OPTION CARE INC/DE
Form 10-Q
November 09, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

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 0-19878

OPTION CARE, INC.

(Exact name of registrant as specified in its charter)

Delaware	**36-3791193**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
485 Half Day Road, Suite 300 **Buffalo Grove, Illinois**	**60089**
(Address of principal executive offices)	(zip code)

(847) 465-2100
(Registrant s telephone number, including area code)

Not applicable
(Former name, former address and former fiscal year, if changed since last report)

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 x No o

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

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

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

Class	**Issued and Outstanding as of November 1, 2006**
Common Stock - $0.01 par value	34,361,439

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OPTION CARE, INC. AND SUBSIDIARIES

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Option Care, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets
(in thousands, except per share amounts)

	September 30, 2006 (Unaudited)	December 31, 2005 (Restated-Note 1)
Assets		
Current assets:		
Cash and cash equivalents	$ 12,456	$ 7,816
Short-term investments	9,200	41,042
Accounts receivable, net	101,981	95,297
Inventory	18,954	15,490
Deferred income tax benefit	4,236	2,856
Other current assets	8,553	9,942
Total current assets	155,380	172,443
Equipment and other fixed assets, net	22,648	18,905
Goodwill, net	164,232	112,220
Other assets	12,269	12,996
Total assets	$ 354,529	$ 316,564
Liabilities and stockholders equity		
Current liabilities:		
Trade accounts payable	$ 29,325	$ 29,958
Current portion of long-term debt	32	48
Other current liabilities	14,433	9,743
Total current liabilities	43,790	39,749
Long-term debt, less current portion	86,284	86,306
Deferred income tax liability	11,537	9,084
Other liabilities	1,140	665
Minority interest	771	593
Total liabilities	143,522	136,397
Stockholders equity:		
Common stock, $.01 par value per share, 60,000 shares authorized, 34,330 and 32,838 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively	343	328
Common stock to be issued, 108 and 134 shares at September 30, 2006 and December 31, 2005, respectively	1,179	1,311
Additional paid-in capital	146,193	128,158
Retained earnings	63,292	50,370
Total stockholders equity	211,007	180,167
Total liabilities and stockholders equity	$ 354,529	$ 316,564

See notes to condensed consolidated financial statements

Option Care, Inc. and Subsidiaries
Condensed Consolidated Statements of Income
(Unaudited)
(in thousands, except per share amounts)

	Three months ended September 30, 2006	2005 (Restated-Note 1)	Nine months ended September 30, 2006	2005 (Restated-Note 1)
Revenue:				
Specialty pharmacy services	$ 84,640	$ 67,239	$ 269,873	$ 209,736
Infusion and related healthcare services	66,657	51,178	188,292	141,716
Other	1,592	3,476	7,023	10,687
Total revenue	152,889	121,893	465,188	362,139
Cost of revenue:				
Cost of goods sold	90,709	71,680	282,721	219,122
Cost of services provided	17,720	13,718	51,306	38,383
Total cost of revenue	108,429	85,398	334,027	257,505
Gross profit	44,460	36,495	131,161	104,634
Selling, general and administrative expenses	30,627	25,318	90,846	72,165
Provision for doubtful accounts	3,542	2,248	10,461	6,727
Depreciation and amortization	1,227	915	3,597	2,668
Total operating expenses	35,396	28,481	104,904	81,560
Operating income	9,064	8,014	26,257	23,074
Interest income (expense), net	(261)	108	(470)	258
Other expense, net	(260)	(73)	(688)	(20)
Income before income taxes	8,543	8,049	25,099	23,312
Income tax provision	3,337	3,137	9,265	8,925
Net income from continuing operations	$ 5,206	$ 4,912	$ 15,834	$ 14,387
Discontinued operations:				
Loss on discontinued operations, net of income taxes	(256)		(893)	
Net income	$ 4,950	$ 4,912	$ 14,941	$ 14,387
Basic net income (loss) per common share:				
Continuing operations	$ 0.15	$ 0.15	$ 0.47	$ 0.44
Discontinued operations	$ (0.01)	$	$ (0.03)	$
Total	$ 0.14	$ 0.15	$ 0.44	$ 0.44
Diluted net income (loss) per common share:				
Continuing operations	$ 0.15	$ 0.14	$ 0.45	$ 0.42
Discontinued operations	$ (0.01)	$	$ (0.03)	$
Total	$ 0.14	$ 0.14	$ 0.42	$ 0.42
Shares used in computing net income per share:				
Basic	34,324	32,771	33,822	32,496
Diluted	35,460	34,679	35,310	34,231
Cash dividends per share	$ 0.0200	$ 0.0200	$ 0.0600	$ 0.0533

