisions for environmental-related matters	1,769	9,093
Defined benefit pension plans net cost	9,975	9,855
Net increase in postretirement liability	1,800	1,800
Other	1,417	494
Change in working capital accounts—net	(195,322)	(220,890)
Costs incurred for environmental-related matters	(6,892)	(20,165)
Costs incurred for qualified exit costs	(5,955)	(1,907)
Other	5,039	(16,194)
Net operating cash	302,075	202,112
INVESTING ACTIVITIES		
Capital expenditures	(72,126)	(69,972)
Acquisitions of businesses, net of cash acquired	(5,000)	(43,993)
Proceeds from sale of assets	2,586	8,979
(Increase) decrease in other investments	(52,854)	14,848
Net investing cash	(127,394)	(90,138)
FINANCING ACTIVITIES		
Net (decrease) increase in short-term borrowings	(17,407)	260,193
Proceeds from long-term debt		1,846
Payments of long-term debt	(949)	(12,164)
Payments of cash dividends	(103,300)	(80,438)
Proceeds from stock options exercised	40,622	88,182
Income tax effect of stock-based compensation exercises and vesting	35,654	36,612
Treasury stock purchased	(232,522)	(362,623)
Other	(18,855)	(27,546)
Net financing cash	(296,757)	(95,938)
Effect of exchange rate changes on cash	570	(2,116)
Net (decrease) increase in cash and cash equivalents	(121,506)	13,920
Cash and cash equivalents at beginning of year	862,590	32,696
Cash and cash equivalents at end of period	\$741,084	\$46,616
Income taxes paid	\$34,666	\$97,709
Interest paid	30,942	20,899

See notes to condensed consolidated financial statements.

THE SHERWIN-WILLIAMS COMPANY AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Periods ended June 30, 2013 and 2012

NOTE 1—BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included.

There have been no significant changes in critical accounting policies since December 31, 2012. Accounting estimates were revised as necessary during the first six months of 2013 based on new information and changes in facts and circumstances.

The Company primarily uses the last-in, first-out (LIFO) method of valuing inventory. An actual valuation of inventory under the LIFO method can be made only at the end of each year based on the inventory levels and costs at that time. Accordingly, interim LIFO calculations are based on management's estimates of expected year-end inventory levels and costs are subject to the final year-end LIFO inventory valuation. In addition, interim inventory levels include management's estimates of annual inventory losses due to shrinkage and other factors. The final year-end valuation of inventory is based on an annual physical inventory count performed during the fourth quarter. For further information on inventory valuations and other matters, refer to the consolidated financial statements and footnotes thereto included in the Company's Form 10-K for the year ended December 31, 2012.

The consolidated results for the three and six months ended June 30, 2013 are not necessarily indicative of the results to be expected for the year ending December 31, 2013.

NOTE 2—IMPACT OF RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS

In February 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-2, which amends the Comprehensive Income Topic of the Accounting Standards Codification (ASC). The updated standard requires the presentation of information about reclassifications out of accumulated other comprehensive income. ASU No. 2013-2 is effective for fiscal years and interim periods within those years beginning after December 15, 2012. The Company has adopted the standard on a prospective basis as required. The updated standard affects the Company's disclosures but has no impact on its results of operations, financial condition or liquidity.

NOTE 3—DIVIDENDS

Dividends paid on common stock during each of the first two quarters of 2013 and 2012 were \$.50 per common share and \$.39 per common share, respectively.

NOTE 4—CHANGES IN CUMULATIVE OTHER COMPREHENSIVE LOSS

The following table summarizes the changes in Cumulative other comprehensive loss for the six months ended June 30, 2013:

(Thousands of dollars)

	Foreign Currency Translation Adjustments	Net Actuarial (Losses) Gains and Prior Service Costs Recognized for Employee Benefit Plans	Unrealized Net Gains (Losses) on Available-for-Sale Securities	Total Cumulative Other Comprehensive Loss
Beginning balance	\$(204,195)	\$(166,595)	\$ 401	\$ (370,389)
Other comprehensive (loss) income before reclassifications ⁽¹⁾	(48,421)	12,190	99	(36,132)
Amounts reclassified from other comprehensive (loss) income ⁽²⁾		(6,450)	(19)	(6,469)
Net other comprehensive (loss) income	(48,421)	5,740	80	(42,601)
Ending balance	\$(252,616)	\$(160,855)	\$ 481	\$ (412,990)

⁽¹⁾ Net of taxes of \$(7,794) for net actuarial gains and prior service costs recognized for employee benefit plans and \$(62) for unrealized net gains on available-for-sale securities.

⁽²⁾ Net of taxes of \$4,124 for net actuarial gains and prior service costs recognized for employee benefit plans and \$12 for unrealized net gains on available-for-sale securities.

