

GRACO INC  
Form 10-Q  
July 23, 2015  
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**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 **June 26, 2015**

Commission File Number: 001-09249

**GRACO INC.**

(Exact name of registrant as specified in its charter)

Minnesota  
(State of incorporation)

41-0285640  
(I.R.S. Employer Identification Number)

88 - 11<sup>th</sup> Avenue N.E.

Minneapolis, Minnesota  
(Address of principal executive offices)

55413  
(Zip Code)

(612) 623-6000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days.

Yes  X  No  \_\_\_\_\_

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or such shorter period that the registrant was required to submit and post such files).

Yes  X  No  \_\_\_\_\_

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

Large Accelerated Filer                                        Accelerated Filer                    \_\_\_\_\_  
Non-accelerated Filer                    \_\_\_\_\_                    Smaller reporting company                    \_\_\_\_\_

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes                    \_\_\_\_\_                    No                      X  

57,729,000 shares of the Registrant's Common Stock, \$1.00 par value, were outstanding as of July 15, 2015.

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(Unaudited) (In thousands except per share amounts)

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 26, 2015	June 27, 2014	June 26, 2015	June 27, 2014
Net Sales	\$ 335,489	\$ 322,549	\$ 641,942	\$ 612,511
Cost of products sold	154,866	145,699	299,190	276,349
Gross Profit	180,623	176,850	342,752	336,162
Product development	14,907	13,405	30,197	26,564
Selling, marketing and distribution	50,126	49,503	101,550	95,845
General and administrative	31,699	28,094	61,883	53,200
Operating Earnings	83,891	85,848	149,122	160,553
Interest expense	4,125	4,676	9,428	9,264
Held separate investment (income), net	(158,833)	(10,562)	(188,356)	(14,237)
Other expense (income), net	(438)	(202)	272	45
Earnings Before Income Taxes	239,037	91,936	327,778	165,481
Income taxes	66,400	25,700	86,300	48,500
Net Earnings	\$ 172,637	\$ 66,236	\$ 241,478	\$ 116,981
Per Common Share				
Basic net earnings	\$ 2.96	\$ 1.10	\$ 4.12	\$ 1.93
Diluted net earnings	\$ 2.90	\$ 1.07	\$ 4.02	\$ 1.88
Cash dividends declared	\$ 0.30	\$ 0.28	\$ 0.60	\$ 0.55

See notes to consolidated financial statements.

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(Unaudited) (In thousands)

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 26, 2015	June 27, 2014	June 26, 2015	June 27, 2014
Net Earnings	\$ 172,637	\$ 66,236	\$ 241,478	\$ 116,981

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Other comprehensive income (loss)				
Cumulative translation adjustment	12,404	(1,908)	9,393	(1,994)
Pension and postretirement medical liability adjustment	1,919	1,225	4,357	2,413
Income taxes				
Pension and postretirement medical liability adjustment	(739)	(436)	(1,641)	(864)
Other comprehensive income (loss)	13,584	(1,119)	12,109	(445)
Comprehensive Income	\$ 186,221	\$ 65,117	\$ 253,587	\$ 116,536

See notes to consolidated financial statements.

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**GRACO INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

(Unaudited)

(In thousands)

	June 26, 2015	Dec 26, 2014
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	\$ 44,258	\$ 23,656
Accounts receivable, less allowances of \$9,300 and \$8,100	262,722	214,944
Inventories	194,568	159,797
Deferred income taxes	21,317	19,969
Investment in businesses held separate	-	421,767
Other current assets	12,277	19,374
<b>Total current assets</b>	<b>535,142</b>	<b>859,507</b>
Property, Plant and Equipment		
Cost	447,367	433,751
Accumulated depreciation	(275,968)	(272,521)
<b>Property, plant and equipment, net</b>	<b>171,399</b>	<b>161,230</b>
Goodwill	403,529	292,574
Other Intangible Assets, net	244,234	176,278
Deferred Income Taxes	38,357	28,982
Other Assets	26,247	26,207
<b>Total Assets</b>	<b>\$ 1,418,908</b>	<b>\$ 1,544,778</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current Liabilities		
Notes payable to banks	\$ 10,354	\$ 5,016
Trade accounts payable	45,145	39,306
Salaries and incentives	38,589	40,775
Dividends payable	17,400	17,790
Other current liabilities	122,284	71,593
<b>Total current liabilities</b>	<b>233,772</b>	<b>174,480</b>
Long-term Debt	300,410	615,000
Retirement Benefits and Deferred Compensation	138,042	136,812

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Deferred Income Taxes	22,854	22,454
Other non-current liabilities	11,475	-
<b>Shareholders' Equity</b>		
Common stock	57,817	59,199
Additional paid-in-capital	399,499	384,704
Retained earnings	343,666	252,865
Accumulated other comprehensive income (loss)	(88,627)	(100,736)
Total shareholders' equity	712,355	596,032
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 1,418,908</b>	<b>\$ 1,544,778</b>

See notes to consolidated financial statements.