See notes to condensed consolidated financial statements

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Option Care, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(Unaudited)
(in thousands)

	Nine Months Ended September 30, 2006	2005 (Restated-Note 1)
Cash flows from operating activities:		
Net income	$ 14,941	$ 14,387
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	6,082	4,607
Provision for doubtful accounts	10,682	6,727
Income from equity investees	396	
Loss on disposals	49	
Non-cash stock compensation expense	1,047	2,540
Deferred income taxes	511	371
Changes in assets and liabilities, net of acquisitions:		
Accounts and notes receivable	(3,048)	(8,450)
Inventory	(984)	2,974
Accounts payable	(11,513)	(4,971)
Income taxes receivable/payable	317	(273)
Change in other assets and liabilities	2,853	(1,995)
Net cash provided by operating activities	21,333	15,917
Cash flows from investing activities:		
Purchases of short-term investments	(13,200)	(170,840)
Sales of short-term investments	45,042	192,566
Purchases of equipment and other, net	(7,874)	(7,094)
Payments for acquisitions, net of cash acquired	(43,817)	(46,367)
Proceeds from disposals	462	
Net cash used in investing activities	(19,387)	(31,735)
Cash flows from financing activities:		
Increase in deferred financing costs	(55)	(166)
Income tax benefit from exercise of stock options	994	1,973
Payments on capital leases and other debt	(38)	(30)
Proceeds from issuance of stock	3,812	6,060
Payments of cash dividends to common shareholders	(2,019)	(1,728)
Net cash provided by financing activities	2,694	6,109
Net increase (decrease) in cash and cash equivalents	4,640	(9,709)
Cash and cash equivalents, beginning of period	7,816	19,816
Cash and cash equivalents, end of period	$ 12,456	$ 10,107

See notes to condensed consolidated financial statements

Option Care, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements
September 30, 2006
(Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Quarterly Report on Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

The balance sheet at December 31, 2005 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. For further information, refer to the consolidated financial statements and footnotes thereto included in Option Care s Annual Report on Form 10-K for the year ended December 31, 2005.

In addition, the balance sheet at December 31, 2005 and statements of income and cash flows for the three and nine months ended September 30, 2005 have been restated to reflect the impact of the adoption of Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*, as of January 1, 2006 utilizing the modified retrospective method (see also Note 9, *Stock-based Compensation)* and to reflect the correction of errors in previously reported pro-forma disclosures of stock-based compensation as then required by SFAS No. 123, *Accounting for Stock-Based Compensation*. The errors in previously reported pro-forma disclosures of stock-based compensation were due to improper tax treatment of compensation expense from our employee stock purchase plan and improper accelerated expensing of certain prior years grants.