NOTE 5—PRODUCT WARRANTIES

Changes in the Company's accrual for product warranty claims during the first six months of 2013 and 2012, including customer satisfaction settlements, were as follows:

(Thousands of dollars)

	2013	2012
Balance at January 1	\$22,710	\$22,071
Charges to expense	11,031	11,710
Settlements	(12,134)	(10,842)
Balance at June 30	\$21,607	\$22,939

For further details on the Company's accrual for product warranty claims, see Note 1 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

NOTE 6—EXIT OR DISPOSAL ACTIVITIES

Liabilities associated with exit or disposal activities are recognized as incurred in accordance with the Exit or Disposal Cost Obligations Topic of the ASC. Qualified exit costs primarily include post-closure rent expenses, incremental post-closure costs and costs of employee terminations. Adjustments may be made to liabilities accrued for qualified exit costs if information becomes available upon which more accurate amounts can be reasonably estimated.

Concurrently, property, plant and equipment is tested for impairment in accordance with the Property, Plant and Equipment Topic of the ASC, and if impairment exists, the carrying value of the related assets is reduced to estimated fair value. Additional impairment may be recorded for subsequent revisions in estimated fair value.

In the six months ended June 30, 2013, three stores in the Paint Stores Group, one branch in the Global Finishes Group and four stores in the Latin America Coatings Group were closed due to lower demand or redundancy.

The following table summarizes the activity and remaining liabilities associated with qualified exit costs at June 30, 2013:

(Thousands of dollars)	Balance at December 31, 2012	Provisions in Cost of goods sold or SG&A	Actual expenditures charged to accrual	Adjustments to prior provisions in Other general expense—net	Balance at June 30, 2013
Exit Plan					
Paint Stores Group stores shutdown in 2013:					
Other qualified exit costs		\$27	\$ (16)		\$11
Paint Stores Group stores shutdown in 2012:					
Other qualified exit costs	\$313		(44)	\$ (1)	268
Global Finishes Group facility shutdown in 2012:					
Severance and related costs	2,236		(1,548)	261	949
Other qualified exit costs	3,430		(3,530)	100	
Global Finishes Group branches shutdown in 2011:					
Other qualified exit costs	290		(93)		197
Other qualified exit costs for facilities shutdown prior to 2011	2,288		(724)	(20)	1,544
Totals	\$8,557	\$27	\$ (5,955)	\$ 340	\$2,969

For further details on the Company's exit or disposal activities, see Note 5 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

NOTE 7—HEALTH CARE, PENSION AND OTHER BENEFITS

Shown below are the components of the Company's net periodic benefit cost for domestic defined benefit pension plans, foreign defined benefit pension plans and postretirement benefits other than pensions:

(Thousands of dollars)	Domestic Defined Benefit Pension Plans		Foreign Defined Benefit Pension Plans		Postretirement Benefits Other than Pensions	
	2013	2012	2013	2012	2013	2012
Three Months Ended June 30:						
Net periodic benefit cost:						
Service cost	\$5,397	\$4,732	\$1,160	\$893	\$766	\$736
Interest cost	4,267	4,331	1,903	1,724	3,045	3,380
Expected return on assets	(10,342)	(11,211)	(1,782)	(1,677)		
Amortization of:						
Prior service cost (credit)	455	398			(82)	(164)
Actuarial loss	3,488	5,485	442	252	984	428
Net periodic benefit cost	\$3,265	\$3,735	\$1,723	\$1,192	\$4,713	\$4,380
Six Months Ended June 30:						
Net periodic benefit cost:						
Service cost	\$10,793	\$9,464	\$2,320	\$1,785	\$1,531	\$1,472
Interest cost	8,534	8,662	3,805	3,449	6,091	6,760
Expected return on assets	(20,684)	(22,421)	(3,564)	(3,354)		

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Amortization of:

Prior service cost (credit)	911	796			(164) (328)
Actuarial loss	6,976	10,971	884	503	1,967	857	
Net periodic benefit cost	\$6,530	\$7,472	\$3,445	\$2,383	\$9,425	\$8,761	

For further details on the Company's health care, pension and other benefits, see Note 6 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

NOTE 8—OTHER LONG-TERM LIABILITIES

The Company initially provides for estimated costs of environmental-related activities relating to its past operations and third party sites for which commitments or clean-up plans have been developed and when such costs can be reasonably estimated based on industry standards and professional judgment. These estimated costs are determined based on currently available facts regarding each site. If the best estimate of costs can only be identified as a range and no specific amount within that range can be determined more likely than any other amount within the range, the minimum of the range is provided. At June 30, 2013, the unaccrued maximum of the estimated range of possible outcomes is \$85.6 million higher than the minimum.

The Company continuously assesses its potential liability for investigation and remediation-related activities and adjusts its environmental-related accruals as information becomes available upon which more accurate costs can be reasonably estimated and as additional accounting guidelines are issued. Actual costs incurred may vary from these estimates due to the inherent uncertainties involved including, among others, the number and financial condition of parties involved with respect to any given site, the volumetric contribution which may be attributed to the Company relative to that attributed to other parties, the nature and magnitude of the wastes involved, the various technologies that can be used for remediation and the determination of acceptable remediation with respect to a particular site.

