

PARKER HANNIFIN CORP
Form 10-Q
February 07, 2019

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

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

For the quarterly period ended December 31, 2018

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 1-4982

PARKER-HANNIFIN CORPORATION

(Exact name of registrant as specified in its charter)

OHIO 34-0451060
(State or other jurisdiction of (IRS Employer
incorporation or organization) Identification No.)

6035 Parkland Blvd., Cleveland, Ohio 44124-4141

(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (216) 896-3000

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 every Interactive Data File required to be submitted 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 such files). Yes No

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

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Number of Common Shares outstanding at December 31, 2018: 129,365,355

PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

PARKER-HANNIFIN CORPORATION
 CONSOLIDATED STATEMENT OF INCOME
 (Dollars in thousands, except per share amounts)
 (Unaudited)

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|-------------|------------------|-------------|
| | December 31, | | December 31, | |
| | 2018 | 2017 | 2018 | 2017 |
| Net sales | \$3,472,045 | \$3,370,673 | \$6,951,339 | \$6,735,324 |
| Cost of sales | 2,602,339 | 2,564,449 | 5,197,162 | 5,087,743 |
| Selling, general and administrative expenses | 397,259 | 408,338 | 791,581 | 805,322 |
| Interest expense | 47,518 | 53,133 | 91,857 | 106,688 |
| Other (income) expense, net | (6,225) | (15,468) | (20,138) | 1,048 |
| Income before income taxes | 431,154 | 360,221 | 890,877 | 734,523 |
| Income taxes | 119,241 | 303,899 | 203,065 | 392,666 |
| Net income | 311,913 | 56,322 | 687,812 | 341,857 |
| Less: Noncontrolling interest in subsidiaries' earnings | 176 | 163 | 364 | 301 |
| Net income attributable to common shareholders | \$311,737 | \$56,159 | \$687,448 | \$341,556 |
| Earnings per share attributable to common shareholders: | | | | |
| Basic | \$2.39 | \$0.42 | \$5.23 | \$2.57 |
| Diluted | \$2.36 | \$0.41 | \$5.15 | \$2.51 |

See accompanying notes to consolidated financial statements.

PARKER-HANNIFIN CORPORATION
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME
(Dollars in thousands)
(Unaudited)

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|---|------------------------------------|-----------|----------------------------------|-----------|
| | 2018 | 2017 | 2018 | 2017 |
| Net income | \$311,913 | \$56,322 | \$687,812 | \$341,857 |
| Less: Noncontrolling interests in subsidiaries' earnings | 176 | 163 | 364 | 301 |
| Net income attributable to common shareholders | 311,737 | 56,159 | 687,448 | 341,556 |
| Other comprehensive (loss) income, net of tax | | | | |
| Foreign currency translation adjustment and other | (43,986) | 28,390 | (79,111) | 101,269 |
| Retirement benefits plan activity | 24,527 | 28,312 | 48,400 | 55,047 |
| Other comprehensive (loss) income | (19,459) | 56,702 | (30,711) | 156,316 |
| Less: Other comprehensive income (loss) for noncontrolling interests | 55 | (73) | (34) | (160) |
| Other comprehensive (loss) income attributable to common shareholders | (19,514) | 56,775 | (30,677) | 156,476 |
| Total comprehensive income attributable to common shareholders | \$292,223 | \$112,934 | \$656,771 | \$498,032 |
| See accompanying notes to consolidated financial statements. | | | | |

PARKER-HANNIFIN CORPORATION
CONSOLIDATED BALANCE SHEET
(Dollars in thousands)
(Unaudited)

| | December 31, 2018 | June 30, 2018 |
|--|----------------------|------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 1,047,385 | \$ 822,137 |
| Marketable securities and other investments | 30,956 | 32,995 |
| Trade accounts receivable, net | 1,938,709 | 2,145,517 |
| Non-trade and notes receivable | 324,254 | 328,399 |
| Inventories | 1,804,564 | 1,621,304 |
| Prepaid expenses and other | 188,868 | 134,886 |
| Total current assets | 5,334,736 | 5,085,238 |
| Plant and equipment | 5,192,144 | 5,215,253 |
| Less: Accumulated depreciation | 3,398,339 | 3,359,016 |
| Plant and equipment, net | 1,793,805 | 1,856,237 |
| Deferred income taxes | 98,779 | 57,623 |
| Investments and other assets | 733,987 | 801,049 |
| Intangible assets, net | 1,883,825 | 2,015,520 |
| Goodwill | 5,462,555 | 5,504,420 |
| Total assets | \$ 15,307,687 | \$ 15,320,087 |
| LIABILITIES | | |
| Current liabilities: | | |
| Notes payable and long-term debt payable within one year | \$ 1,144,347 | \$ 638,466 |
| Accounts payable, trade | 1,307,178 | 1,430,306 |
| Accrued payrolls and other compensation | 319,787 | 427,500 |
| Accrued domestic and foreign taxes | 182,617 | 198,878 |
| Other accrued liabilities | 555,005 | 502,333 |
| Total current liabilities | 3,508,934 | 3,197,483 |
| Long-term debt | 4,303,331 | 4,318,559 |
| Pensions and other postretirement benefits | 937,938 | 1,177,605 |
| Deferred income taxes | 286,622 | 234,858 |
| Other liabilities | 449,696 | 526,089 |
| Total liabilities | 9,486,521 | 9,454,594 |
| EQUITY | | |
| Shareholders' equity: | | |
| Serial preferred stock, \$.50 par value; authorized 3,000,000 shares; none issued | — | — |
| Common stock, \$.50 par value; authorized 600,000,000 shares; issued 181,046,128 shares at December 31 and June 30 | 90,523 | 90,523 |
| Additional capital | 521,854 | 496,592 |
| Retained earnings | 12,114,448 | 11,625,975 |
| Accumulated other comprehensive (loss) | (1,795,497) | (1,763,086) |
| Treasury shares, at cost; 51,680,773 shares at December 31 and 48,632,105 shares at June 30 | (5,116,119) | (4,590,138) |
| Total shareholders' equity | 5,815,209 | 5,859,866 |
| Noncontrolling interests | 5,957 | 5,627 |

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| | | |
|--|---------------|---------------|
| Total equity | 5,821,166 | 5,865,493 |
| Total liabilities and equity | \$ 15,307,687 | \$ 15,320,087 |
| See accompanying notes to consolidated financial statements. | | |

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PARKER-HANNIFIN CORPORATION
CONSOLIDATED STATEMENT OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

| | Six Months Ended December 31, | |
|---|----------------------------------|------------|
| | 2018 | 2017 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net income | \$687,812 | \$341,857 |
| Adjustments to reconcile net income to net cash provided by operations: | | |
| Depreciation | 115,000 | 120,335 |
| Amortization | 107,543 | 113,881 |
| Share incentive plan compensation | 64,615 | 64,267 |
| Deferred income tax expense | 47,401 | (74,101) |
| Foreign currency transaction loss | 2,526 | 12,620 |
| Loss (gain) on plant and equipment and intangible assets | 3,428 | (26,529) |
| Loss on sale of businesses | 623 | — |
| Loss (gain) on marketable securities | 5,701 | (1) |
| (Gain) loss on investments | (3,213 |) 33,759 |
| Changes in assets and liabilities, net of effect of acquisitions: | | |
| Accounts receivable, net | 185,638 | 49,986 |
| Inventories | (176,094) | (207,334) |
| Prepaid expenses | (40,555) | (81,168) |
| Other assets | 14,214 | (45,710) |
| Accounts payable, trade | (120,253) | (92,267) |
| Accrued payrolls and other compensation | (104,726) | (111,687) |
| Accrued domestic and foreign taxes | (14,758) | 5,796 |
| Other accrued liabilities | 18,960 | 59,003 |
| Pensions and other postretirement benefits | (173,040) | 25,379 |
| Other liabilities | (79,782) | 268,688 |
| Net cash provided by operating activities | 541,040 | 456,774 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Acquisitions (net of cash acquired of \$690 in 2018) | (2,042) | — |
| Capital expenditures | (94,426) | (144,781) |
| Proceeds from sale of plant and equipment | 34,121 | 59,848 |
| Proceeds from sale of businesses | 19,540 | — |
| Purchases of marketable securities and other investments | (2,845) | (78,309) |
| Maturities and sales of marketable securities and other investments | 14,432 | 12,710 |
| Other | (90) | 8,706 |
| Net cash (used in) investing activities | (31,310) | (141,826) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Proceeds from exercise of stock options | 635 | 2,076 |
| Payments for common shares | (565,970) | (136,436) |
| Proceeds from notes payable, net | 606,019 | 138,900 |
| Proceeds from long-term borrowings | 1 | 1,718 |
| Payments for long-term borrowings | (100,209) | (12,895) |
| Dividends | (200,459) | (176,187) |
| Net cash (used in) financing activities | (259,983) | (182,824) |
| Effect of exchange rate changes on cash | (24,499) | 7,760 |

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| | | |
|--|-------------|-------------|
| Net increase in cash and cash equivalents | 225,248 | 139,884 |
| Cash and cash equivalents at beginning of year | 822,137 | 884,886 |
| Cash and cash equivalents at end of period | \$1,047,385 | \$1,024,770 |

See accompanying notes to consolidated financial statements.

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PARKER-HANNIFIN CORPORATION
BUSINESS SEGMENT INFORMATION

(Dollars in thousands)

(Unaudited)

The Company operates in two reportable business segments: Diversified Industrial and Aerospace Systems.

Diversified Industrial - This segment produces a broad range of motion-control and fluid systems and components used in all kinds of manufacturing, packaging, processing, transportation, mobile construction, refrigeration and air conditioning, agricultural and military machinery and equipment and has a significant portion of international operations. Sales are made directly to major original equipment manufacturers (OEMs) and through a broad distribution network to smaller OEMs and the aftermarket.

Aerospace Systems - This segment designs and manufactures products and provides aftermarket support for commercial, business jet, military and general aviation aircraft, missile and spacecraft markets. The Aerospace Systems Segment provides a full range of systems and components for hydraulic, pneumatic and fuel applications.