The following table sets forth the impact of the adoption of SFAS No. 123(R) utilizing the modified retrospective method and the correction of errors in previously reported pro-forma disclosures of stock-based compensation on the Condensed Consolidated Balance Sheet as of December 31, 2005 (in thousands):

	As Reported	Effect of FAS 123(R) Adoption	As Restated
Total current assets	$ 172,443	$	$ 172,443
Equipment and other fixed assets, net	18,905		18,905
Goodwill, net	112,220		112,220
Other intangible assets, net(1)	3,450		3,450
Investment in affiliates(1)	4,911		4,911
Non-current portion of deferred income tax benefit(1)	230	2,886	3,116
Other long-term assets(1)	1,519		1,519
Total assets	$ 313,678	$ 2,886	$ 316,564
Total liabilities	136,397		136,397
Common stock and common stock to be issued	1,639		1,639
Additional paid-in capital	113,686	14,472	128,158
Retained earnings	61,956	(11,586)	50,370
Total stockholders equity	177,281	2,886	180,167
Total liabilities and stockholders equity	$ 313,678	$ 2,886	$ 316,564

(1) Included in the accompanying restated Condensed Consolidated Balance as of December 31, 2005 within Other assets .

The following table sets forth the impact of the adoption of SFAS No. 123(R) utilizing the modified retrospective method and the correction of errors in previously reported pro-forma disclosures of stock-based compensation on the Condensed Consolidated Statement of Income for the three and nine months ended September 30, 2005 (in thousands, except per share amounts):

	Three months ended September 30, 2005			**Nine months ended September 30, 2005**		
	As Reported	**Effect of FAS 123(R) Adoption**	**As Restated**	**As Reported**	**Effect of FAS 123(R) Adoption**	**As Restated**
Total revenue	$ 121,893	$	$ 121,893	$ 362,139	$	$ 362,139
Cost of goods sold	71,680		71,680	219,122		219,122
Cost of services provided	13,688	30	13,718	38,269	114	38,383
Total cost of revenue	85,368	30	85,398	257,391	114	257,505
Gross profit	36,525	(30)	36,495	104,748	(114)	104,634
Selling, general and administrative expenses	24,689	629	25,318	69,739	2,426	72,165
Other operating expenses	3,163		3,163	9,395		9,395
Total operating expenses	27,852	629	28,481	79,134	2,426	81,560
Operating income	8,673	(659)	8,014	25,614	(2,540)	23,074
Interest income	108		108	258		258
Other expense, net	(73)		(73)	(20)		(20)
Income before income taxes	8,708	(659)	8,049	25,852	(2,540)	23,312
Income tax provision	3,348	(211)	3,137	9,798	(873)	8,925
Net income	$ 5,360	$ (448)	$ 4,912	$ 16,054	$ (1,667)	$ 14,387
Net income per common share:						
Basic	$ 0.16	$ (0.01)	$ 0.15	$ 0.49	$ (0.05)	$ 0.44
Diluted	$ 0.16	$ (0.02)	$ 0.14	$ 0.47	$ (0.05)	$ 0.42
Shares used in computing net income per share:						
Basic	32,771		32,771	32,496		32,496
Diluted	34,566	113	34,679	34,163	68	34,231

The following table sets forth the impact of the adoption of SFAS No. 123(R) utilizing the modified retrospective method and the correction of errors in previously reported pro-forma disclosures of stock-based compensation on the Condensed Consolidated Statement of Cash Flows for the nine months ended September 30, 2005 (in thousands):

	As Reported	Effect of FAS 123(R) Adoption	As Restated
Cash flows from operating activities:			
Net income	$ 16,054	$ (1,667)	$ 14,387
Adjustments to reconcile net income to cash provided by operating activities:			
Non-cash stock compensation expense		2,540	2,540
Deferred income taxes	1,244	(873)	371
Income tax benefit from exercise of stock options	1,973	(1,973)	
Other adjustments	(1,381)		(1,381)
Net cash provided by operating activities	17,890	(1,973)	15,917
Net cash used in investing activities	(31,735)		(31,735)
Cash flows from financing activities:			
Income tax benefit from exercise of stock options		1,973	1,973
Other cash flows from financing activities	4,136		4,136
Net cash provided by financing activities	4,136	1,973	6,109
Net decrease in cash and cash equivalents	(9,709)		(9,709)
Cash and cash equivalents, beginning of period	19,816		19,816
Cash and cash equivalents, end of period	$ 10,107	$	$ 10,107