Included in Other long-term liabilities at June 30, 2013 and 2012 were accruals for extended environmental-related activities of \$93.8 million and \$83.9 million, respectively. Estimated costs of current investigation and remediation activities of \$17.1 million and \$42.9 million are included in Other accruals at June 30, 2013 and 2012, respectively. Two of the Company's currently and formerly owned manufacturing sites account for the majority of the accrual for environmental-related activities and the unaccrued maximum of the estimated range of possible outcomes at June 30, 2013. At June 30, 2013, \$58.5 million, or 52.8 percent of the total accrual, related directly to these two sites. In the aggregate unaccrued maximum of \$85.6 million at June 30, 2013, \$56.6 million, or 66.1 percent, related to the two manufacturing sites. While environmental investigations and remedial actions are in different stages at these sites, additional investigations, remedial actions and monitoring will likely be required at each site.

Management cannot presently estimate the ultimate potential loss contingencies related to these sites or other less significant sites until such time as a substantial portion of the investigation at the sites is completed and remedial action plans are developed. In the event any future loss contingency significantly exceeds the current amount accrued, the recording of the ultimate liability may result in a material impact on net income for the annual or interim period during which the additional costs are accrued. Management does not believe that any potential liability ultimately attributed to the Company for its environmental-related matters will have a material adverse effect on the Company's financial condition, liquidity, or cash flow due to the extended period of time during which environmental investigation and remediation takes place. An estimate of the potential impact on the Company's operations cannot be made due to the aforementioned uncertainties.

Management expects these contingent environmental-related liabilities to be resolved over an extended period of time. Management is unable to provide a more specific time frame due to the indefinite amount of time to conduct investigation activities at any site, the indefinite amount of time to obtain environmental agency approval, as necessary, with respect to investigation and remediation activities, and the indefinite amount of time necessary to conduct remediation activities.

For further details on the Company's Other long-term liabilities, see Note 8 to the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

NOTE 9 – LITIGATION

In the course of its business, the Company is subject to a variety of claims and lawsuits, including, but not limited to, litigation relating to product liability and warranty, personal injury, environmental, intellectual property, commercial, contractual and antitrust claims that are inherently subject to many uncertainties regarding the possibility of a loss to the Company. These uncertainties will ultimately be resolved when one or more future events occur or fail to occur confirming the incurrence of a liability or the reduction of a liability. In accordance with the Contingencies Topic of the ASC, the Company accrues for these contingencies by a charge to income when it is both probable that one or more future events will occur confirming the fact of a loss and the amount of the loss can be reasonably estimated. In the event that the Company's loss contingency is ultimately determined to be significantly higher than currently

accrued, the recording of the additional liability may result in a material impact on the Company's results of operations, liquidity or financial condition for the annual or interim period during which such additional liability is accrued. In those cases where no accrual is recorded because it is not probable that a liability has been incurred and the amount of any such loss cannot be reasonably estimated, any potential liability ultimately determined to be attributable to the Company may result in a material impact on the Company's results of operations, liquidity or financial condition for the annual or interim period during which such liability is accrued. In those cases where no accrual is recorded or

exposure to loss exists in excess of the amount accrued, the Contingencies Topic of the ASC requires disclosure of the contingency when there is a reasonable possibility that a loss or additional loss may have been incurred.

Lead pigment and lead-based paint litigation. The Company's past operations included the manufacture and sale of lead pigments and lead-based paints. The Company, along with other companies, is and has been a defendant in a number of legal proceedings, including individual personal injury actions, purported class actions, and actions brought by various counties, cities, school districts and other government-related entities, arising from the manufacture and sale of lead pigments and lead-based paints. The plaintiffs' claims have been based upon various legal theories, including negligence, strict liability, breach of warranty, negligent misrepresentations and omissions, fraudulent misrepresentations and omissions, concert of action, civil conspiracy, violations of unfair trade practice and consumer protection laws, enterprise liability, market share liability, public nuisance, unjust enrichment and other theories. The plaintiffs seek various damages and relief, including personal injury and property damage, costs relating to the detection and abatement of lead-based paint from buildings, costs associated with a public education campaign, medical monitoring costs and others. The Company is also a defendant in legal proceedings arising from the manufacture and sale of non-lead-based paints that seek recovery based upon various legal theories, including the failure to adequately warn of potential exposure to lead during surface preparation when using non-lead-based paint on surfaces previously painted with lead-based paint. The Company believes that the litigation brought to date is without merit or subject to meritorious defenses and is vigorously defending such litigation. The Company has not settled any lead pigment or lead-based paint litigation. The Company expects that additional lead pigment and lead-based paint litigation may be filed against the Company in the future asserting similar or different legal theories and seeking similar or different types of damages and relief.

Notwithstanding the Company's views on the merits, litigation is inherently subject to many uncertainties, and the Company ultimately may not prevail. Adverse court rulings or determinations of liability, among other factors, could affect the lead pigment and lead-based paint litigation against the Company and encourage an increase in the number and nature of future claims and proceedings. In addition, from time to time, various legislation and administrative regulations have been enacted, promulgated or proposed to impose obligations on present and former manufacturers of lead pigments and lead-based paints respecting asserted health concerns associated with such products or to overturn the effect of court decisions in which the Company and other manufacturers have been successful.