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|--|------------------------------------|-------------|----------------------------------|-------------|
| | 2018 | 2017 | 2018 | 2017 |
| Net sales | | | | |
| Diversified Industrial: | | | | |
| North America | \$1,632,059 | \$1,565,416 | \$3,313,103 | \$3,160,107 |
| International | 1,223,679 | 1,255,569 | 2,457,445 | 2,494,343 |
| Aerospace Systems | 616,307 | 549,688 | 1,180,791 | 1,080,874 |
| Total net sales | \$3,472,045 | \$3,370,673 | \$6,951,339 | \$6,735,324 |
| Segment operating income | | | | |
| Diversified Industrial: | | | | |
| North America | \$257,774 | \$225,807 | \$532,885 | \$481,834 |
| International | 189,085 | 164,806 | 395,179 | 356,597 |
| Aerospace Systems | 121,463 | 87,148 | 231,318 | 164,582 |
| Total segment operating income | 568,322 | 477,761 | 1,159,382 | 1,003,013 |
| Corporate general and administrative expenses | 63,890 | 46,942 | 114,215 | 88,292 |
| Income before interest expense and other expense | 504,432 | 430,819 | 1,045,167 | 914,721 |
| Interest expense | 47,518 | 53,133 | 91,857 | 106,688 |
| Other expense | 25,760 | 17,465 | 62,433 | 73,510 |
| Income before income taxes | \$431,154 | \$360,221 | \$890,877 | \$734,523 |

PARKER-HANNIFIN CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Dollars in thousands, except per share amounts

1. Management representation

In the opinion of the management of the Company, the accompanying unaudited consolidated financial statements contain all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the Company's financial position as of December 31, 2018, the results of operations for the three and six months ended December 31, 2018 and 2017 and cash flows for the six months then ended. These financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company's 2018 Annual Report on Form 10-K. Interim period results are not necessarily indicative of the results to be expected for the full fiscal year. Certain prior-year amounts have been reclassified to conform to current-year presentation.

The Company has evaluated subsequent events that have occurred through the date these financial statements were issued. No subsequent events have occurred that required adjustment to these financial statements.

2. New accounting pronouncements

In August 2018, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2018-14, "Compensation--Retirement Benefits--Defined Benefit Plans--General." ASU 2018-14 aims to improve disclosure effectiveness by adding, removing or clarifying certain disclosure requirements related to defined benefit pension or other postretirement plans. ASU 2018-14 is effective for fiscal years ending after December 15, 2020. Early adoption is permitted. The Company has not yet determined the effect that ASU 2018-14 will have on its financial statements.

In August 2018, the FASB issued ASU 2018-13, "Fair Value Measurement." ASU 2018-13 aims to improve disclosure effectiveness by adding, modifying or removing certain disclosure requirements for both recurring and nonrecurring fair value measurements. ASU 2018-13 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2019. Early adoption is permitted upon issuance of the ASU for any removed or modified disclosure. Adoption of additional disclosures may be delayed until their effective dates. The Company has not yet determined the effect that ASU 2018-13 will have on its financial statements.

In February 2018, the FASB issued ASU 2018-02, "Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income." ASU 2018-02 allows for a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the U.S. Tax Cuts and Jobs Act (TCJ Act) reduction of the U.S. federal corporate income tax rate. The amendments also require certain disclosures about stranded tax effects. ASU 2018-02 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018. Early adoption is permitted in any period after the issuance of the update. The amendments in this update should be applied either in the period of adoption or retrospectively to each period in which the effect of the change in the U.S. federal corporate income tax rate in the TCJ Act is recognized. The Company has not yet determined the effect that ASU 2018-02 will have on its financial statements.

In August 2017, the FASB issued ASU 2017-12, "Targeted Improvements to Accounting for Hedging Activities." ASU 2017-12 provides targeted improvements to Topic 815 accounting for hedging activities by expanding an entity's ability to hedge non-financial and financial risk components and reduce complexity in fair value hedges of interest rate risk. The guidance eliminates the requirement to separately measure and report hedge ineffectiveness and generally requires the entire change in the fair value of a hedging instrument to be presented in the same income statement line as the hedged item. The guidance also eases certain documentation and assessment requirements and modifies the accounting for components excluded from the assessment of hedge effectiveness. ASU 2017-12 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018. Early application is permitted in any interim period after issuance of the update. ASU 2017-12 should be applied using a modified retrospective approach for cash flow and net investment hedge relationships that exist on the date of adoption and prospectively for presentation and disclosure requirements. The Company has not yet determined the effect that ASU 2017-12 will have on its financial statements.

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In March 2017, the FASB issued ASU 2017-07, "Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost." ASU 2017-07 requires that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. ASU 2017-07 also provides that only the service cost component is eligible for capitalization, when applicable. ASU 2017-07 should be applied retrospectively for the income

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statement presentation of net periodic pension cost and net periodic postretirement benefit cost and prospectively, on or after the effective date, for the capitalization of the service cost component of net periodic pension cost and net periodic postretirement benefit cost. On July 1, 2018, the Company retrospectively adopted ASU 2017-07 and reclassified prior-year amounts using a practical expedient that permits the usage of amounts previously disclosed in the retirement benefits note. As a result, \$4,621 and \$4,125 of expense was reclassified from cost of sales and selling, general and administrative expenses, respectively, to other (income) expense, net for the prior-year quarter. Expense of \$14,205 and \$8,812 was reclassified from cost of sales and selling, general and administrative expenses, respectively, to other (income) expense, net for the first six months of fiscal 2018.

In October 2016, the FASB issued ASU 2016-16, "Intra-Entity Transfers of Assets Other Than Inventory." ASU 2016-16 provides that an entity should recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. Consequently, the amendments in ASU 2016-16 eliminate the exception for an intra-entity transfer of an asset other than inventory. The Company adopted ASU 2016-16 on July 1, 2018 and recorded a cumulative effect adjustment of approximately \$19 million to reduce retained earnings.

In August 2016, the FASB issued ASU 2016-15, "Classification of Certain Cash Receipts and Cash Payments." ASU 2016-15 provides specific guidance on several cash flow classification issues to reduce diversity in practice in how certain transactions are classified within the statement of cash flows. On July 1, 2018, the Company adopted ASU 2016-15 and retrospectively adjusted its Statement of Cash Flows. These retrospective adjustments were not material. In June 2016, the FASB issued ASU 2016-13, "Measurement of Credit Losses on Financial Instruments." ASU 2016-13 requires a financial asset (or a group of financial assets) measured at amortized cost to be presented at the net amount expected to be collected. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net carrying value at the amount expected to be collected on the financial asset. Credit losses relating to available-for-sale debt securities should be recorded through an allowance for credit losses. ASU 2016-13 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2019. Early adoption is permitted. The Company has not yet determined the effect that ASU 2016-13 will have on its financial statements.

In February 2016, the FASB issued ASU 2016-02, "Leases." ASU 2016-02 requires lessees to put most leases with terms greater than 12 months on their balance sheet by recognizing a liability to make lease payments and an asset representing their right to use the asset during the lease term. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election, by class of underlying asset, not to recognize the corresponding assets and lease liabilities. Lessee recognition, measurement, and presentation of expenses and cash flows will not change significantly from existing guidance and lessor accounting is largely unchanged. ASU 2016-02 also changes the definition of a lease and requires qualitative and quantitative disclosures that provide information about the amount, timing, and uncertainty of cash flows arising from leases. ASU 2016-02 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018. Early adoption is permitted. Adoption of this ASU is planned for the beginning of the first quarter of fiscal 2020. The Company has not yet determined the effect that ASU 2016-02 will have on its financial statements.

In January 2016, the FASB issued ASU 2016-01, "Recognition and Measurement of Financial Assets and Liabilities." ASU 2016-01 requires equity investments (excluding equity method investments and investments that are consolidated) to be measured at fair value with changes in fair value recognized in net income. Equity investments that do not have a readily determinable fair value may be measured at cost, adjusted for impairment and observable price changes. ASU 2016-01 also simplifies the impairment assessment of equity investments, eliminates the disclosure of the assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at cost on the balance sheet and requires the exit price to be used when measuring fair value of financial instruments for disclosure purposes. Under ASU 2016-01, changes in fair value (resulting from instrument-specific credit risk) are presented separately in other comprehensive income for liabilities measured using the fair value option. Financial assets and liabilities are presented separately by measurement category and type, either on the balance sheet or in the financial statement disclosures. The Company adopted ASU 2016-01 on July 1, 2018 and reclassified approximately \$2 million of unrealized gains from accumulated other comprehensive (loss) to retained earnings.

In May 2014, the FASB issued ASU 2014-09, "Revenues with Contracts with Customers." ASU 2014-09 requires revenue recognition to depict the transfer of goods or services to customers in an amount that reflects the consideration that a company expects to be entitled to in exchange for the goods or services. To achieve this principle, a company must apply five steps including identifying the contract with a customer, identifying the performance obligations in the contract, determining the transaction price, allocating the transaction price to the performance obligations, and recognizing revenue when (or as) the company satisfies the performance obligation. The Company adopted ASU 2014-09 on July 1, 2018 using the modified retrospective method and recorded a cumulative effect adjustment to increase retained earnings by approximately \$5 million. See Note 3 for further discussion.

3. Revenue recognition

Revenue is derived primarily from the sale of products in a variety of mobile, industrial and aerospace markets. Revenues are recognized when control of the promised goods or services in a contract (i.e., performance obligations) are transferred to the customer. Control is transferred when the customer has the ability to direct the use of and obtain the benefits from the goods or services. A majority of the Company's revenues are recognized at a point in time when control is transferred to the customer, which is generally at the time of shipment. However, a portion of the Company's revenues are recognized over time if the customer simultaneously receives control as the Company performs work under a contract, if the customer controls the asset as it is being produced, or if the product being produced for the customer has no alternative use and the Company has a contractual right to payment. For contracts recognized over time, the Company uses the cost-to-cost, efforts expended or units of delivery method depending on the nature of the contract, including length of production time.

A contract's transaction price is allocated to each distinct performance obligation. When there are multiple performance obligations within a contract, the transaction price is allocated to each performance obligation based on its standalone selling price. The primary method used to estimate a standalone selling price is the price observed in standalone sales to customers of the same product or service. Revenue is recognized when the appropriate revenue recognition criteria for the individual performance obligations have been satisfied.

The Company considers the contractual consideration payable by the customer and assesses variable consideration that may affect the total transaction price. Variable consideration primarily includes prompt pay discounts, rebates and volume discounts and is included in the estimated transaction price when there is a basis to reasonably estimate the amount, including whether the estimate should be constrained in order to avoid a significant reversal of revenue in a future period. These estimates are based on historical experience, anticipated performance under the terms of the contract and the Company's best judgment at the time.

Payment terms vary by customer and the geographical location of the customer. The time between when revenue is recognized and payment is due is not significant. The Company's contracts with customers generally do not include significant financing components or noncash consideration.

Taxes collected from customers and remitted to governmental authorities are excluded from revenue. Shipping and handling costs are treated as fulfillment costs and are included in cost of sales. The costs to obtain a contract where the amortization period for the related asset is one year or less are expensed as incurred.

There is generally no unilateral right to return products. The Company primarily offers an assurance-type standard warranty that the product will conform to certain specifications for a defined period of time or period of usage after delivery. This type of warranty does not represent a separate performance obligation.