2. Long-Term Debt

In November 2004, we completed an offering of $86.3 million of 2.25% convertible senior notes due 2024 in a private placement to qualified institutional buyers. We filed a Registration Statement on Form S-3 on January 24, 2005, as subsequently amended, to register the notes under the Securities Act of 1933. The notes are convertible into cash and, if applicable, shares of our common stock based on an initial conversion rate, subject to adjustment, of 55.5278 shares per $1,000 principal amount of notes (which represents an initial conversion price of $18.01 per share), in certain circumstances. The conversion rate and conversion price were subsequently adjusted to 83.5519 and $11.97 per share, respectively, pursuant to the terms of the notes as a result of our 3-for-2 common stock split on March 31, 2005 and the $0.02 per share dividends paid each quarter thereafter. Holders may convert their notes into cash and, if applicable, shares of our common stock prior to the stated maturity only under the following circumstances: (1) during any calendar quarter after the calendar quarter ended December 31, 2004, if the closing sale price of our common stock for each of 20 or more consecutive trading days in a period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter exceeds 120% of the conversion price in effect on the last trading day of the immediately preceding calendar quarter; (2) during the five business day period after any five consecutive trading day period (the note measurement period) in which the average trading price per $1,000 principal amount of notes was equal to or less than 97% of the average conversion value of the notes during the note measurement period; (3) upon the occurrence of specified corporate transactions; or (4) if we have called the notes for redemption. In general, upon conversion, the holder of each note will receive the conversion value of the note payable in cash, up to the principal amount of the note, and common stock for the note s conversion value in excess of such principal amount (plus an additional cash payout in lieu of fractional shares). If the notes are surrendered for conversion in connection with certain fundamental changes that occur before November 1, 2009, holders will in certain circumstances also receive a make-whole premium in addition to the cash and shares to which holders are otherwise entitled to receive upon conversion. The convertible senior notes will mature on November 1, 2024 and will not be redeemable by us prior to November 1, 2009. Holders of the convertible notes may require us to repurchase all or a portion of the convertible notes for cash on November 1, 2009, November 1, 2014 and November 1, 2019. Interest will be paid at 2.25% per annum, payable semi-annually in arrears on May 1 and November 1 of each year to the holders of record at the close of business on the preceding April 15 and October 15, respectively. The notes are senior unsecured obligations and rank equally with all of our existing and future senior unsecured indebtedness. None of the required conditions for potential conversion of the notes by the holders occurred during the nine months ended September 30, 2006. The holders of the notes possess no stockholder rights, such as dividend or voting rights, unless and until they convert their notes into cash and shares of our common stock.

On May 5, 2006, we entered into a five-year revolving Credit Agreement with LaSalle Bank National Association (the Agreement). The initial revolving loan commitment under the Agreement is $35 million. Provided there is no event of default, we have the option to increase the revolving loan commitment to a maximum of $100 million during the first two years of the

Agreement. We will pay interest on borrowings at rates ranging from prime plus zero or LIBOR plus 1.00% to a maximum of prime plus 0.25% or LIBOR plus 1.75% based on our debt to EBITDA ratio for the applicable period. We will also pay a non-use fee ranging from 0.15% to 0.225% of the unused portion of the revolving loan commitment. The interest rates and non-use fee rates payable are based on our Total Debt to EBITDA Ratio, as defined in the agreement, for the applicable period. We must maintain compliance with various financial and other covenants during the life of the Agreement. We incurred fees of approximately $150,000 related to negotiating this Agreement. We have had no borrowings under the Agreement from inception through September 30, 2006.