Due to the uncertainties involved, management is unable to predict the outcome of the lead pigment and lead-based paint litigation, the number or nature of possible future claims and proceedings, or the effect that any legislation and/or administrative regulations may have on the litigation or against the Company. In addition, management cannot reasonably determine the scope or amount of the potential costs and liabilities related to such litigation, or resulting from any such legislation and regulations. The Company has not accrued any amounts for such litigation. With respect to such litigation, including the public nuisance litigation, the Company does not believe that it is probable that a loss has occurred, and it is not possible to estimate the range of potential losses as there is no prior history of a loss of this nature and there is no substantive information upon which an estimate could be based. In addition, any potential liability that may result from any changes to legislation and regulations cannot reasonably be estimated. In the event any significant liability is determined to be attributable to the Company relating to such litigation, the recording of the liability may result in a material impact on net income for the annual or interim period during which such liability is accrued. Additionally, due to the uncertainties associated with the amount of any such liability and/or the nature of any other remedy which may be imposed in such litigation, any potential liability determined to be attributable to the Company arising out of such litigation may have a material adverse effect on the Company's results of operations, liquidity or financial condition. An estimate of the potential impact on the Company's results of operations, liquidity or financial condition cannot be made due to the aforementioned uncertainties.

Public nuisance claim litigation. The Company and other companies are or were defendants in legal proceedings seeking recovery based on public nuisance liability theories, among other theories, brought by the State of Rhode Island, the City of St. Louis, Missouri, various cities and counties in the State of New Jersey, various cities in the State of Ohio and the State of Ohio, the City of Chicago, Illinois, the City of Milwaukee, Wisconsin and the County of Santa Clara, California and other public entities in the State of California. Except for the Santa Clara County, California proceeding, all of these legal proceedings have been concluded in favor of the Company and other

defendants at various stages in the proceedings.

The proceedings initiated by the State of Rhode Island included two jury trials. At the conclusion of the second trial, the jury returned a verdict finding that (i) the cumulative presence of lead pigment in paints and coatings on buildings in the State of Rhode Island constitutes a public nuisance, (ii) the Company, along with two other defendants, caused or substantially contributed to the creation of the public nuisance, and (iii) the Company and two other defendants should be ordered to abate the public nuisance. The Company and two other defendants appealed and, on July 1, 2008, the Rhode Island Supreme Court, among other determinations, reversed the judgment of abatement with respect to the Company and two other defendants. The Rhode Island Supreme Court's decision reversed the public nuisance liability judgment against the Company on the basis that the complaint failed to state a public nuisance claim as a matter of law.

The Santa Clara County, California proceeding was initiated in March 2000 in the Superior Court of the State of California, County of Santa Clara. In the original complaint, the plaintiffs asserted various claims including fraud and concealment, strict product liability/failure to warn, strict product liability/design defect, negligence, negligent breach of a special duty, public nuisance, private nuisance, and violations of California's Business and Professions Code. A number of the asserted claims were resolved in favor of the defendants through pre-trial proceedings. The named plaintiffs in the Fourth Amended Complaint, filed on March 16, 2011, are the Counties of Santa Clara, Alameda, Los Angeles, Monterey, San Mateo, Solano and Ventura, and the Cities of Oakland, San Diego and San Francisco. The Fourth Amended Complaint asserts a sole claim for public nuisance, alleging that the presence of lead products for use in paint and coatings in, on and around buildings in the plaintiffs' jurisdictions constitutes a public nuisance. The plaintiffs seek the abatement of the alleged public nuisance that exists within the plaintiffs' jurisdictions. A trial commenced on July 15, 2013.

Litigation seeking damages from alleged personal injury. The Company and other companies are defendants in a number of legal proceedings seeking monetary damages and other relief from alleged personal injuries. These proceedings include claims by children allegedly injured from ingestion of lead pigment or lead-containing paint, claims for damages allegedly incurred by the children's parents or guardians, and claims for damages allegedly incurred by professional painting contractors. These proceedings generally seek compensatory and punitive damages, and seek other relief including medical monitoring costs. These proceedings include purported claims by individuals, groups of individuals and class actions.

The plaintiff in *Thomas v. Lead Industries Association, et al.*, initiated an action in state court against the Company, other alleged former lead pigment manufacturers and the Lead Industries Association in September 1999. The claims against the Company and the other defendants included strict liability, negligence, negligent misrepresentation and omissions, fraudulent misrepresentation and omissions, concert of action, civil conspiracy and enterprise liability. Implicit within these claims is the theory of "risk contribution" liability (Wisconsin's theory which is similar to market share liability) due to the plaintiff's inability to identify the manufacturer of any product that allegedly injured the plaintiff. The case ultimately proceeded to trial and, on November 5, 2007, the jury returned a defense verdict, finding that the plaintiff had ingested white lead carbonate, but was not brain damaged or injured as a result. The plaintiff appealed and, on December 16, 2010, the Wisconsin Court of Appeals affirmed the final judgment in favor of the Company and other defendants.