Disaggregation of revenue

Revenue from contracts with customers is disaggregated by technology platforms for the Diversified Industrial Segment, by product platforms for the Aerospace Systems Segment and by geographic location for the total Company. The Diversified Industrial Segment is an aggregation of several business units, which manufacture motion-control and fluid power system components for builders and users of various type of manufacturing, packaging, processing, transportation, agricultural, construction, and military vehicles and equipment. Contracts consist of individual purchase orders for standard product, blanket purchase orders and production contracts. Blanket purchase orders are often associated with individual purchase orders and have terms and conditions which are subject to a master supply or distributor agreement. Individual production contracts, some of which may include multiple performance obligations, are typically for products to be manufactured to the customer's specifications. Revenue in the Diversified Industrial Segment is typically recognized at the time of product shipment, but a portion of revenue may be recognized over time for installation services or in situations where the product being manufactured has no alternative use and the Company has an enforceable right to payment.

Diversified Industrial Segment revenues by technology platform:

| | |
|--------|------------|
| Three | Six Months |
| Months | Ended |

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| | Ended | |
|-------------------------------------|--------------|--------------|
| | December 31, | December 31, |
| | 2018 | 2018 |
| Motion Systems | \$ 856,357 | \$ 1,715,930 |
| Flow and Process Control | 1,015,200 | 2,076,264 |
| Filtration and Engineered Materials | 984,181 | 1,978,354 |
| Total | \$ 2,855,738 | \$ 5,770,548 |

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The Aerospace Systems Segment produces hydraulic, fuel, pneumatic and electro-mechanical systems and components, which are utilized on virtually every domestic commercial, military and general aviation aircraft and which also perform a vital role in naval vessels and land-based weapon systems. Contracts generally consist of blanket purchase orders and individual long-term production contracts. Blanket purchase orders, which have terms and conditions subject to long-term supply agreements, are typically associated with individual purchase orders. Revenue in the Aerospace Systems Segment is typically recognized at the time of product shipment, but a portion of revenue may be recognized over time in situations where the customer controls the asset as it is being produced or the product being manufactured has no alternative use and the Company has an enforceable right to payment.

Aerospace Systems Segment revenues by product platform:

| | Three Months Ended December 31, 2018 | Six Months Ended December 31, 2018 |
|--------------------------|--|---|
| Flight Control Actuation | \$ 189,670 | \$ 352,606 |
| Fuel and Inerting | 157,262 | 301,308 |
| Hydraulics | 108,893 | 211,390 |
| Engines | 71,647 | 136,033 |
| Fluid Conveyance | 68,868 | 139,072 |
| Other | 19,967 | 40,382 |
| Total | \$ 616,307 | \$ 1,180,791 |

Total Company revenues by geographic region based on the Company's selling operation's location:

| | Three Months Ended December 31, 2018 | Six Months Ended December 31, 2018 |
|---------------|--|---|
| North America | \$ 2,248,806 | \$ 4,494,897 |
| Europe | 714,550 | 1,440,860 |
| Asia Pacific | 465,974 | 927,614 |
| Latin America | 42,715 | 87,968 |
| Total | \$ 3,472,045 | \$ 6,951,339 |

The majority of revenues from the Aerospace Systems Segment is generated from sales to customers within North America.

Contract balances

Contract assets and contract liabilities are reported on a contract-by-contract basis. Contract assets reflect revenue recognized and performance obligations satisfied in advance of customer billing. Contract liabilities relate to payments received in advance of the satisfaction of performance under the contract. Payments from customers are received based on the terms established in the contract with the customer.

Total contract assets and contract liabilities are as follows:

| | December 31, 2018 |
|--|----------------------|
| Contract assets, current (included within Prepaid expenses and other) | \$ 19,263 |
| Contract assets, noncurrent (included within Investments and other assets) | 2,328 |
| Total contract assets | 21,591 |
| Contract liabilities, current (included within Other accrued liabilities) | (65,320) |
| Contract liabilities, noncurrent (included within Other liabilities) | (468) |

| | |
|----------------------------|--------------|
| Total contract liabilities | (65,788) |
| Net contract (liabilities) | \$ (44,197) |

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During the six months ended December 31, 2018, net contract liabilities increased \$6 million from the July 1, 2018 net contract liabilities amount of \$38 million. The increase in net contract liabilities was primarily due to advance payments from customers exceeding revenue recognized during the period. During the six months ended December 31, 2018, approximately \$20 million of revenue was recognized that was included in the contract liabilities at July 1, 2018.

Remaining performance obligations

The Company's backlog represents written firm orders from a customer to deliver products and, in the case of blanket purchase orders, only includes the portion of the order for which a schedule or release has been agreed to with the customer. The Company believes its backlog represents its unsatisfied or partially unsatisfied performance obligations. Backlog at December 31, 2018 was \$4,209 million, of which approximately 92 percent is expected to be recognized as revenue within the next 12 months and the balance thereafter.

Adoption of ASU 2014-09

On July 1, 2018, the Company adopted ASU 2014-09 using the modified retrospective approach. The provisions of ASU 2014-09 were applied only to contracts that were not completed as of July 1, 2018. Comparative prior-period financial information has not been restated and continues to be reported under the accounting standards in effect for the comparative prior-year period.

The cumulative effect of the changes made to the Company's Consolidated Balance Sheet as of July 1, 2018 related to the adoption of ASU 2014-09 is as follows:

| | Balance as of June 30, 2018 | Cumulative Effect of Adjustments | Balance as of July 1, 2018 |
|--------------------------------|--------------------------------------|---|----------------------------------|
| Assets: | | | |
| Trade accounts receivable, net | \$2,145,517 | \$ (11) | \$2,145,506 |
| Inventories | 1,621,304 | 23,205 | 1,644,509 |
| Prepaid expenses and other | 134,886 | 14,575 | 149,461 |
| Investments and other assets | 801,049 | 2,020 | 803,069 |
| Liabilities: | | | |
| Other accrued liabilities | \$502,333 | \$ 28,288 | \$530,621 |
| Other liabilities | 526,089 | 5,160 | 531,249 |
| Deferred income taxes | 234,858 | 1,560 | 236,418 |
| Equity: | | | |
| Retained earnings | \$11,625,975 | \$ 4,781 | \$11,630,756 |

The adoption of ASU 2014-09 had an immaterial impact on the Company's net sales, results of operations and financial position for the three and six months ended December 31, 2018.

4. Earnings per share

The following table presents a reconciliation of the numerator and denominator of basic and diluted earnings per share for the three and six months ended December 31, 2018 and 2017.

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|--|------------------------------------|-------------|----------------------------------|-------------|
| | 2018 | 2017 | 2018 | 2017 |
| Numerator: | | | | |
| Net income attributable to common shareholders | \$311,737 | \$ 56,159 | \$687,448 | \$ 341,556 |
| Denominator: | | | | |
| Basic - weighted average common shares | 130,361,273 | 133,112,568 | 131,361,464 | 133,144,766 |
| Increase in weighted average common shares from dilutive effect of equity-based awards | 1,949,937 | 3,082,351 | 2,088,210 | 2,729,764 |
| Diluted - weighted average common shares, assuming exercise of equity-based awards | 132,311,210 | 136,194,919 | 133,449,674 | 135,874,530 |
| Basic earnings per share | \$2.39 | \$ 0.42 | \$5.23 | \$ 2.57 |
| Diluted earnings per share | \$2.36 | \$ 0.41 | \$5.15 | \$ 2.51 |

For the three months ended December 31, 2018 and 2017, 1,335,187 and 3,245 common shares subject to equity-based awards, respectively, were excluded from the computation of diluted earnings per share because the effect of their exercise would be anti-dilutive. For the six months ended December 31, 2018 and 2017, 836,099 and 706,512 common shares subject to equity-based awards, respectively, were excluded from the computation of diluted earnings per share because the effect of their exercise would be anti-dilutive.

5. Share repurchase program

The Company has a program to repurchase its common shares. On October 22, 2014, the Board of Directors of the Company approved an increase in the overall number of shares authorized for repurchase under the program so that, beginning on such date, the aggregate number of shares authorized for repurchase was 35 million. There is no limitation on the number of shares that can be repurchased in a fiscal year. There is no expiration date for this program. Repurchases may be funded primarily from operating cash flows and commercial paper borrowings and the shares are initially held as treasury shares. During the three-month period ended December 31, 2018, the Company repurchased 3,008,512 shares at an average price, including commissions, of \$166.20 per share. During the six-month period ended December 31, 2018, the Company repurchased 3,302,453 shares at an average price, including commissions, of \$166.54 per share.

6. Trade accounts receivable, net

Trade accounts receivable are initially recorded at their net collectible amount and are generally recorded at the time the revenue from the sales transaction is recorded. Receivables are written off to bad debt primarily when, in the judgment of the Company, the receivable is deemed to be uncollectible due to the insolvency of the debtor. Allowance for doubtful accounts was \$8,178 and \$9,672 at December 31, 2018 and June 30, 2018, respectively.

7. Non-trade and notes receivable

The non-trade and notes receivable caption in the Consolidated Balance Sheet is comprised of the following components:

| | December 31, June 30, | |
|----------------------------|-----------------------|-----------|
| | 2018 | 2018 |
| Notes receivable | \$ 160,380 | \$149,254 |
| Accounts receivable, other | 163,874 | 179,145 |
| Total | \$ 324,254 | \$328,399 |

8. Inventories

The inventories caption in the Consolidated Balance Sheet is comprised of the following components:

| | December 31, June 30, | |
|-------------------|-----------------------|--------------|
| | 2018 | 2018 |
| Finished products | \$ 737,243 | \$673,323 |
| Work in process | 866,357 | 765,835 |
| Raw materials | 200,964 | 182,146 |
| Total | \$ 1,804,564 | \$ 1,621,304 |

9. Business realignment charges

The Company incurred business realignment charges and acquisition integration costs in fiscal 2019 and fiscal 2018. The acquisition integration costs related to the fiscal 2017 acquisition of CLARCOR, Inc.

Business realignment charges and acquisition integration costs presented in the Business Segment Information are as follows:

| | Three Months Ended | | Six Months Ended | |
|------------------------|--------------------|----------|------------------|----------|
| | December 31, | | December 31, | |
| | 2018 | 2017 | 2018 | 2017 |
| Diversified Industrial | \$7,382 | \$24,684 | \$15,940 | \$37,947 |
| Aerospace Systems | — | 692 | — | 1,455 |
| Other expense | 220 | — | 275 | — |

Work force reductions in connection with such business realignment charges and acquisition integration costs in the Business Segment Information are as follows:

| | Three Months Ended | | Six Months Ended | |
|------------------------|--------------------|------|------------------|-------|
| | December 31, | | December 31, | |
| | 2018 | 2017 | 2018 | 2017 |
| Diversified Industrial | 164 | 723 | 365 | 1,265 |
| Aerospace Systems | — | 19 | — | 56 |

The business realignment charges primarily consist of severance costs related to actions taken under the Company's simplification initiative aimed at reducing organizational and process complexity, as well as plant closures, with the majority of the charges incurred in Europe and North America. The Company believes the realignment actions will positively impact future results of operations but will not have a material effect on liquidity and sources and uses of capital.