3. Earnings Per Share Data

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

	Three months ended September 30, 2006	Three months ended September 30, 2005	Nine months ended September 30, 2006	Nine months ended September 30, 2005
Basic:				
Net income from continuing operations	$ 5,206	$ 4,912	$ 15,834	$ 14,387
Net loss from discontinued operations	(256)		(893)	
Net income	$ 4,950	$ 4,912	$ 14,941	$ 14,387
Average shares outstanding	34,324	32,771	33,822	32,496
Basic earnings from continuing operations per share	$ 0.15	$ 0.15	$ 0.47	$ 0.44
Basic loss from discontinued operations per share	(0.01)		(0.03)	
Basic earnings per share	$ 0.14	$ 0.15	$ 0.44	$ 0.44
Diluted:				
Net income from continuing operations	$ 5,206	$ 4,912	$ 15,834	$ 14,387
Net loss from discontinued operations	(256)		(893)	
Net income	$ 4,950	$ 4,912	$ 14,941	$ 14,387
Average shares outstanding	34,324	32,771	33,822	32,496
Net effect of dilutive stock options Based on the treasury stock method	873	1,073	985	1,070
Net effect of dilutive contingently convertible debt (1)	263	835	503	665
Total diluted shares	35,460	34,679	35,310	34,231
Diluted earnings from continuing operations per share	$ 0.15	$ 0.14	$ 0.45	$ 0.42
Diluted loss from discontinued operations per share	(0.01)		(0.03)	
Diluted earnings per share	$ 0.14	$ 0.14	$ 0.42	$ 0.42

(1) Weighted average shares issuable upon conversion of all $86.3 million of our 2.25% convertible senior notes due 2024.

4. Operating Segments

We report our results of operations from one identifiable segment, with three service lines: specialty pharmacy services, infusion and related healthcare services, and other.

Specialty pharmacy services involve the distribution of injectable and infused pharmaceuticals to treat a wide range of chronic health conditions. We purchase specialty pharmaceuticals from manufacturers and wholesale distributors, fill prescriptions provided by physicians, and label, package and deliver the pharmaceuticals to patients homes or

physicians   offices, either ourselves or through contract couriers. These pharmaceuticals may require refrigeration during shipping as well as special handling to prevent potency degradation. Depending on therapy, we may also administer the specialty pharmaceuticals to the patient at one of our ambulatory infusion centers. Patients receiving treatment are often provided special counseling and education regarding their condition and treatment program.

Infusion and related healthcare services typically involve the intravenous administration of medications at the patient s home or other non-hospital sites such as one of our ambulatory infusion suites. Infusion pharmacy services treat a wide range of acute and

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chronic health conditions, including infections, dehydration, cancer, pain and nutritional deficiencies. All of our company-owned pharmacies provide infusion pharmacy services. Several of our company-owned pharmacies also provide home health nursing services, respiratory therapy services and home medical equipment sales and rentals. We also have one location that provides home hospice services.

Other revenue consists of royalties and other fees generated from our franchised pharmacy network and, for the three and nine months ended September 30, 2005, software licensing and support revenue generated by our subsidiary, Management by Information, Inc. (MBI). The MBI business was sold during the fourth quarter of 2005 and therefore generated no revenue during the three and nine months ended September 30, 2006.

5. Significant Customers and Concentration of Credit Risk

We generate the majority of our revenue from managed care contracts and other agreements with commercial third party payors by providing health care services to their members. Our principal managed care contract is with Blue Cross and Blue Shield of Florida, to whose members we provide infusion pharmacy services and specialty pharmacy services. The contract may be terminated by either party on 90 days notice and, unless terminated, renews annually each September for an additional one-year term. We also generate revenue from government healthcare programs such as Medicare and Medicaid.

The following table sets forth information regarding revenue and accounts receivable related to our most significant payors as of the dates and for the periods presented:

	Revenue Three months ended September 30, 2006	2005	Nine months ended September 30, 2006	2005	Accounts Receivable September 30, 2006	December 31, 2005
Blue Cross and Blue Shield of Florida	14 %	14 %	13 %	14 %	8 %	9 %
Medicare & Medicaid	21 %	15 %	20 %	17 %	20 %	22 %
All other payors (1)	65 %	71 %	67 %	69 %	72 %	69 %
Total	100 %	100 %	100 %	100 %	100 %	100 %

(1) No other payor represents 10% or more of our revenue or accounts receivable as of the dates and for the periods presented.