Wisconsin is the only jurisdiction to date to apply a theory of liability with respect to alleged personal injury (i.e., risk contribution/market share liability) that does not require the plaintiff to identify the manufacturer of the product that allegedly injured the plaintiff in the lead pigment and lead-based paint litigation. Although the risk contribution liability theory was applied during the *Thomas* trial, the constitutionality of this theory as applied to the lead pigment cases has not been judicially determined by the Wisconsin state courts. However, in an unrelated action filed in the United States District Court for the Eastern District of Wisconsin, *Gibson v. American Cyanamid, et al.*, on November 15, 2010, the District Court held that Wisconsin's risk contribution theory as applied in that case violated the defendants' right to substantive due process and is unconstitutionally retroactive. The District Court's decision in *Gibson v. American Cyanamid, et al.*, has been appealed by the plaintiff.

Insurance coverage litigation. The Company and its liability insurers, including certain underwriters at Lloyd's of London, initiated legal proceedings against each other to primarily determine, among other things, whether the costs and liabilities associated with the abatement of lead pigment are covered under certain insurance policies issued to the Company. The Company's action, filed on March 3, 2006 in the Common Pleas Court, Cuyahoga County, Ohio, is currently stayed and inactive. The liability insurers' action, which was filed on February 23, 2006 in the Supreme Court of the State of New York, County of New York, has been dismissed. An ultimate loss in the insurance coverage litigation would mean that insurance proceeds could be unavailable under the policies at issue to mitigate any ultimate abatement related costs and liabilities. The Company has not recorded any assets related to these insurance policies or otherwise assumed that proceeds from these insurance policies would be received in estimating any contingent liability accrual. Therefore, an ultimate loss in the insurance coverage litigation without a determination of liability against the Company in the lead pigment or lead-based paint litigation will have no impact on the Company's results of operation, liquidity or financial condition. As previously stated, however, the Company has not accrued any amounts

for the lead pigment or lead-based paint litigation and any significant liability ultimately determined to be attributable to the Company relating to such litigation may result in a material impact on the Company's results of operations, liquidity or financial condition for the annual or interim period during which such liability is accrued.

Department of Labor (DOL) leveraged ESOP settlement. As previously disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2012, on February 20, 2013, the Company reached a settlement with the DOL of the DOL's investigation of transactions related to the Company's ESOP that were implemented on August 1, 2006 and August 27, 2003. The DOL had notified the Company, among others, of potential enforcement claims asserting breaches of fiduciary obligations and sought compensatory and equitable remedies. The Company resolved all ESOP related claims with the DOL by agreeing, in part, to make a one-time payment of \$80.0 million to the ESOP, resulting in a \$49.2 million after tax charge to

earnings in the fourth quarter of 2012. The Company made this required \$80.0 million payment to the ESOP during the first quarter of 2013.

Import duty assessment settlement. During the second quarter of 2013, the Company recorded a charge of \$11.8 million to Cost of goods sold due to an assessment as a result of audits brought by the Brazilian government related to the handling of import duties on products brought into the country for the years 2006 through 2008, resulting in an after-tax charge of \$8.4 million. The Company elected to accept a voluntary amnesty program offered by the government to resolve this issue rather than incur significant legal expenses to contest the assessment in court. The Company's import duty processes were changed beginning in 2009, however, years subsequent to 2008 remain open to audit. No additional accruals for potential assessments have been recorded.

NOTE 10—OTHER

Other general expense - net

Included in Other general expense - net were the following:

(Thousands of dollars)	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2013	2012	2013	2012
Provisions for environmental matters—net	\$1,446	\$3,988	\$1,769	\$9,093
(Gain) loss on disposition of assets	(1,173)	(814)	2,323	(935)
Adjustments to prior provisions for qualified exit costs	212	(88)	340	(35)
Total	\$485	\$3,086	\$4,432	\$8,123

Provisions for environmental matters—net represent site-specific increases or decreases to environmental-related accruals as information becomes available upon which more accurate costs can be reasonably estimated and as additional accounting guidelines are issued. Environmental-related accruals are not recorded net of insurance proceeds in accordance with the Offsetting Subtopic of the Balance Sheet Topic of the ASC. See Note 8 for further details on the Company's environmental-related activities.

The (gain) loss on disposition of assets represents net realized (gains) losses associated with the disposal of fixed assets previously used in the conduct of the primary business of the Company.

The adjustments to prior provisions for qualified exit costs represent site specific increases or decreases to accrued qualified exit costs as adjustments for costs of employee terminations are required or as information becomes available upon which more accurate amounts can be reasonably estimated. See Note 6 for further details on the Company's exit or disposal activities.