Table of Contents**GRACO INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Unaudited) (In thousands)

	Twenty-six Weeks Ended	
	June 26, 2015	June 27, 2014
<b>Cash Flows From Operating Activities</b>		
Net Earnings	\$ 241,478	\$ 116,981
Adjustments to reconcile net earnings to net cash provided by operating activities		
Depreciation and amortization	21,969	18,327
Deferred income taxes	(11,324)	(5,710)
Share-based compensation	10,990	9,818
Excess tax benefit related to share-based payment arrangements	(700)	(2,300)
(Gain) loss on sale of business	(147,261)	-
Change in		
Accounts receivable	(33,934)	(42,019)
Inventories	(24,540)	(9,806)
Trade accounts payable	7,879	6,219
Salaries and incentives	(8,230)	(9,670)
Retirement benefits and deferred compensation	6,094	2,749
Other accrued liabilities	56,035	3,916
Other	(21,792)	(4,476)
<b>Net cash provided by operating activities</b>	<b>96,664</b>	<b>84,029</b>
<b>Cash Flows From Investing Activities</b>		
Property, plant and equipment additions	(19,886)	(17,062)
Acquisition of businesses, net of cash acquired	(187,853)	(65,219)
Proceeds from sale of assets	589,808	-
Investment in businesses held separate	-	530
Other	(250)	(599)
<b>Net cash provided by (used in) investing activities</b>	<b>381,819</b>	<b>(82,350)</b>
<b>Cash Flows From Financing Activities</b>		
Borrowings (payments) on short-term lines of credit, net	5,336	2,659
Borrowings on long-term line of credit	458,540	325,665
Payments on long-term line of credit	(773,130)	(211,275)
Payments of debt issuance costs	-	(890)
Excess tax benefit related to share-based payment arrangements	700	2,300
Common stock issued	14,511	17,792
Common stock repurchased	(130,635)	(93,820)
Cash dividends paid	(35,339)	(33,485)
<b>Net cash provided by (used in) financing activities</b>	<b>(460,017)</b>	<b>8,946</b>



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Effect of exchange rate changes on cash	2,136	(813)
Net increase (decrease) in cash and cash equivalents	20,602	9,812
Cash and cash equivalents		
Beginning of year	23,656	19,756
End of period	\$ 44,258	\$ 29,568

See notes to consolidated financial statements.

Table of Contents**GRACO INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

1. The consolidated balance sheet of Graco Inc. and Subsidiaries (the Company) as of June 26, 2015 and the related statements of earnings for the thirteen and twenty-six weeks ended June 26, 2015 and June 27, 2014, and cash flows for the twenty-six weeks ended June 26, 2015 and June 27, 2014 have been prepared by the Company and have not been audited.

In the opinion of management, these consolidated financial statements reflect all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position of the Company as of June 26, 2015, and the results of operations and cash flows for all periods presented.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. Therefore, these statements should be read in conjunction with the financial statements and notes thereto included in the Company's 2014 Annual Report on Form 10-K.

The results of operations for interim periods are not necessarily indicative of results that will be realized for the full fiscal year.

2. The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share amounts):

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 26, 2015	June 27, 2014	June 26, 2015	June 27, 2014
Net earnings available to common shareholders	\$ 172,637	\$ 66,236	\$ 241,478	\$ 116,981
Weighted average shares outstanding for basic earnings per share	58,235	60,453	58,608	60,637
Dilutive effect of stock options computed using the treasury stock method and the average market price	1,387	1,575	1,436	1,596
Weighted average shares outstanding for diluted earnings per share	59,622	62,028	60,044	62,233
Basic earnings per share	\$ 2.96	\$ 1.10	\$ 4.12	\$ 1.93

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Diluted earnings per share	\$	2.90	\$	1.07	\$	4.02	\$	1.88
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Stock options to purchase 1,357,000 and 876,000 shares were not included in the June 26, 2015 and June 27, 2014 computations of diluted earnings per share, respectively, because they would have been anti-dilutive.