6. Seasonal Revenue Trends

Synagis®, one of the specialty pharmaceuticals that we provide to patients, is seasonal. Synagis® is a drug used for the prevention of respiratory syncytial virus (RSV) in high-risk pediatric patients. RSV infection is a seasonal condition, with the season generally lasting from October through April.

Option Care s quarterly Synagis® revenue for the year 2005 and the first three quarters of 2006 was as follows (in thousands):

	Synagis® revenue	% of Total Revenue (1)
Quarter ended March 31, 2005	$ 15,536	12.9 %
Quarter ended June 30, 2005	4,492	3.8 %
Quarter ended September 30, 2005	862	0.7 %
Quarter ended December 31, 2005	15,905	11.2 %
Fiscal year 2005	$ 36,795	7.3 %
Quarter ended March 31, 2006	$ 27,102	17.5 %
Quarter ended June 30, 2006	$ 8,372	5.3 %
Quarter ended September 30, 2006	$ 1,780	1.2 %

(1) Percent of total revenue is calculated based on total revenue from continuing operations.

7. Acquisitions

We completed two acquisitions and entered into a binding agreement for a third acquisition during the nine months ended September 30, 2006. The results of operations for each business were consolidated as of the effective date of the acquisition. The purpose of each acquisition was to increase our revenue and net income by accomplishing one or both of the following goals: (1) expanding our geographic coverage, and (2) consolidating our position in the markets we serve.

Effective May 15, 2006, we acquired all of the outstanding stock of our Eatontown, New Jersey franchise. The initial purchase price was $18.2 million, paid $14.0 million in cash and $4.2 million in shares of our common stock. We may owe additional consideration of up to $7.4 million, payable in 2007, 2008 and/or 2009 based on achievement of certain financial performance targets. Concurrent with the acquisition of this franchise, we recorded a gain of $1.2 million related to settlement of their pre-existing franchise relationship. This gain is included within Other Revenue on our Condensed Consolidated Statements of Income for the nine months ended September 30, 2006. Related to this acquisition, we have recorded goodwill of $16.4 million, all of which is expected to be deductible for income tax purposes.

Effective March 13, 2006 (the Effective Date), we entered into a binding purchase agreement to acquire a home infusion business with operations in New York. The purchase price was $25.0 million, of which $16.5 million was paid in cash on the Effective Date, $7.5 million was paid in unregistered shares of our common stock and $1.0 million is payable pursuant to the terms of a note. Pursuant to terms contained in the binding purchase agreement, the unregistered shares will be repurchased by us during the quarter ending December 31, 2006 in exchange for a cash payment of $7.5 million. Under the terms of the purchase agreement, we will receive the acquired interest in the business at the closing date, which is the earlier of two days following the receipt of approval from the New York Department of Health or 270 days subsequent to the Effective Date. The total cost of the acquisition is subject to working capital and earn-out adjustments. The total purchase price has been allocated $22.2 million to goodwill and the remainder to accounts receivable and other working capital items. We anticipate that all of the goodwill will be deductible for tax purposes. Financial Accounting Standards Board Interpretation No. 46 (Revised December 2003), *Consolidation of Variable Interest Entities*, addresses the consolidation of business enterprises to which customary conditions of consolidation, such as a majority voting interest, do not apply. As a result of the purchase agreement and related joint coordination agreement, the acquired business is deemed to be a variable interest entity (VIE) and we are the primary beneficiary of this VIE as of the Effective Date. Accordingly, we have included the business in our consolidated financial reporting as of the Effective Date. Prior to the closing date, and subsequent to the Effective Date, creditors of the VIE will not have recourse to the assets of our company. Subsequent to the closing date, the acquired business will cease to be a VIE and will become a wholly-owned subsidiary of our company. As of September 30, 2006, the closing date had not yet been reached for this acquisition.