Other expense (income) - net

Included in Other expense (income) - net were the following:

(Thousands of dollars)	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2013	2012	2013	2012
Dividend and royalty income	\$(813)	\$(851)	\$(3,637)	\$(2,101)
Net expense from financing activities	2,845	1,041	4,743	4,021
Foreign currency transaction related losses (gains)	3,196	1,374	5,944	(3,704)
Other income	(7,107)	(5,229)	(14,419)	(8,480)
Other expense	2,594	3,561	5,363	5,173
Total	\$715	\$(104)	\$(2,006)	\$(5,091)

The net expense from financing activities includes the net expense relating to the change in the Company's financing fees.

Foreign currency transaction related losses (gains) represent net realized losses (gains) on U.S. dollar-denominated liabilities of foreign subsidiaries and net realized and unrealized losses (gains) from foreign currency option and forward contracts. There were no foreign currency option and forward contracts outstanding at June 30, 2013 and

2012.

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Other income and Other expense included items of revenue, gains, expenses and losses that were unrelated to the primary business purpose of the Company. There were no items within the other income or other expense caption that were individually significant.

NOTE 11—INCOME TAXES

The effective tax rate was 32.5 percent and 32.0 percent for the second quarter and first six months of 2013, respectively, compared to 30.5 percent and 30.2 percent for the second quarter and first six months of 2012, respectively. The increase in the effective tax rate for the second quarter and first six months of 2013 compared to 2012 was primarily due to the impact of additional state income tax expense as well as a reduction in tax benefits related to federal income tax credits.

At December 31, 2012, the Company had \$28.1 million in unrecognized tax benefits, the recognition of which would have an effect of \$25.0 million on the current provision for income taxes. Included in the balance of unrecognized tax benefits at December 31, 2012, was \$7.0 million related to tax positions for which it is reasonably possible that the total amounts could significantly change during the next twelve months. This amount represents a decrease in unrecognized tax benefits comprised of items related to federal audits of partnership investments, assessed state income tax audits, state settlement negotiations currently in progress and expiring statutes in federal and foreign jurisdictions.

The Company classifies all income tax related interest and penalties as income tax expense. At December 31, 2012, the Company had accrued \$6.2 million for the potential payment of income tax interest and penalties.

There were no significant changes to any of the balances of unrecognized tax benefits at December 31, 2012 during the first six months of 2013.

On January 2, 2013, the American Taxpayer Relief Act (ATRA) was enacted which retroactively reinstated and extended the Federal Research and Development Tax Credit from January 1, 2012 to December 31, 2013. As a result, the Company recognized a \$2.0 million discrete tax benefit during the first quarter of 2013. The other provisions of the Act will have a negligible impact on the Company's effective tax rate in 2013.

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction, and various state and foreign jurisdictions. The IRS commenced an examination of the Company's U.S. income tax returns for the 2008 and 2009 tax years in the third quarter of 2011. Fieldwork was completed during the second quarter of 2013. At this time, the Company has determined that an insignificant payment is due for issues under review during this audit period. The Company has fully resolved all IRS issues for the 2003 through 2009 tax years relating to the matters challenging the ESOP related federal income tax deductions claimed by the Company. With the exception of \$2.0 million of interest related to the 2008 tax year, all ESOP related settlement payments have been made to the IRS.

As of June 30, 2013, the Company is subject to non-U.S. income tax examinations for the tax years of 2006 through 2012. In addition, the Company is subject to state and local income tax examinations for the tax years 2002 through 2012.

NOTE 12—NET INCOME PER COMMON SHARE

(Thousands of dollars except per share data)	Three Months Ended		Six Months Ended	
	June 30, 2013	2012	June 30, 2013	2012
Basic				
Average common shares outstanding	101,665,737	101,446,643	101,813,398	101,758,496
Net income	\$257,287	\$227,813	\$373,472	\$328,029
Less net income allocated to unvested restricted shares	(1,639)	(1,908)	(2,278)	(2,689)
Net income allocated to common shares	\$255,648	\$225,905	\$371,194	\$325,340
Basic net income per common share	\$2.51	\$2.23	\$3.65	\$3.20
Diluted				
Average common shares outstanding	101,665,737	101,446,643	101,813,398	101,758,496
Stock options and other contingently issuable shares ⁽¹⁾	2,231,043	2,556,485	2,218,320	2,341,550
Average common shares outstanding assuming dilution	103,896,780	104,003,128	104,031,718	104,100,046
Net income	\$257,287	\$227,813	\$373,472	\$328,029
Less net income allocated to unvested restricted shares assuming dilution	(1,607)	(1,865)	(2,235)	(2,633)
Net income allocated to common shares assuming dilution	\$255,680	\$225,948	\$371,237	\$325,396
Diluted net income per common share	\$2.46	\$2.17	\$3.57	\$3.13

⁽¹⁾ There were no options excluded due to their anti-dilutive effect for the three and six months ended June 30, 2013 and 2012.