3. Options on common shares granted and outstanding, as well as the weighted average exercise price, are shown below (in thousands, except exercise prices):

	Option Shares	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price
Outstanding, December 26, 2014	4,975	\$ 44.72	3,318	\$ 34.86
Granted	537	74.23		
Exercised	(109)	34.55		
Canceled	(11)	71.93		
Outstanding, June 26, 2015	5,392	\$ 47.81	3,726	\$ 37.92

The Company recognized year-to-date share-based compensation of \$11.0 million in 2015 and \$9.8 million in 2014. As of June 26, 2015, there was \$17.2 million of unrecognized compensation cost related to unvested options, expected to be recognized over a weighted average period of 1.8 years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions and results:

	Twenty-six Weeks Ended	
	June 26, 2015	June 27, 2014
Expected life in years	6.5	6.5
Interest rate	1.7 %	2.0 %
Volatility	35.1 %	36.1 %
Dividend yield	1.6 %	1.5 %
Weighted average fair value per share	\$ 23.22	\$ 24.83

Under the Company's Employee Stock Purchase Plan, the Company issued 166,000 shares in 2015 and 193,000 shares in 2014. The fair value of the employees' purchase rights under this Plan was estimated on the date of grant. The benefit of the 15 percent discount from the lesser of the fair market value per common share on the first day and the last day of the plan year was added to the fair value of the employees' purchase rights determined using the Black-Scholes option-pricing model with the following assumptions and results:

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	Twenty-six Weeks Ended	
	June 26, 2015	June 27, 2014
Expected life in years	1.0	1.0
Interest rate	0.2 %	0.1 %
Volatility	18.9 %	21.4 %
Dividend yield	1.6 %	1.4 %
Weighted average fair value per share	\$ 16.51	\$ 17.81

In April 2015, shareholders of the Company approved the Graco Inc. 2015 Stock Incentive Plan. The plan provides for issuance of up to 3.5 million shares of Graco common stock.

Shares authorized for issuance under stock option and purchase plans are shown below (in thousands):

	Total Shares Authorized	Available for Future
		Issuance as of June 26, 2015
Stock Incentive Plan (2015)	3,500	3,460
Employee Stock Purchase Plan (2006)	7,000	4,928
<b>Total</b>	<b>10,500</b>	<b>8,388</b>

Amounts available for future issuance exclude outstanding options. Options outstanding as of June 26, 2015 include options granted under three plans that were replaced by subsequent plans. No shares are available for future grants under those plans.

4. The components of net periodic benefit cost for retirement benefit plans were as follows (in thousands):

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 26, 2015	June 27, 2014	June 26, 2015	June 27, 2014
<b>Pension Benefits</b>				
Service cost	\$ 1,907	\$ 1,697	\$ 4,003	\$ 3,439
Interest cost	3,605	3,940	7,380	8,076
Expected return on assets	(4,659)	(5,211)	(9,576)	(10,630)
Amortization and other	2,426	1,355	4,779	2,688
Net periodic benefit cost	\$ 3,279	\$ 1,781	\$ 6,586	\$ 3,573
<b>Postretirement Medical</b>				
Service cost	\$ 150	\$ 125	\$ 300	\$ 250
Interest cost	227	278	453	555
Amortization	(101)	(126)	(202)	(254)

Net periodic benefit cost	\$	276	\$	277	\$	551	\$	551
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## 5. Changes in components of accumulated other comprehensive income (loss), net of tax were (in thousands):

	Pension and Post- retirement Medical	Cumulative Translation Adjustment	Total
Thirteen Weeks Ended			
June 27, 2014			
Beginning balance	\$ (49,372)	\$ 3,697	\$ (45,675)
Other comprehensive income before reclassifications	-	(1,908)	(1,908)
Amounts reclassified from accumulated other comprehensive income	789	-	789
Ending balance	\$ (48,583)	\$ 1,789	\$ (46,794)
Thirteen Weeks Ended			
June 26, 2015			
Beginning balance	\$ (75,048)	\$ (27,163)	\$ (102,211)
Other comprehensive income before reclassifications	-	12,404	12,404
Amounts reclassified from accumulated other comprehensive income	1,180	-	1,180
Ending balance	\$ (73,868)	\$ (14,759)	\$ (88,627)
Twenty-six Weeks Ended			
June 27, 2014			
Beginning balance	\$ (50,132)	\$ 3,783	\$ (46,349)
Other comprehensive income before reclassifications	-	(1,994)	(1,994)
Amounts reclassified from accumulated other comprehensive income	1,549	-	1,549
Ending balance	\$ (48,583)	\$ 1,789	\$ (46,794)
Twenty-six Weeks Ended			
June 26, 2015			
Beginning balance	\$ (76,584)	\$ (24,152)	\$ (100,736)
Other comprehensive income before reclassifications	-	9,393	9,393
Amounts reclassified from accumulated other comprehensive income	2,716	-	2,716
Ending balance	\$ (73,868)	\$ (14,759)	\$ (88,627)