The business realignment charges and acquisition integration costs are presented in the Consolidated Statement of Income as follows:

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|----------|------------------|----------|
| | December 31, | | December 31, | |
| | 2018 | 2017 | 2018 | 2017 |
| Cost of sales | \$3,669 | \$13,657 | \$8,068 | \$22,772 |
| Selling, general and administrative expenses | 3,713 | 11,719 | 7,872 | 16,630 |
| Other (income) expense, net | 220 | — | 275 | — |

As of December 31, 2018, approximately \$7 million in severance payments had been made relating to business realignment charges and acquisition integration charges incurred during fiscal 2019, the remainder of which are expected to be paid by December 31, 2019. Severance payments relating to prior-year business realignment and acquisition integration actions are being made as required. Remaining severance payments related to current-year and

prior-year business realignment actions of approximately \$18 million are primarily reflected within the other accrued liabilities caption in the Consolidated Balance Sheet. Additional charges may be recognized in future periods related to the business realignment and acquisition integration actions described above, the timing and amount of which are not known at this time.

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10. Equity

Changes in equity for the three months ended December 31, 2018 and 2017 are as follows:

| | Common Stock | Additional Capital | Retained Earnings | Accumulated Other Comprehensive (Loss) | Treasury Shares | Noncontrolling Interests | Total Equity |
|-----------------------------------|-----------------|-----------------------|----------------------|---|--------------------|-----------------------------|--------------|
| Balance at September 30, 2018 | \$ 90,523 | \$ 503,052 | \$ 11,902,300 | \$ (1,775,983) | \$ (4,618,512) | \$ 5,726 | \$ 6,107,106 |
| Net income | | | 311,737 | | | 176 | 311,913 |
| Other comprehensive income (loss) | | | | (19,514) | | 55 | (19,459) |
| Dividends paid (\$0.76 per share) | | | (99,589) | | | | (99,589) |
| Stock incentive plan activity | | 18,802 | | | 2,393 | | 21,195 |
| Shares purchased at cost | | | | | (500,000) | | (500,000) |
| Balance at December 31, 2018 | \$ 90,523 | \$ 521,854 | \$ 12,114,448 | \$ (1,795,497) | \$ (5,116,119) | \$ 5,957 | \$ 5,821,166 |

| | Common Stock | Additional Capital | Retained Earnings | Accumulated Other Comprehensive (Loss) | Treasury Shares | Noncontrolling Interests | Total Equity |
|-----------------------------------|-----------------|-----------------------|----------------------|---|--------------------|-----------------------------|--------------|
| Balance at September 30, 2017 | \$ 90,523 | \$ 528,956 | \$ 11,127,641 | \$ (1,824,503) | \$ (4,397,677) | \$ 5,719 | \$ 5,530,659 |
| Net income | | | 56,159 | | | 163 | 56,322 |
| Other comprehensive income (loss) | | | | 56,775 | | (73) | 56,702 |
| Dividends paid (\$0.66 per share) | | | (88,083) | | | | (88,083) |
| Stock incentive plan activity | | 5,047 | | | 8,563 | | 13,610 |
| Shares purchased at cost | | | | | (50,000) | | (50,000) |
| Balance at December 31, 2017 | \$ 90,523 | \$ 534,003 | \$ 11,095,717 | \$ (1,767,728) | \$ (4,439,114) | \$ 5,809 | \$ 5,519,210 |

Changes in equity for the six months ended December 31, 2018 and 2017 are as follows:

| | Common Stock | Additional Capital | Retained Earnings | Accumulated Other Comprehensive (Loss) | Treasury Shares | Noncontrolling Interests | Total Equity |
|--|-----------------|-----------------------|----------------------|---|--------------------|-----------------------------|--------------|
| Balance at June 30, 2018 | \$ 90,523 | \$ 496,592 | \$ 11,625,975 | \$ (1,763,086) | \$ (4,590,138) | \$ 5,627 | \$ 5,865,493 |
| Impact of adoption of accounting standards | | | 1,483 | (1,734) | | | (251) |
| Net income | | | 687,448 | | | 364 | 687,812 |
| Other comprehensive (loss) | | | | (30,677) | | (34) | (30,711) |

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| | | | | | | | | |
|-----------------------------------|----------|-----------|--------------|----------------|---------------|------------|--|-------------|
| Dividends paid (\$1.52 per share) | | | | (200,458) | | | | (200,458) |
| Stock incentive plan activity | | 25,262 | | | | 24,019 | | 49,281 |
| Shares purchased at cost | | | | | | (550,000) | | (550,000) |
| Balance at December 31, 2018 | \$90,523 | \$521,854 | \$12,114,448 | \$(1,795,497) | \$(5,116,119) | \$5,957 | | \$5,821,166 |

| | Common Stock | Additional Capital | Retained Earnings | Accumulated Other Comprehensive (Loss) | Treasury Shares | Noncontrolling Interests | Total Equity |
|-----------------------------------|--------------|--------------------|-------------------|--|-----------------|--------------------------|--------------|
| Balance at June 30, 2017 | \$90,523 | \$543,879 | \$10,930,348 | \$(1,924,204) | \$(4,378,897) | \$5,697 | \$5,267,346 |
| Net income | | | 341,556 | | | 301 | 341,857 |
| Other comprehensive income (loss) | | | | 156,476 | | (160) | 156,316 |
| Dividends paid (\$1.32 per share) | | | (176,187) | | | | (176,187) |
| Stock incentive plan activity | | (9,876) | | | 39,783 | | 29,907 |
| Acquisition activity | | | | | | (29) | (29) |
| Shares purchased at cost | | | | | (100,000) | | (100,000) |
| Balance at December 31, 2017 | \$90,523 | \$534,003 | \$11,095,717 | \$(1,767,728) | \$(4,439,114) | \$5,809 | \$5,519,210 |

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Changes in accumulated other comprehensive (loss) in shareholders' equity by component for the six months ended December 31, 2018 and 2017 are as follows:

| | Foreign Currency Translation Adjustment and Other | Retirement Benefit Plans | Total |
|--|---|--------------------------------|-----------------|
| Balance at June 30, 2018 | \$ (943,477) | \$ (819,609) | \$ (1,763,086) |
| Impact of adoption of ASU 2016-01 | (1,734) | — | (1,734) |
| Other comprehensive loss before reclassifications | (82,655) | — | (82,655) |
| Amounts reclassified from accumulated other comprehensive (loss) | 3,578 | 48,400 | 51,978 |
| Balance at December 31, 2018 | \$ (1,024,288) | \$ (771,209) | \$ (1,795,497) |

| | Foreign Currency Translation Adjustment and Other | Retirement Benefit Plans | Total |
|--|---|--------------------------------|-----------------|
| Balance at June 30, 2017 | \$ (925,342) | \$ (998,862) | \$ (1,924,204) |
| Other comprehensive income before reclassifications | 101,429 | — | 101,429 |
| Amounts reclassified from accumulated other comprehensive (loss) | — | 55,047 | 55,047 |
| Balance at December 31, 2017 | \$ (823,913) | \$ (943,815) | \$ (1,767,728) |

Significant reclassifications out of accumulated other comprehensive (loss) in shareholders' equity for the three and six months ended December 31, 2018 and 2017 are as follows:

| Details about Accumulated Other Comprehensive (Loss) Components | Income (Expense) Reclassified from Accumulated Other Comprehensive (Loss) | | Consolidated Statement of Income Classification |
|---|---|--|--|
| | Three Months Ended December 31, 2018 | Six Months Ended December 31, 2018 | |
| Retirement benefit plans | | | |
| Amortization of prior service cost and initial net obligation | \$ (1,652) | \$ (3,293) | Other (income) expense, net |
| Recognized actuarial loss | (30,696) | (59,993) | Other (income) expense, net |
| Total before tax | (32,348) | (63,286) | |
| Tax benefit | 7,821 | 14,886 | |
| Net of tax | \$ (24,527) | \$ (48,400) | |
| Details about Accumulated Other Comprehensive (Loss) Components | Income (Expense) Reclassified from Accumulated Other | | Consolidated Statement of Income Classification |

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| | Comprehensive (Loss) | | |
|---|-------------------------|------------|-----------------------------|
| | Three | Six | |
| | Months | Months | |
| | Ended | Ended | |
| | December | December | |
| | 31, 2017 | 31, 2017 | |
| Retirement benefit plans | | | |
| Amortization of prior service cost and initial net obligation | \$(1,545) | \$(3,683) | Other (income) expense, net |
| Recognized actuarial loss | (35,929) | (74,960) | Other (income) expense, net |
| Total before tax | (37,474) | (78,643) | |
| Tax benefit | 9,162 | 23,596 | |
| Net of tax | \$(28,312) | \$(55,047) | |

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11. Goodwill and intangible assets

The changes in the carrying amount of goodwill for the six months ended December 31, 2018 are as follows:

| | Diversified Industrial Segment | Aerospace Systems Segment | Total |
|--|--------------------------------------|---------------------------------|-------------|
| Balance at June 30, 2018 | \$5,405,771 | \$98,649 | \$5,504,420 |
| Acquisition | 2,940 | — | 2,940 |
| Foreign currency translation and other | (44,799) | (6) | (44,805) |
| Balance at December 31, 2018 | \$5,363,912 | \$98,643 | \$5,462,555 |

The acquisition line represents the goodwill allocation during the measurement period subsequent to the applicable acquisition date.

Intangible assets are amortized on the straight-line method over their legal or estimated useful lives. The following summarizes the gross carrying value and accumulated amortization for each major category of intangible assets:

| | December 31, 2018 | | June 30, 2018 | |
|--------------------------|-----------------------------|-----------------------------|--------------------------|-----------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Patents | \$261,548 | \$123,194 | \$265,423 | \$117,440 |
| Trademarks | 542,931 | 238,962 | 546,905 | 227,580 |
| Customer lists and other | 2,440,534 | 999,032 | 2,482,079 | 933,867 |
| Total | \$3,245,013 | \$1,361,188 | \$3,294,407 | \$1,278,887 |

Total intangible amortization expense for the six months ended December 31, 2018 was \$105,090. The estimated amortization expense for the five years ending June 30, 2019 through 2023 is \$196,130, \$185,468, \$180,870, \$175,010 and \$167,513, respectively.

Intangible assets are evaluated for impairment whenever events or circumstances indicate that the undiscounted net cash flows to be generated by their use over their expected useful lives and eventual disposition may be less than their net carrying value. No material intangible asset impairments occurred during the six months ended December 31, 2018.