Effective March 1, 2006, we acquired a home infusion and RT/DME business with operations in Connecticut, Illinois, New Jersey and Ohio. Through this acquisition we acquired full equity ownership of one C corporation and one limited liability company for $5.0 million in cash, subject to certain adjustments. In connection with this acquisition, we recorded goodwill of $5.5 million, subject to adjustment related to contingencies involving the value of acquired assets. We anticipate that substantially all of the goodwill will be deductible for income tax purposes.

During the nine months ended September 30, 2006, we recorded additional goodwill of $7.9 million related to additional consideration paid and payable to the former owners of businesses we acquired in 2005 and 2004. We paid the additional consideration $7.5 million in cash and $1.0 million in 70,000 shares of our common stock.

For our current year acquisitions, the allocation of purchase price is tentative and subject to adjustment. The following table sets forth the allocation of purchase price for the nine months ended September 30, 2006 for our current year acquisition and additional consideration for our prior year acquisitions (in thousands):

	Nine months ended September 30, 2006
Purchase Price:	
Paid in cash	$ 43,817
Paid/payable in shares of Option Care common stock	12,636
Earn-out payable	1,559
Liabilities assumed	12,533
	$ 70,545
Allocation of Purchase Price:	
Goodwill	$ 52,400
Accounts receivable, net	14,044
Other tangible assets	3,627

Other intangible assets	475	
	$	70,545

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The following table sets forth information regarding the changes in our gross and net goodwill during the nine months ended September 30, 2006 (in thousands):

	Goodwill	Accumulated Amortization	Goodwill, net
December 31, 2005	$ 116,160	$ (3,940)	$ 112,220
Current year acquisitions	44,486		44,486
Prior year acquisitions	7,914		7,914
Current year disposals	(388)		(388)
September 30, 2006	$ 168,172	$ (3,940)	$ 164,232

8. Discontinued Operations

On August 1, 2006, we completed the sale of our home health agency in Portland, Oregon for $500,000. We recorded a pre-tax gain of $242,000 on this sale. In addition, during the quarter ended September 30, 2006 we ceased operations of our home health agency in Phoenix, Arizona and recorded a pre-tax loss of $291,000 on this disposal. The operations and cash flows of these home health agencies have been eliminated from our ongoing operations as a result of these transactions, and we will not have any significant continuing involvement in their operations. Accordingly, the results of operations of these home health agencies, including any gains or losses on sale or disposal, are now reported as discontinued operations, net of tax, in our condensed consolidated statements of income. There was no impact to the reported results for the three or nine months ended September 30, 2005 as we acquired both home health agencies on or after October 1, 2005.

Selected financial information related to our discontinued operations is summarized as follows (in thousands):

	Three months ended September 30, 2006	Nine months ended September 30, 2006
Total revenue	$ 498	$ 4,436
Pre-tax loss on disposal of discontinued operations	(49)	(49)
Loss from discontinued operations before income taxes	(367)	(1,350)
Income tax benefit	160	506
Loss on discontinued operations, net of income taxes	$ (256)	$ (893)

9. Franchise-related Revenue

We maintain a national franchise network through which we generate a portion of our revenue. Our franchise-related revenues include: (1) royalties; (2) vendor rebates and administration fees; and (3) franchise settlement and related fees. Each of these types of revenue can fluctuate over time, with the largest potential fluctuations relating to franchise settlements. Franchise-related revenue is included within our Other revenue service line. The following table sets forth our franchise-related revenue for the periods indicated (in thousands):

	Three months ended September 30,		Nine months ended September 30,	
	2006	2005	2006	2005
Franchise-related revenue:				
Royalties	$ 1,270	$ 1,775	$ 4,064	$ 5,690
Vendor rebates and administration fees	99	113	525	302
Franchise settlements and related fees		506	1,427	2,997
Total franchise-related revenue	$ 1,369	$ 2,393	$ 6,016	$ 8,989

During the nine months ended September 30, 2006, we recorded franchise settlement revenue of $1.4 million. Of this total, $1.2 million was related to settlement of our pre-existing franchise relationship with a business we acquired and $200,000 was related to the negotiated early termination of one of our franchises.