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Amounts related to pension and postretirement medical adjustments are reclassified to pension cost, which is allocated to cost of products sold and operating expenses based on salaries and wages, approximately as follows (in thousands):

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 26, 2015	June 27, 2014	June 26, 2015	June 27, 2014
Cost of products sold	\$ 707	\$ 440	\$ 1,645	\$ 876
Product development	319	195	702	382
Selling, marketing and distribution	529	354	1,232	689
General and administrative	364	236	778	466
<b>Total before tax</b>	<b>\$ 1,919</b>	<b>\$ 1,225</b>	<b>\$ 4,357</b>	<b>\$ 2,413</b>
Income tax (benefit)	(739)	(436)	(1,641)	(864)
<b>Total after tax</b>	<b>\$ 1,180</b>	<b>\$ 789</b>	<b>\$ 2,716</b>	<b>\$ 1,549</b>

On May 11, 2015, the Company entered into an accelerated share repurchase arrangement ( ASR ) with a financial institution. In exchange for an up-front payment of \$60 million, the financial institution delivered 742,880 shares of Company common stock with a fair value of \$54 million. The total number of shares ultimately delivered under the ASR is determined at the end of the purchase period (up to three months, but not less than one month) based on the volume weighted-average price ( VWAP ) of the Company s common stock during that period. If there were no change in the market price of the Company s stock during the purchase period, the Company would receive approximately 90,000 additional shares at the end of the purchase period.

The Company accounted for the up-front payment as a reduction of shareholders equity in the period made. Shares received under the ASR were retired and reflected as a reduction of outstanding shares on the date delivered for purposes of calculating earnings per share. The forward contract aspect of the ASR met all of the applicable criteria for equity classification, and therefore, was accounted for as a derivative indexed to the Company s equity.

Subsequent to the end of the second quarter, the purchase period ended and the Company received an additional 94,515 shares to complete the ASR at an average realized price of \$71.65 per share.

6. Beginning with the first quarter of 2015 the Company revised the presentation of its financial reporting segments. Operations of the Process and the Oil and Natural Gas divisions, historically included in the Industrial segment, are now aggregated with the Lubrication division (formerly reported as a separate segment) in the newly-formed Process segment. This change aligns the types of products offered and markets served within the segments. Prior year segment information has been restated to conform to 2015 reporting.

A summary of the Company s three reportable segments (Industrial, Process and Contractor) follows.

The Industrial segment includes our Industrial Products and Applied Fluid Technologies divisions. The Industrial segment markets equipment and pre-engineered packages for moving and applying paints, coatings, sealants, adhesives and other fluids. Markets served



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include automotive and vehicle assembly and components production, wood and metal products, rail, marine, aerospace, farm, construction, bus, recreational vehicles, and various other industries.

The Process segment includes our Process, Oil and Natural Gas, and Lubrication divisions. The Process segment markets pumps, valves, meters and accessories to move and dispense chemicals, oil and natural gas, water, waste water, petroleum, food, lubricants and other fluids. Markets served include food and beverage, dairy, oil and natural gas, pharmaceutical, cosmetics, electronics, waste water, mining, fast oil change facilities, service garages, fleet service centers, automobile dealerships and industrial lubrication applications.

The Contractor segment remains unchanged. The Contractor segment markets sprayers for architectural coatings for painting, corrosion control, texture, and line striping.

Sales and operating earnings by segment were as follows (in thousands):

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 26, 2015	June 27, 2014	June 26, 2015	June 27, 2014
<b>Net Sales</b>				
Industrial	\$ 153,502	\$ 156,578	\$ 296,768	\$ 308,624
Process	71,946	54,850	139,627	107,860
Contractor	110,041	111,121	205,547	196,027
<b>Total</b>	<b>\$ 335,489</b>	<b>\$ 322,549</b>	<b>\$ 641,942</b>	<b>\$ 612,511</b>
<b>Operating Earnings</b>				
Industrial	\$ 50,738	\$ 50,892	\$ 93,678	\$ 99,997
Process	13,988	13,572	24,486	26,215
Contractor	27,040	28,289	46,415	46,539
Unallocated corporate (expense)	(7,875)	(6,905)	(15,457)	(12,198)
<b>Total</b>	<b>\$ 83,891</b>	<b>\$ 85,848</b>	<b>\$ 149,122</b>	<b>\$ 160,553</b>