12. Retirement benefits

Net pension benefit cost recognized included the following components:

| | Three Months Ended December 31, 2018 | | Six Months Ended December 31, 2017 | |
|--|---|-----------|--|-----------|
| Service cost | \$17,983 | \$18,242 | \$38,492 | \$41,300 |
| Interest cost | 40,551 | 36,138 | 80,417 | 71,824 |
| Expected return on plan assets | (62,701) | (65,350) | (125,578) | (128,526) |
| Amortization of prior service cost | 1,677 | 1,511 | 3,325 | 3,615 |
| Amortization of net actuarial loss | 30,692 | 35,468 | 59,985 | 74,150 |
| Amortization of initial net obligation | 4 | 5 | 9 | 10 |
| Net pension benefit cost | \$28,206 | \$26,014 | \$56,650 | \$62,373 |

During the three months ended December 31, 2018 and 2017, the Company recognized \$631 and \$1,091, respectively, in expense related to other postretirement benefits. During the six months ended December 31, 2018 and 2017, the Company recognized \$1,281 and \$2,180, respectively, in expense related to other postretirement benefits.

Components of net pension benefit cost and other postretirement benefit cost, other than service cost, are included in other (income) expense, net in the Consolidated Statement of Income.

In September 2018, the Company made a discretionary \$200 million cash contribution to its domestic qualified defined benefit plan.

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13. Income taxes

On December 22, 2017, the TCJ Act was enacted into law. The TCJ Act significantly reforms the Internal Revenue Code of 1986, as amended, by among other things, establishing a flat corporate income tax rate of 21 percent and creating a territorial tax system (with a one-time transition tax imposed on previously undistributed foreign earnings and profits).

The Securities and Exchange Commission staff issued Staff Accounting Bulletin (SAB) 118, which provided guidance on accounting for the tax effects of the TCJ Act. SAB 118 provided a measurement period that should not extend beyond one year from the TCJ Act's enactment date for companies to complete the applicable accounting under Topic 740. In accordance with SAB 118, and based on the information available, the Company recorded additional tax expense of \$14,485 related to the estimated one-time transition tax during the three months ended December 31, 2018. This adjustment is a result of the Company's analysis of related proposed regulations that were issued subsequent to the recording of the previous provisional amount. The company now considers its provisional accounting for the effects of the TCJ Act, which includes the remeasurement of deferred tax balances and related valuation allowances, the one-time transition tax and the repatriation of undistributed foreign earnings, as being complete and as meeting the recognition guidance under Topic 740. The Company is in the process of evaluating the final transition tax regulations that were published on January 16, 2019.

During the period ended September 30, 2018, the Company made the accounting policy election to treat taxes related to Global Intangible Low-Taxed Income as a current period expense when incurred.

The Company and its subsidiaries file income tax returns in the United States and in various foreign jurisdictions. In the normal course of business, the Company is subject to examination by taxing authorities throughout the world. The Company is open to assessment of its federal income tax returns by the U.S. Internal Revenue Service for fiscal years after 2011, and its state and local returns for fiscal years after 2012. The Company is also open to assessment for foreign jurisdictions for fiscal years after 2009. Unrecognized tax benefits reflect the difference between positions taken or expected to be taken on income tax returns and the amounts reflected in the financial statements.

As of December 31, 2018, the Company had gross unrecognized tax benefits of \$146,632, all of which, if recognized, would affect the effective tax rate. The accrued interest related to the gross unrecognized tax benefits, excluded from the amounts above, is \$23,411. It is reasonably possible that within the next 12 months the amount of gross unrecognized tax benefits could be reduced by up to approximately \$110,000 as a result of the revaluation of existing uncertain tax positions arising from developments in the examination process or the closure of tax statutes. Any increase in the amount of gross unrecognized tax benefits within the next 12 months is expected to be insignificant.

14. Financial instruments

The Company's financial instruments consist primarily of cash and cash equivalents, marketable securities and other investments, accounts receivable and long-term investments as well as obligations under accounts payable, trade, notes payable and long-term debt. Due to their short-term nature, the carrying values for cash and cash equivalents, accounts receivable, accounts payable, trade and notes payable approximate fair value.

Marketable securities and other investments include deposits, equity investments and available-for-sale debt securities. Deposits are recorded at cost, and equity investments and available-for-sale debt securities are recorded at fair value. Changes in fair value related to available-for-sale debt securities are recorded in accumulated other comprehensive (loss). Upon the adoption of ASU 2016-01 on July 1, 2018, changes in fair value of equity investments are recognized in net income. Prior to the adoption of ASU 2016-01, these changes in fair value were recognized in accumulated other comprehensive (loss).

Gross unrealized gains and losses related to both equity investments and available-for-sale debt securities were not material as of December 31, 2018 and June 30, 2018. There were no facts or circumstances that indicated the unrealized losses were other than temporary.

The contractual maturities of available-for-sale debt securities were predominantly one to three years at December 31, 2018 and June 30, 2018. Actual maturities of available-for-sale debt securities may differ from their contractual maturities as the Company has the ability to liquidate the available-for-sale debt securities after giving appropriate notice to the issuer.

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The carrying value of long-term debt and estimated fair value of long-term debt are as follows:

| | December 31, June 30, | |
|--|-----------------------|-------------|
| | 2018 | 2018 |
| Carrying value of long-term debt | \$ 4,343,138 | \$4,460,402 |
| Estimated fair value of long-term debt | 4,383,759 | 4,548,796 |

The fair value of long-term debt is classified within level 2 of the fair value hierarchy.

The Company utilizes derivative and non-derivative financial instruments, including forward exchange contracts, costless collar contracts, cross-currency swap contracts and certain foreign denominated debt designated as net investment hedges, to manage foreign currency transaction and translation risk. The derivative financial instrument contracts are with major investment grade financial institutions and the Company does not anticipate any material non-performance by any of the counterparties. The Company does not hold or issue derivative financial instruments for trading purposes.

The Company's €700 million aggregate principal amount of Senior Notes due 2025 have been designated as a hedge of the Company's net investment in certain foreign subsidiaries. The translation of the Senior Notes due 2025 into U.S. dollars is recorded in accumulated other comprehensive (loss) and remains there until the underlying net investment is sold or substantially liquidated.

Derivative financial instruments are recognized on the Consolidated Balance Sheet as either assets or liabilities and are measured at fair value.

The location and fair value of derivative financial instruments reported in the Consolidated Balance Sheet are as follows:

| | Balance Sheet Caption | December 31, June 30, | |
|-------------------------------|--------------------------------|-----------------------|----------|
| | | 2018 | 2018 |
| Net investment hedges | | | |
| Cross-currency swap contracts | Other assets | \$ 17,126 | \$ 7,614 |
| Cash flow hedges | | | |
| Costless collar contracts | Non-trade and notes receivable | 278 | 932 |
| Costless collar contracts | Other accrued liabilities | 4,553 | 236 |

The cross-currency swap and costless collar contracts are reflected on a gross basis in the Consolidated Balance Sheet. The Company has not entered into any master netting arrangements.

Gains or losses on derivatives that are not hedges are adjusted to fair value through the cost of sales caption in the Consolidated Statement of Income. Gains or losses on derivatives that are hedges are adjusted to fair value through accumulated other comprehensive (loss) in the Consolidated Balance Sheet until the hedged item is recognized in earnings.

The cross-currency swap contracts have been designated as hedging instruments. The costless collar contracts have not been designated as hedging instruments and are considered to be economic hedges of forecasted transactions.

Gains or losses on derivative financial instruments that were recorded in the Consolidated Statement of Income for the three and six months ended December 31, 2018 and 2017 were not material.

Gains (losses) on derivative and non-derivative financial instruments that were recorded in accumulated other comprehensive (loss) in the Consolidated Balance Sheet are as follows:

| | Three Months | | Six Months | |
|-------------------------------|--------------|-----------|--------------|-----------|
| | Ended | | Ended | |
| | December 31, | | December 31, | |
| | 2018 | 2017 | 2018 | 2017 |
| Cross-currency swap contracts | \$5,700 | \$(2,725) | \$7,619 | \$(9,298) |
| Foreign denominated debt | 7,144 | (10,893) | 11,271 | (27,727) |

There was no ineffectiveness of the cross-currency swap contracts or foreign denominated debt, nor was any portion of these financial instruments excluded from the effectiveness testing, during the six months ended December 31,

2018 and 2017.

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A summary of financial assets and liabilities that were measured at fair value on a recurring basis at December 31, 2018 and June 30, 2018 are as follows:

| | Fair Value at December 31, 2018 | Quoted Prices In Active Markets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---------------------------------|---|---|---|
| Assets: | | | | |
| Equity securities | \$ 12,988 | \$12,988 | \$ — | \$ — |
| Corporate bonds | 4,859 | 4,859 | — | — |
| Asset-backed and mortgage-backed securities | 6,046 | — | 6,046 | — |
| Derivatives | 21,377 | — | 21,377 | — |
| Investments measured at net asset value | 7,064 | | | |
| Liabilities: | | | | |
| Derivatives | 15,856 | — | 15,856 | — |

| | Fair Value at June 30, 2018 | Quoted Prices In Active Markets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|-----------------------------|---|---|---|
| Assets: | | | | |
| Equity securities | \$ 2,956 | \$ 2,956 | \$ — | \$ — |
| Corporate bonds | 5,331 | 5,331 | — | — |
| Asset-backed and mortgage-backed securities | 3,911 | — | 3,911 | — |
| Derivatives | 14,110 | — | 14,110 | — |
| Investments measured at net asset value | 7,208 | | | |
| Liabilities: | | | | |
| Derivatives | 5,315 | — | 5,315 | — |

The fair values of the equity securities, corporate bonds and asset-backed and mortgage-backed securities are determined using the closing market price reported in the active market in which the fund is traded or the market price for similar assets that are traded in an active market.

Derivatives consist of forward exchange, costless collar and cross-currency swap contracts, the fair values of which are calculated using market observable inputs including both spot and forward prices for the same underlying currencies. The calculation of fair value of the cross-currency swap contracts also utilizes a present value cash flow model that has been adjusted to reflect the credit risk of either the Company or the counterparty.

Investments measured at net asset value primarily consist of investments in fixed income mutual funds, which are measured at fair value using the net asset value per share practical expedient. These investments have not been categorized in the fair value hierarchy. The Company has the ability to liquidate these investments after giving appropriate notice to the issuer.

The primary investment objective for all investments is the preservation of principal and liquidity while earning income.

There are no other financial assets or financial liabilities that are marked to market on a recurring basis. Fair values are transferred between levels of the fair value hierarchy when facts and circumstances indicate that a change in the method of estimating the fair value of a financial asset or financial liability is warranted.

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PARKER-HANNIFIN CORPORATION

FORM 10-Q

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS
FOR THE THREE AND SIX MONTHS ENDED DECEMBER 31, 2018
AND COMPARABLE PERIODS ENDED DECEMBER 31, 2017

OVERVIEW

The Company is a leading worldwide diversified manufacturer of motion and control technologies and systems, providing precision engineered solutions for a wide variety of mobile, industrial and aerospace markets.