The Company has two classes of participating securities: common shares and restricted shares, representing 99% and 1% of outstanding shares, respectively. The restricted shares are shares of unvested restricted stock granted under the Company's restricted stock award program. Unvested restricted shares granted prior to April 21, 2010 received non-forfeitable dividends. Accordingly, the shares are considered a participating security and the two-class method of calculating basic and diluted earnings per share is required. Effective April 21, 2010, the restricted stock award program was revised and dividends on performance-based restricted shares granted after this date are deferred and payment is contingent upon the awards vesting. Only the time-based restricted shares, which continue to receive non-forfeitable dividends, are considered a participating security. Basic and diluted earnings per share are calculated using the two-class method in accordance with the Earnings Per Share Topic of the ASC.

NOTE 13—REPORTABLE SEGMENT INFORMATION

The Company reports segment information in the same way that management internally organizes its business for assessing performance and making decisions regarding allocation of resources in accordance with the Segment Disclosures Topic of the ASC. The Company has determined that it has four reportable operating segments: Paint Stores Group, Consumer Group, Global Finishes Group and Latin America Coatings Group (individually, a "Reportable Segment" and collectively, the "Reportable Segments").

(Thousands of dollars) Three Months Ended June 30, 2013						
	Paint Stores Group	Consumer Group	Global Finishes Group	Latin America Coatings Group	Administrative	Consolidated Totals
Net external sales	\$ 1,606,509	\$ 393,660	\$ 513,524	\$ 198,991	\$ 1,205	\$ 2,713,889
Intersegment transfers		658,202	3,740	9,691	(671,633)	
Total net sales and intersegment transfers	\$ 1,606,509	\$ 1,051,862	\$ 517,264	\$ 208,682	\$ (670,428)	\$ 2,713,889
Segment profit	\$ 332,972	\$ 79,042	(1) \$ 54,462	\$ 856		\$ 467,332
Interest expense					\$ (15,069)	(15,069)
Administrative expenses and other					(71,379)	(71,379)
Income before income taxes	\$ 332,972	\$ 79,042	\$ 54,462	\$ 856	\$ (86,448)	\$ 380,884
Three Months Ended June 30, 2012						
	Paint Stores Group	Consumer Group	Global Finishes Group	Latin America Coatings Group	Administrative	Consolidated Totals
Net external sales	\$ 1,488,109	\$ 397,749	\$ 498,693	\$ 187,281	\$ 1,190	\$ 2,573,022
Intersegment transfers		655,276	1,935	11,649	(668,860)	
Total net sales and intersegment transfers	\$ 1,488,109	\$ 1,053,025	\$ 500,628	\$ 198,930	\$ (667,670)	\$ 2,573,022
Segment profit	\$ 266,982	\$ 80,757	(1) \$ 48,032	\$ 9,281		\$ 405,052
Interest expense					\$ (10,230)	(10,230)
Administrative expenses and other					(67,019)	(67,019)
Income before income taxes	\$ 266,982	\$ 80,757	\$ 48,032	\$ 9,281	\$ (77,249)	\$ 327,803

(1) Segment profit includes \$8,108 and \$7,968 of mark-up on intersegment transfers realized as a result of external sales by the Paint Stores Group during the second quarter of 2013 and 2012, respectively.

Six Months Ended June 30, 2013						
	Paint Stores Group	Consumer Group	Global Finishes Group	Latin America Coatings Group	Administrative	Consolidated Totals
Net external sales	\$2,774,446	\$702,240	\$1,000,342	\$ 401,627	\$ 2,402	\$4,881,057
Intersegment transfers		1,165,906	5,031	19,912	(1,190,849)	
Total net sales and intersegment transfers	\$2,774,446	\$1,868,146	\$1,005,373	\$ 421,539	\$ (1,188,447)	\$4,881,057
Segment profit	\$462,685	\$133,014	(²) \$88,393	\$ 21,695		\$705,787
Interest expense					\$ (30,380)	(30,380)
Administrative expenses and other					(126,139)	(126,139)
Income before income taxes	\$462,685	\$133,014	\$88,393	\$ 21,695	\$ (156,519)	\$549,268
Six Months Ended June 30, 2012						
	Paint Stores Group	Consumer Group	Global Finishes Group	Latin America Coatings Group	Administrative	Consolidated Totals
Net external sales	\$2,611,187	\$718,122	\$981,768	\$ 395,874	\$ 2,415	\$4,709,366
Intersegment transfers		1,158,776	4,265	22,624	(1,185,665)	
Total net sales and intersegment transfers	\$2,611,187	\$1,876,898	\$986,033	\$ 418,498	\$ (1,183,250)	\$4,709,366
Segment profit	\$379,694	\$136,063	(²) \$76,669	\$ 29,168		\$621,594
Interest expense					\$ (20,567)	(20,567)
Administrative expenses and other					(130,909)	(130,909)
Income before income taxes	\$379,694	\$136,063	\$76,669	\$ 29,168	\$ (151,476)	\$470,118

(²) Segment profit includes \$14,278 and \$14,644 of mark-up on intersegment transfers realized as a result of external sales by the Paint Stores Group during the first six months of 2013 and 2012, respectively.