Assets by segment were as follows (in thousands):

	June 26, 2015	Dec 26, 2014
Industrial	\$ 567,759	\$ 548,868
Process	499,113	304,903
Contractor	214,092	176,757
Unallocated corporate	137,944	514,250
<b>Total</b>	<b>\$ 1,418,908</b>	<b>\$ 1,544,778</b>

Unallocated corporate assets decreased due to the sale of the Liquid Finishing assets in the second quarter of 2015 (see note 12).

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Geographic information follows (in thousands):

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	June 26, 2015	June 27, 2014	June 26, 2015	June 27, 2014
Net sales				
(based on customer location)				
United States	\$ 170,921	\$ 156,160	\$ 330,249	\$ 290,082
Other countries	164,568	166,389	311,693	322,429
Total	\$ 335,489	\$ 322,549	\$ 641,942	\$ 612,511

	June 26, 2015	Dec 26, 2014
Long-lived assets		
United States	\$ 140,935	\$ 131,131
Other countries	30,464	30,099
Total	\$ 171,399	\$ 161,230

7. Major components of inventories were as follows (in thousands):

	June 26, 2015	Dec 26, 2014
Finished products and components	\$ 108,684	\$ 87,384
Products and components in various stages of completion	49,864	47,682
Raw materials and purchased components	82,105	69,212
	240,653	204,278
Reduction to LIFO cost	(46,085)	(44,481)
Total	\$ 194,568	\$ 159,797

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8. Information related to other intangible assets follows (dollars in thousands):

	Estimated Life (years)	Cost	Accumulated Amortization	Foreign Currency Translation	Book Value
June 26, 2015					
Customer relationships	3 - 14	\$ 197,823	\$ (29,364)	\$ (4,368)	\$ 164,091
Patents, proprietary technology and product documentation	3 - 11	20,499	(8,134)	(318)	12,047
Trademarks, trade names and other	5	495	(91)	(42)	362
		218,817	(37,589)	(4,728)	176,500
Not Subject to Amortization:					
Brand names		69,165	-	(1,431)	67,734
<b>Total</b>		<b>\$ 287,982</b>	<b>\$ (37,589)</b>	<b>\$ (6,159)</b>	<b>\$ 244,234</b>

December 26, 2014					
Customer relationships	3 - 14	\$ 143,144	\$ (21,948)	\$ (7,334)	\$ 113,862
Patents, proprietary technology and product documentation	3 - 11	18,268	(7,126)	(655)	10,487
Trademarks, trade names and other	5	175	(44)	-	131
		161,587	(29,118)	(7,989)	124,480
Not Subject to Amortization:					
Brand names		55,265	-	(3,467)	51,798
<b>Total</b>		<b>\$ 216,852</b>	<b>\$ (29,118)</b>	<b>\$ (11,456)</b>	<b>\$ 176,278</b>

Amortization of intangibles for the quarter was \$4.4 million in 2015 and \$2.7 million in 2014 and for the year-to-date was \$8.5 million in 2015 and \$5.8 million in 2014. Estimated annual amortization expense is as follows: \$17.4 million in 2015, \$17.6 million in 2016, \$17.3 million in 2017, \$17.0 million in 2018, \$16.9 million in 2019 and \$98.8 million thereafter.

Changes in the carrying amount of goodwill in 2015 were as follows (in thousands):

	Industrial	Process	Contractor	Total
Beginning balance	\$ 188,273	\$ 91,569	\$ 12,732	\$ 292,574
Additions from business acquisitions	5,037	101,730	-	106,767
Foreign currency translation	2,846	1,342	-	4,188

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Ending balance	\$ 196,156	\$ 194,641	\$ 12,732	\$ 403,529
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9. Components of other current liabilities were (in thousands):

	June 26, 2015	Dec 26, 2014
Accrued self-insurance retentions	\$ 7,371	\$ 7,089
Accrued warranty and service liabilities	7,641	7,609
Accrued trade promotions	5,830	7,697
Payable for employee stock purchases	4,951	9,126
Customer advances and deferred revenue	15,763	8,918
Income taxes payable	48,104	5,997
Other	32,624	25,157
 Total other current liabilities	 \$ 122,284	 \$ 71,593