The Company's order rates provide a near-term perspective of the Company's outlook particularly when viewed in the context of prior and future order rates. The Company publishes its order rates on a quarterly basis. The lead time between the time an order is received and revenue is realized generally ranges from one day to 12 weeks for mobile and industrial orders and from one day to 18 months for aerospace orders. The Company believes the leading economic indicators of these markets that have a strong correlation to the Company's future order rates are as follows:

- Purchasing Managers Index (PMI) on manufacturing activity specific to regions around the world with respect to most mobile and industrial markets;

- Global aircraft miles flown and global revenue passenger miles for commercial aerospace markets and Department of Defense spending for military aerospace markets; and

- Housing starts with respect to the North American residential air conditioning market and certain mobile construction markets.

A PMI above 50 indicates that the manufacturing activity specific to a region of the world in the mobile and industrial markets is expanding. A PMI below 50 indicates the opposite. Recent PMI levels for some regions around the world were as follows:

| | December 31, 2018 | June 30, 2018 | December 31, 2017 |
|--------------------|-------------------|---------------|-------------------|
| United States | 54.1 | 60.2 | 59.7 |
| Eurozone countries | 51.4 | 54.9 | 60.6 |
| China | 49.7 | 51.0 | 51.5 |
| Brazil | 52.6 | 49.8 | 52.4 |

Global aircraft miles flown increased by approximately six percent, and available revenue passenger miles increased by approximately seven percent from their comparable fiscal 2018 levels. The Company anticipates that U.S.

Department of Defense spending with regard to appropriations and operations and maintenance for the U.S.

Government's fiscal year 2019 will be approximately nine percent higher than the comparable fiscal 2018 level.

Housing starts in November 2018 were approximately five percent higher than housing starts in December 2017 and approximately seven percent higher than housing starts in June 2018. United States Census Bureau housing starts data for November 2018 was used as the December 2018 data was unavailable.

The Company believes many opportunities for profitable growth are available. The Company intends to focus primarily on business opportunities in the areas of energy, water, food, environment, defense, life sciences, infrastructure and transportation. The Company believes it can meet its strategic objectives by:

- Serving the customer and continuously enhancing its experience with the Company;
- Successfully executing its Win Strategy initiatives relating to engaged people, premier customer experience, profitable growth and financial performance;
- Maintaining its decentralized division and sales company structure;
- Fostering a safety first and entrepreneurial culture;
- Engineering innovative systems and products to provide superior customer value through improved service, efficiency and productivity;
- Delivering products, systems and services that have demonstrable savings to customers and are priced by the value they deliver;
- Acquiring strategic businesses;
- Organizing around targeted regions, technologies and markets;
- Driving efficiency by implementing lean enterprise principles; and
- Creating a culture of empowerment through its values, inclusion and diversity, accountability and teamwork.

Acquisitions will be considered from time to time to the extent there is a strong strategic fit, while at the same time maintaining the Company's strong financial position. In addition, the Company will continue to assess its existing businesses and initiate efforts to divest businesses that are not considered to be a good long-term strategic fit for the Company. Future business divestitures could have a negative effect on the Company's results of operations.

The discussion below is structured to separately discuss the Consolidated Statement of Income, Results by Business Segment, Consolidated Balance Sheet and Consolidated Statement of Cash Flows.

CONSOLIDATED STATEMENT OF INCOME

| (dollars in millions) | Three Months Ended | | Six Months Ended | |
|---|--------------------|-----------|------------------|-----------|
| | December 31, | | December 31, | |
| | 2018 | 2017 | 2018 | 2017 |
| Net sales | \$3,472.0 | \$3,370.7 | \$6,951.3 | \$6,735.3 |
| Gross profit margin | 25.0 | % 23.9 | % 25.2 | % 24.5 |
| Selling, general and administrative expenses | \$397.3 | \$408.3 | \$791.6 | \$805.3 |
| Selling, general and administrative expenses, as a percent of sales | 11.4 | % 12.1 | % 11.4 | % 12.0 |
| Interest expense | \$47.5 | \$53.1 | \$91.9 | \$106.7 |
| Other (income) expense, net | \$(6.2) | \$(15.5) | \$(20.1) | \$1.0 |
| Effective tax rate | 27.7 | % 84.4 | % 22.8 | % 53.5 |
| Net income | \$311.9 | \$56.3 | \$687.8 | \$341.9 |
| Net income, as a percent of sales | 9.0 | % 1.7 | % 9.9 | % 5.1 |

Net sales for the current-year quarter and first six months of fiscal 2019 increased compared to the comparable prior-year periods primarily due to higher sales in the Diversified Industrial North American businesses and the Aerospace Systems Segment. The effect of currency rate changes decreased net sales by approximately \$73 million in the current-year quarter (\$67 million of which was attributable to the Diversified Industrial International businesses) and \$130 million for the first six months of fiscal 2019 (\$118 million of which was attributable to the Diversified Industrial International businesses).

Gross profit margin (calculated as net sales minus cost of sales, divided by net sales) increased in the current-year quarter and the first six months of fiscal 2019 primarily due to higher margins in the Aerospace Systems Segment driven by increased aftermarket and original equipment manufacturer (OEM) volume and profitability. Diversified Industrial Segment margins remained relatively flat for the current-year quarter and first six months of fiscal 2019. Cost of sales for the current-year quarter and prior-year quarter also included business realignment charges and acquisition integration costs of \$3.7 million and \$13.7 million, respectively, and \$8.1 million and \$22.8 million for the

first six months of fiscal 2019 and 2018, respectively.

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Selling, general and administrative expenses decreased for the current-year quarter and the first six months of fiscal 2019 primarily due to the benefits from prior-year restructuring activities and the Company's simplification initiative. These benefits were partially offset by higher net expense associated with the Company's deferred compensation programs due to unfavorable market fluctuations related to investments associated with these programs more than offsetting favorable changes in the related liabilities. Selling, general and administrative expenses for the current-year quarter and prior-year quarter also included business realignment charges and acquisition integration costs of \$3.7 million and \$11.7 million, respectively, and \$7.9 million and \$16.6 million for the first six months of fiscal 2019 and 2018, respectively.

Interest expense for the current-year quarter and first six months of fiscal 2019 decreased from the comparable prior-year periods due to lower average debt outstanding.

Other (income) expense, net included the following:

| (dollars in millions) | Three Months Ended | | Six Months Ended | |
|---|--------------------|-------------------|-------------------|-------------------|
| | December 31, 2018 | December 31, 2017 | December 31, 2018 | December 31, 2017 |
| Expense (income) | | | | |
| Income related to equity method investments | \$(23.0) | \$(11.5) | \$(45.8) | \$(18.5) |
| Non-service components of retirement benefit cost | 10.8 | 8.7 | 19.3 | 23.0 |
| Divestitures and asset sales and writedowns | 5.4 | (26.0) | 4.5 | (26.2) |
| Sale and writedown of investments | — | 20.0 | — | 33.8 |
| Other items, net | 0.6 | (6.7) | 1.9 | (11.1) |
| | \$(6.2) | \$(15.5) | \$(20.1) | \$1.0 |

Effective tax rate for the current-year quarter and the first six months of fiscal 2019 was lower than the comparable prior-year periods primarily due to a net decrease in discrete tax costs resulting from the enactment of the U.S Tax Cuts and Jobs Act (TCJ Act) that were recorded in the prior year periods. The Company expects the fiscal 2019 effective tax rate will be approximately 23.5 percent.

RESULTS BY BUSINESS SEGMENT

Diversified Industrial Segment

| (dollars in millions) | Three Months Ended | | Six Months Ended | |
|-----------------------|--------------------|-------------------|-------------------|-------------------|
| | December 31, 2018 | December 31, 2017 | December 31, 2018 | December 31, 2017 |
| Net sales | | | | |
| North America | \$1,632.1 | \$1,565.4 | \$3,313.1 | \$3,160.1 |
| International | 1,223.7 | 1,255.6 | 2,457.4 | 2,494.3 |
| Operating income | | | | |
| North America | 257.8 | 225.8 | 532.9 | 481.8 |
| International | \$189.1 | \$164.8 | \$395.2 | \$356.6 |
| Operating margin | | | | |
| North America | 15.8 | % 14.4 | % 16.1 | % 15.2 |
| International | 15.5 | % 13.1 | % 16.1 | % 14.3 |
| Backlog | \$2,161.2 | \$2,140.9 | \$2,161.2 | \$2,140.9 |

The Diversified Industrial Segment operations experienced the following percentage changes in net sales in the current-year period versus the comparable prior-year period:

| | Period Ending December 31, 2018 | |
|--|---------------------------------------|---------------|
| | Three Months | Six Months |
| Diversified Industrial North America – as reported | 4.3 % | 4.8 % |
| Divestitures | (0.4)% | (0.4) % |
| Currency | (0.3)% | (0.4) % |
| Diversified Industrial North America – without divestitures and currency | 5.0 % | 5.6 % |
| | | |
| Diversified Industrial International – as reported | (2.5)% | (1.5) % |
| Divestitures | (0.8)% | (0.9) % |
| Currency | (5.3)% | (4.7) % |
| Diversified Industrial International – without divestitures and currency | 3.6 % | 4.1 % |
| | | |
| Total Diversified Industrial Segment – as reported | 1.2 % | 2.1 % |
| Divestitures | (0.6)% | (0.6) % |
| Currency | (2.6)% | (2.3) % |
| Total Diversified Industrial Segment – without divestitures and currency | 4.4 % | 5.0 % |

The above presentation reconciles the percentage changes in net sales of the Diversified Industrial Segment reported in accordance with U.S. GAAP to percentage changes in net sales adjusted to remove the effects of divestitures made within the prior four fiscal quarters as well as the effects of currency exchange rates (a non-GAAP measure). The effects of divestitures and currency exchange rates are removed to allow investors and the Company to meaningfully evaluate the percentage changes in net sales on a comparable basis from period to period.

Excluding the effects of divestitures and changes in currency exchange rates, Diversified Industrial North American sales increased for the current-year quarter and first six months of fiscal 2019 primarily due to higher demand from distributors and end-users in the heavy-duty truck, engines, construction equipment, cars and light truck, farm and agricultural equipment, refrigeration and general industrial machinery markets, partially offset by lower demand from end users in the semiconductor, machine tool, oil and gas and power generation markets.

Excluding the effects of divestitures and changes in currency exchange rates, Diversified Industrial International sales for the current-year quarter and first six months of fiscal 2019 increased primarily due to higher demand from distributors and end users in the mobile markets. The increase in sales for the current year quarter is primarily due to a 45 percent increase in both Europe and the Asia Pacific region. The Asia Pacific region accounted for 50 percent of the increase in sales for the first six months of fiscal 2019, while Europe and Latin America contributed 30 percent and 20 percent, respectively. Within the Asia Pacific region, the increase in sales in the current-year quarter and first six months of fiscal 2019 was primarily experienced from distributors and end users in the construction equipment and oil and gas markets, partially offset by lower end-user demand in the general industrial machinery and semiconductor markets. Within Europe, distributors and end users in the construction equipment, heavy-duty truck, industrial trucks and material handling, and telecommunications markets experienced the largest increase in demand during both the current-year quarter and first six months of fiscal 2019, which was partially offset by lower end-user demand in the cars and light truck and general industrial machinery markets. The increase in sales in Latin America for the current-year quarter and first six months of fiscal 2019 was primarily due to higher demand from distributors and end users in the construction equipment and farm and agricultural equipment markets, partially offset by lower end-user demand in the industrial machinery market.