In the reportable segment financial information, Segment profit was total net sales and intersegment transfers less operating costs and expenses. Domestic intersegment transfers were accounted for at the approximate fully absorbed manufactured cost, based on normal capacity volumes, plus customary distribution costs. International intersegment transfers were accounted for at values comparable to normal unaffiliated customer sales. The Administrative segment includes the administrative expenses of the Company's corporate headquarters site. Also included in the Administrative segment was interest expense, interest and investment income, certain expenses related to closed facilities and environmental-related matters, and other expenses which were not directly associated with the Reportable Segments. The Administrative segment did not include any significant foreign operations. Also included in the Administrative segment was a real estate management unit that is responsible for the ownership, management and leasing of non-retail properties held primarily for use by the Company, including the Company's headquarters site, and disposal of idle facilities. Sales of this segment represented external leasing revenue of excess headquarters space or leasing of facilities no longer used by the Company in its primary businesses. Gains and losses from the sale of property were not a significant operating factor in determining the performance of the Administrative segment. Net external sales and segment profit of all consolidated foreign subsidiaries were \$531.6 million and \$5.6 million, respectively, for the second quarter of 2013, and \$491.9 million and \$32.5 million, respectively, for the second quarter of 2012. Net external sales and segment profit of these subsidiaries were \$1.048 billion and \$31.2 million, respectively, for the first six months of 2013, and \$993.8 million and \$67.3 million, respectively, for the first six months of 2012. Long-lived assets of these subsidiaries totaled \$765.9 million and \$637.7 million at June 30, 2013 and June 30, 2012, respectively. Domestic operations accounted for the remaining net external sales, segment profits

and long-lived assets. No single geographic area outside the United States was significant relative to consolidated net external sales, income before taxes, or consolidated long-lived assets.

Export sales and sales to any individual customer were each less than 10 percent of consolidated sales to unaffiliated customers during all periods presented.

NOTE 14—ACQUISITIONS

On November 9, 2012, the Company entered into a definitive Stock Purchase Agreement to purchase all of the issued and outstanding shares of Consorcio Comex, S.A. de C.V. (Comex) for an aggregate purchase price of approximately \$2.34 billion, including assumed debt. The Stock Purchase Agreement was amended on June 24, 2013 to extend the date by which the

agreement can be terminated by either party to August 31, 2013. Comex is a leader in the paint and coatings market in Mexico with headquarters in Mexico City. Completion of the transaction is subject to certain conditions and regulatory approvals. On July 17, 2013, the Federal Competition Commission of Mexico (FCCM) informed the Company that the acquisition was not authorized by the FCCM by a 3-2 vote of its members. The Company is preparing a response to address the Commission's concerns.

The completed acquisitions below have been accounted for as purchases and their results of operations have been included in the consolidated financial statements since the date of acquisition. Both acquisitions resulted in the recognition of goodwill and intangible assets.

Effective December 18, 2012, the Company acquired Jiangsu Pulanna Coating Co., Ltd. (Pulanna). Headquartered in Changzhou, China, Pulanna is a leading automotive refinishes coatings manufacturer in China. The acquisition strengthens the Global Finishes Group's established presence in China and its ability to serve automotive customers around the world.

Effective June 1, 2012, the Company acquired Geocel Holdings Corporation. Geocel manufactures innovative caulks, sealants, and adhesives specially designed for tough construction and repair applications in commercial, residential, industrial and transport non-automotive markets. Geocel has operations in both the United States and United Kingdom. The acquisition strengthens the Consumer Group's sealant and adhesive market position.

The following unaudited pro-forma summary presents consolidated financial information as if Pulanna and Geocel had been acquired as of the beginning of each period presented. The pro-forma consolidated financial information does not necessarily reflect the actual results that would have occurred had the acquisitions taken place on January 1, 2012 or of future results of operations of Pulanna and Geocel under ownership and operation of the Company.

(Thousands of dollars except per share data)	Three Months Ended		Six Months Ended	
	June 30, 2013	2012	June 30, 2013	2012
Net sales	\$2,713,889	\$2,597,205	\$4,881,057	\$4,754,057
Net income	257,287	231,181	373,472	334,407
Net income per common share:				
Basic	\$2.51	\$2.26	\$3.65	\$3.26
Diluted	\$2.46	\$2.20	\$3.57	\$3.19

NOTE 15—FAIR VALUE MEASUREMENTS

The Fair Value Measurements and Disclosures Topic of the ASC applies to the Company's financial and non-financial assets and liabilities. The guidance applies when other standards require or permit the fair value measurement of assets and liabilities. It does not expand the use of fair value measurements. The Company did not have any fair value measurements for its non-financial assets and liabilities during the second quarter. The following table presents the Company's financial assets and liabilities that are measured at fair value on a recurring basis, categorized using the fair value hierarchy:

(Thousands of dollars)

Fair Value at June 30,	Quoted Prices in Active Markets for Identical Assets	Significant Other	Significant Unobservable