Operating margins in both the Diversified Industrial North American and International businesses for the current-year quarter and first six months of fiscal 2019 increased due to higher sales volume, lower operating expenses resulting from prior-year business realignment and acquisition integration activities and the Company's simplification initiative,

and lower restructuring expenses in the current year. In both businesses these benefits were partially offset by increased manufacturing expenses associated with higher sales volume.

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The following business realignment expenses and acquisition integration costs are included in Diversified Industrial North American and Diversified Industrial International operating income:

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|--------------------------------------|---------------------------------|--------|-------------------------------|--------|
| (dollars in millions) | 2018 | 2017 | 2018 | 2017 |
| Diversified Industrial North America | \$3.8 | \$11.0 | \$8.5 | \$20.8 |
| Diversified Industrial International | 3.6 | 13.7 | 7.4 | 17.2 |

The business realignment charges primarily consist of severance costs related to actions taken under the Company's simplification initiative implemented by operating units throughout the world as well as plant closures. The majority of the Diversified Industrial International business realignment charges were incurred in Europe. The Company anticipates that cost savings realized from the work force reduction measures taken in the first six months of fiscal 2019 will not materially impact operating income in fiscal 2019 or fiscal 2020. Acquisition integration costs primarily relate to the integration of the fiscal 2017 acquisition of CLARCOR Inc. and are primarily incurred in the Diversified Industrial North American businesses. The Company expects to continue to take the actions necessary to structure appropriately the operations of the Diversified Industrial Segment. Such actions are expected to result in approximately \$19 million of additional business realignment charges and acquisition integration costs in the remainder of fiscal 2019.

Diversified Industrial Segment backlog as of December 31, 2018 increased slightly from the prior-year quarter primarily due to orders exceeding shipments in the Diversified Industrial North American businesses, partially offset by shipments exceeding orders in the Diversified Industrial International businesses. Within the International businesses, backlog in Europe represented 95 percent of the decrease from the prior-year quarter.

As of December 31, 2018, Diversified Industrial Segment backlog remained relatively flat compared to the June 30, 2018 amount of \$2,167.2 million due to orders exceeding shipments in the International businesses offset by shipments exceeding orders in the North American businesses. Within the International businesses, orders exceeding shipments in Europe and Latin America were partially offset by shipments exceeding orders in the Asia Pacific region.

Backlog consists of written firm orders from a customer to deliver products and, in the case of blanket purchase orders, only includes the portion of the order for which a schedule or release date has been agreed to with the customer. The dollar value of backlog is equal to the amount that is expected to be billed to the customer and reported as a sale.

The Company anticipates Diversified Industrial North American sales for fiscal 2019 will increase between 1.4 percent and 3.9 percent from their fiscal 2018 level, and Diversified Industrial International sales for fiscal 2019 will decrease between 4.9 percent and 2.5 percent from their fiscal 2018 level. Diversified Industrial North American operating margins in fiscal 2019 are expected to range from 16.6 percent to 17.2 percent, and Diversified Industrial International operating margins in fiscal 2019 are expected to range from 15.7 percent to 16.1 percent.

Aerospace Systems Segment

| | Three Months Ended December 31, | | Six Months Ended December 31, | |
|-----------------------|---------------------------------|-----------|-------------------------------|-----------|
| (dollars in millions) | 2018 | 2017 | 2018 | 2017 |
| Net sales | \$616.3 | \$549.7 | \$1,180.8 | \$1,080.9 |
| Operating income | \$121.5 | \$87.1 | \$231.3 | \$164.6 |
| Operating margin | 19.7 | % 15.9 | % 19.6 | % 15.2 |
| Backlog | \$2,047.9 | \$1,820.9 | \$2,047.9 | \$1,820.9 |

The increase in net sales in the Aerospace Systems Segment for the current-year quarter and first six months of fiscal 2019 was primarily due to higher volume in the commercial and military aftermarket businesses as well as the

commercial and military OEM businesses. The higher operating margin for the current-year quarter and first six months was primarily due to higher aftermarket and OEM volume and profitability, higher joint venture earnings, lower engineering and development costs, and lower operating costs. Operating margins in the first six months of fiscal 2019 also benefited from the absence of unfavorable contract settlements that occurred in the comparable prior-year period.

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The increase in backlog from the prior-year quarter is due to orders exceeding shipments within the commercial and military OEM and commercial and military aftermarket businesses. The increase in backlog from the June 30, 2018 amount of \$1,954.0 million is primarily due to orders exceeding shipments within the military OEM and commercial and military aftermarket businesses, partially offset by shipments exceeding orders in the commercial OEM business. Backlog consists of written firm orders from a customer to deliver products and, in the case of blanket purchase orders, only includes the portion of the order for which a schedule or release date has been agreed to with the customer. The dollar value of backlog is equal to the amount that is expected to be billed to the customer and reported as a sale.

For fiscal 2019, sales are expected to increase between 4.5 percent and 6.6 percent from the fiscal 2018 level and operating margins are expected to range from 18.9 percent to 19.3 percent. A higher concentration of commercial OEM volume in future product mix and higher than expected new product development costs could result in lower margins.

Corporate general and administrative expenses

Corporate general and administrative expenses were \$63.9 million in the current-year quarter compared to \$46.9 million in the comparable prior-year quarter and were \$114.2 million for the first six months of fiscal 2019 compared to \$88.3 million for the first six months of fiscal 2018. As a percent of sales, corporate general and administrative expenses were 1.8 percent and 1.4 percent in the current-year and prior-year quarter, respectively. During the first six months of fiscal 2019 and 2018, Corporate general and administrative expenses were 1.6 percent and 1.3 percent of sales, respectively. Corporate general and administrative expenses increased during the current-year quarter and first six months of fiscal 2019 from the respective prior-year periods primarily due to unfavorable market fluctuations related to investments associated with the Company's deferred compensation program more than offsetting favorable changes in the related liabilities.

Other expense (in the Results By Business Segment) included the following:

| (dollars in millions) | Three Months | | Six Months | |
|---|--------------|--------------|--------------|--------------|
| | Ended | Ended | Ended | Ended |
| | December 31, | December 31, | December 31, | December 31, |
| Expense (income) | 2018 | 2017 | 2018 | 2017 |
| Foreign currency transaction | \$(1.0) | \$9.0 | \$2.5 | \$12.6 |
| Stock-based compensation | 8.2 | 9.5 | 36.7 | 35.4 |
| Pensions | 4.9 | 4.4 | 10.2 | 12.9 |
| Divestitures and asset sales and writedowns | 5.4 | (26.0) | 4.5 | (26.2) |
| Sale and writedown of investments | — | 20.0 | — | 33.8 |
| Other items, net | 8.3 | 0.6 | 8.5 | 5.0 |
| | \$25.8 | \$17.5 | \$62.4 | \$73.5 |

Foreign currency transaction primarily relates to the impact of changes in foreign exchange rates on cash, marketable securities and other investments and intercompany transactions.

CONSOLIDATED BALANCE SHEET

| (dollars in millions) | December 31, 2018 | June 30, 2018 |
|--------------------------------|-------------------|---------------|
| Cash | \$1,078.3 | \$855.1 |
| Trade accounts receivable, net | 1,938.7 | 2,145.5 |
| Inventories | 1,804.6 | 1,621.3 |
| Shareholders' equity | 5,815.2 | 5,859.9 |
| Working capital | 1,825.8 | 1,887.8 |
| Current ratio | 1.52 | 1.59 |

Cash (comprised of cash and cash equivalents and marketable securities and other investments) includes \$994 million and \$836 million held by the Company's foreign subsidiaries at December 31, 2018 and June 30, 2018, respectively.

As a result of the TCJ Act, the prior worldwide tax system was replaced by a territorial tax system, which generally allows companies to repatriate future foreign source earnings without incurring additional U.S. federal taxes. However, other U.S. or foreign taxes may be incurred should cash be distributed between the Company's subsidiaries. The Company has determined it will no longer permanently reinvest certain foreign earnings. All other undistributed foreign earnings remain permanently reinvested.

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Trade accounts receivable, net are receivables due from customers for sales of product. Days sales outstanding relating to trade accounts receivable was 52 days at December 31, 2018, and 51 days at June 30, 2018. The Company believes that its receivables are collectible and appropriate allowances for doubtful accounts have been recorded.

Inventories as of December 31, 2018 increased \$183 million due to an increase in inventories in both the Diversified Industrial and Aerospace Systems Segments, partially offset by a decrease of \$13 million related to the effect of foreign currency translation. Within the Diversified Industrial Segment, approximately 65 percent of the increase in inventories occurred in the Diversified Industrial North American businesses, and approximately 35 percent of the increase occurred in the Diversified Industrial International businesses. Days supply of inventory was 77 days at December 31, 2018, 64 days at June 30, 2018 and 78 days at December 31, 2017.

Shareholders' equity activity during the first six months of fiscal 2019 included a decrease of approximately \$550 million as a result of share repurchases and a decrease of approximately \$79 million as a result of foreign currency translation.

CONSOLIDATED STATEMENT OF CASH FLOWS

| | Six Months Ended December 31, | |
|---|-------------------------------------|----------|
| (dollars in millions) | 2018 | 2017 |
| Cash provided by (used in): | | |
| Operating activities | \$541.0 | \$456.8 |
| Investing activities | (31.3) | (141.8) |
| Financing activities | (260.0) | (182.8) |
| Effect of exchange rates | (24.5) | 7.8 |
| Net increase in cash and cash equivalents | \$225.2 | \$140.0 |

Cash flows from operating activities for the first six months of fiscal 2019 was higher than the first six months of fiscal 2018 primarily due to an increase in net income and cash provided by working capital items, partially offset by a \$200 million discretionary cash contribution to the Company's domestic qualified defined benefit plan. The Company continues to focus on managing its inventory and other working capital requirements.

Cash flows from investing activities includes net maturities (purchases) of marketable securities and other investments of \$12 million and \$(66) million in the first six months of fiscal 2019 and 2018, respectively. Cash flows from investing activities also includes \$94 million of capital expenditures during the first six months of fiscal 2019 compared to \$145 million of capital expenditures during first six months of fiscal 2018.

Cash flows from financing activities for the first six months of fiscal 2019 includes net commercial paper borrowings of \$606 million compared to net borrowings of \$139 million in the first six months of fiscal 2018. During the first six months of fiscal 2019, the Company also repaid \$100 million of long-term debt. Cash flows from financing activities includes repurchase activity under the Company's share repurchase program. The Company repurchased 3.3 million common shares for \$550 million in the first six months of fiscal 2019 compared to the repurchase of 0.6 million common shares for \$100 million in the first six months of fiscal 2018.

The Company's goal is to have no less than an "A" rating on senior debt to ensure availability and reasonable cost of external funds. In periods following significant capital deployment, including for share repurchases or acquisitions, certain of the ratings assigned to the Company's senior debt may be, and at December 31, 2018 was, lower than the stated goal. The Company does not presently believe that its ability to borrow funds in the future at desirable tenors and affordable interest rates will be impacted if certain of its ratings are temporarily below an "A" level at the time of such borrowings. At December 31, 2018, the long-term credit ratings assigned to the Company's senior debt securities by the credit rating agencies engaged by the Company were as follows:

| | |
|---------------------------------|------|
| Fitch Ratings | A- |
| Moody's Investor Services, Inc. | Baa1 |
| Standard & Poor's | A |

At December 31, 2018, the Company had a line of credit totaling \$2,000 million through a multi-currency revolving credit agreement with a group of banks, \$859 million of which was available. The credit agreement expires in October 2021; however, the Company has the right to request a one-year extension of the expiration date on an annual basis, which request may result in changes to the current terms and conditions of the credit agreement. Advances from the credit agreement can be used for general corporate purposes, including acquisitions, and for the refinancing of existing indebtedness. The credit agreement requires the payment of an annual facility fee, the amount of which may increase in the event the Company's credit ratings are lowered. Although a lowering of the Company's credit ratings would likely increase the cost of future debt, it would not limit the Company's ability to use the credit agreement nor would it accelerate the repayment of any outstanding borrowings.

As of December 31, 2018, the Company was authorized to sell up to \$2,000 million of short-term commercial paper notes. As of December 31, 2018, \$1,141 million of commercial paper notes were outstanding, and the largest amount of commercial paper notes outstanding during the current-year quarter was \$1,233 million.

The Company's credit agreements and indentures governing certain debt securities contain various covenants, the violation of which would limit or preclude the use of the credit agreements for future borrowings, or might accelerate the maturity of the related outstanding borrowings covered by the indentures. Based on the Company's rating level at December 31, 2018, the most restrictive financial covenant provides that the ratio of debt to debt-shareholders' equity cannot exceed .60 to 1.0. At December 31, 2018, the Company's debt to debt-shareholders' equity ratio was .49 to 1.0. The Company is in compliance with all covenants and expects to remain in compliance during the term of the credit agreements and indentures.

FORWARD-LOOKING STATEMENTS

Forward-looking statements contained in this and other written and oral reports are made based on known events and circumstances at the time of release, and as such, are subject in the future to unforeseen uncertainties and risks. These statements may be identified from the use of forward-looking terminology such as “anticipates,” “believes,” “may,” “should,” “could,” “potential,” “continues,” “plans,” “forecasts,” “estimates,” “projects,” “predicts,” “would,” “intends,” “anticipates,” “is likely,” “will,” or the negative of these terms and similar expressions, and include all statements regarding future performance, earnings projections, events or developments. It is possible that the future performance and earnings projections of the Company, including its individual segments, may differ materially from current expectations, depending on economic conditions within its mobile, industrial and aerospace markets, and the Company’s ability to maintain and achieve anticipated benefits associated with announced realignment activities, strategic initiatives to improve operating margins, actions taken to combat the effects of the current economic environment, and growth, innovation and global diversification initiatives. Additionally, the actual impact of the TCJ Act on future performance and earnings projections may change based on subsequent judicial or regulatory interpretations of the TCJ Act that impact the Company’s tax calculations. A change in the economic conditions in individual markets may have a particularly volatile effect on segment performance.

Among other factors which may affect future performance are:

- changes in business relationships with and purchases by or from major customers, suppliers or distributors, including delays or cancellations in shipments;
- disputes regarding contract terms or significant changes in financial condition, changes in contract cost and revenue estimates for new development programs, and changes in product mix;
- ability to identify acceptable strategic acquisition targets; uncertainties surrounding timing, successful completion or integration of acquisitions and similar transactions, including the integration of CLARCOR Inc.; ability to successfully divest businesses planned for divestiture and realize the anticipated benefits of such divestitures;
- the determination to undertake business realignment activities and the expected costs thereof and, if undertaken, the ability to complete such activities and realize the anticipated cost savings from such activities;
- ability to implement successfully capital allocation initiatives, including timing, price and execution of share repurchases;
- availability, limitations or cost increases of raw materials, component products and/or commodities that cannot be recovered in product pricing;
- ability to manage costs related to insurance and employee retirement and health care benefits;
- compliance costs associated with environmental laws and regulations;
- potential labor disruptions;
- threats associated with and efforts to combat terrorism and cyber-security risks;
- uncertainties surrounding the ultimate resolution of outstanding legal proceedings, including the outcome of any appeals;
- global competitive market conditions, including global reactions to U.S. trade policies, and resulting effects on sales and pricing; and
- global economic factors, including manufacturing activity, air travel trends, currency exchange rates, difficulties entering new markets and general economic conditions such as inflation, deflation, interest rates and credit availability.

The Company makes these statements as of the date of this disclosure, and undertakes no obligation to update them unless otherwise required by law.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company manages foreign currency transaction and translation risk by utilizing derivative and non-derivative financial instruments, including forward exchange contracts, costless collar contracts, cross-currency swap contracts and certain foreign denominated debt designated as net investment hedges. The derivative financial instrument contracts are with major investment grade financial institutions and the Company does not anticipate any material non-performance by any of the counterparties. The Company does not hold or issue derivative financial instruments for trading purposes.

Derivative financial instruments are recognized on the Consolidated Balance Sheet as either assets or liabilities and are measured at fair value. Further information on the fair value of these contracts is provided in Note 14 to the Consolidated Financial Statements. Gains or losses on derivatives that are not hedges are adjusted to fair value through the Consolidated Statement of Income. Gains or losses on derivatives that are hedges are adjusted to fair value through accumulated other comprehensive (loss) in the Consolidated Balance Sheet until the hedged item is recognized in earnings. The translation of the foreign denominated debt that has been designated as a net investment hedge is recorded in accumulated other comprehensive (loss) and remains there until the underlying net investment is sold or substantially liquidated.

The Company's debt portfolio contains variable rate debt, inherently exposing the Company to interest rate risk. The Company's objective is to maintain a 60/40 mix between fixed rate and variable rate debt thereby limiting its exposure to changes in near-term interest rates.

ITEM 4. CONTROLS AND PROCEDURES

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's principal executive officer and principal financial officer, of the effectiveness of the Company's disclosure controls and procedures as of December 31, 2018. Based on this evaluation, the Company's principal executive officer and principal financial officer concluded that, as of December 31, 2018, the Company's disclosure controls and procedures were effective.

There was no change in the Company's internal control over financial reporting during the quarter ended December 31, 2018 that materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PARKER-HANNIFIN CORPORATION
PART II - OTHER INFORMATION

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds.

(a) Unregistered Sales of Equity Securities. Not applicable.

(b) Use of Proceeds. Not applicable.

(c) Issuer Purchases of Equity Securities.

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid Per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1) | (d) Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs (1) |
|--|--------------------------------------|----------------------------------|--|--|
| October 1, 2018 through October 31, 2018 | 107,400 | \$ 167.35 | 107,400 | 15,200,752 |
| November 1, 2018 through November 30, 2018 | 2,801,208 | \$ 166.53 | 2,801,208 | 12,399,544 |
| December 1, 2018 through December 31, 2018 | 99,904 | \$ 155.00 | 99,904 | 12,299,640 |
| Total: | 3,008,512 | | 3,008,512 | |

On October 22, 2014, the Company publicly announced that the Board of Directors increased the overall maximum number of shares authorized for repurchase under the Company's share repurchase program, first announced on (1) August 16, 1990, so that, beginning on October 22, 2014, the maximum aggregate number of shares authorized for repurchase was 35 million shares. There is no limitation on the amount of shares that can be repurchased in a fiscal year. There is no expiration date for this program.

ITEM 6. Exhibits.

The following documents are furnished as exhibits and are numbered pursuant to Item 601 of Regulation S-K:

| Exhibit No. | Description of Exhibit |
|-------------|--|
| 3(a) | <u>Regulations, Amended and Restated as of January 24, 2019.*</u> |
| 10(a) | <u>Form of 2017 Parker-Hannifin Corporation Restricted Stock Unit Award Agreement.*</u> |
| 10(b) | <u>Form of 2017 Parker-Hannifin Corporation Restricted Stock Unit Award Agreement.*</u> |
| 10(c) | <u>Form of 2017 Parker-Hannifin Corporation Restricted Stock Unit Terms and Conditions for Awards Granted.*</u> |
| 10(d) | <u>Form of 2018 Parker-Hannifin Corporation Stock Appreciation Rights Award Agreement.*</u> |
| 10(e) | <u>2018 Parker-Hannifin Corporation Stock Appreciation Rights Terms and Conditions.*</u> |
| 10(f) | <u>Form of Notice of Award under the Parker-Hannifin Corporation Long-Term Incentive Plan Under the Performance Bonus Plan, as Amended and Restated, effective as of January 1, 2019.*</u> |
| 10(g) | <u>Parker-Hannifin Corporation Long-Term Incentive Performance Plan Under the Performance Bonus Plan, as Amended and Restated, effective as of January 1, 2019.*</u> |
| 31(a) | <u>Certification of the Principal Executive Officer Pursuant to 17 CFR 240.13a-14(a), as Adopted Pursuant to §302 of the Sarbanes-Oxley Act of 2002.*</u> |
| 31(b) | <u>Certification of the Principal Financial Officer Pursuant to 17 CFR 240.13a-14(a), as Adopted Pursuant to §302 of the Sarbanes-Oxley Act of 2002.*</u> |
| 32 | <u>Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to §906 of the Sarbanes-Oxley Act of 2002. *</u> |
| 101.INS | XBRL Instance Document.* |
| 101.SCH | XBRL Taxonomy Extension Schema Document.* |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document.* |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document. * |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document.* |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document.* |

*Submitted electronically herewith.

Attached as Exhibit 101 to this report are the following formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Statement of Income for the three months ended December 31, 2018 and 2017, (ii) Consolidated Statement of Income for the six months ended December 31, 2018 and 2017, (iii) Consolidated

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Statement of Comprehensive Income for the three months ended December 31, 2018 and 2017, (iv) Consolidated Statement of Comprehensive Income for the six months ended December 31, 2018 and 2017, (v) Consolidated Balance Sheet at December 31, 2018 and June 30, 2018, (vi) Consolidated Statement of Cash Flows for the six months ended December 31, 2018 and 2017, and (vii) Notes to Consolidated Financial Statements for the six months ended December 31, 2018.

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SIGNATURE

Pursuant to the requirements 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.

PARKER-HANNIFIN CORPORATION
(Registrant)

/s/ Catherine A. Suever
Catherine A. Suever
Executive Vice President - Finance & Administration and
Chief Financial Officer

Date: February 7, 2019