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During the nine months ended September 30, 2005, we recorded franchise settlement revenue of $3.0 million. Of this total, $1.9 million was related to early release of a franchise from our network and $800,000 was related to our acquisition of a franchise. We also recorded $300,000 in additional royalty revenue related to settlement of under-reported prior period royalties by the franchise that was early released from our network.

10. Stock-based Compensation

Effective January 1, 2006, we adopted SFAS No. 123(R), *Share-Based Payment*, utilizing the modified retrospective method. Prior to January 1, 2006, we accounted for stock-based compensation under the recognition and measurement provisions of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, as permitted by SFAS No. 123, *Accounting for Stock-Based Compensation*. SFAS No. 123(R) supersedes Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends SFAS No. 95, *Statement of Cash Flows*. SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options and shares purchased under our employee stock purchase plan, to be recognized in the income statement based on their fair values. We have restated the results for all prior periods to include compensation cost for all share-based payments based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123.

The following table sets forth the impact to our income before taxes, net income and basic and diluted earnings per common share for the three and nine months ended September 30, 2006 and 2005 of the adoption of SFAS No. 123(R) utilizing the modified retrospective method (in thousands, except per share amounts):

	Three months ended September 30,		**Nine months ended September 30,**	
	2006	**2005**	**2006**	**2005**
Impact on net income for all stock-based compensation:				
Stock option grants	$ (454)	$ (315)	$ (1,173)	$ (1,075)
Employee stock purchase plan withholdings	(141)	(77)	(357)	(286)
Cumulative effect of a change in estimate			483	
Correction of pro-forma disclosure compensation expense		(267)		(1,179)
Total impact on income before income taxes	(595)	(659)	(1047)	(2,540)
Provision for income taxes	177	153	269	534
Correction of pro-forma disclosure income tax benefit		58		339
Total impact on net income	$ (418)	$ (448)	$ (778)	$ (1,667)
Impact on net income per common share:				
Basic	$ (0.01)	$ (0.01)	$ (0.02)	$ (0.05)
Diluted	$ (0.01)	$ (0.01)	$ (0.02)	$ (0.05)

Prior to the adoption of SFAS No. 123(R), we presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the Statement of Cash Flows. SFAS No. 123(R) requires the cash flows resulting from the tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. Accordingly, we have reclassified the $2.0 million excess tax benefit as a financing cash inflow on the Condensed Consolidated Statement of Cash Flows for the nine months ended September 30, 2005.

We amortize the calculated fair value of our outstanding stock options straight-line over the vesting period of the options. The fair value of options granted under our stock option plan during the three and nine months ended September 30, 2006 and 2005 was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions:

	Three months ended September 30,		**Nine months ended September 30,**	
	2006	**2005**	**2006**	**2005**

Annual dividend yield per share	$ 0.08	$ 0.08	$ 0.08	$ 0.08
Expected volatility	30 %	30 %	28 %	32 %
Weighted average risk-free interest rate	4.92 %	4.08 %	5.14 %	3.77 %
Expected grant life (years)	4.6	4.0	4.6	4.0
Weighted average per share fair value of options granted	$ 3.58	$ 3.77	$ 3.58	$ 3.93

During the three and nine months ended September 30, 2006, we issued 135,207 and 410,025 shares of our common stock from the exercise of options granted through our stock incentive plan. In the quarter ended March 31, 2006, we issued 133,044 shares of our common stock to employees who participated in our employee stock purchase plan during 2005.

11. Recently Issued Accounting Pronouncement

In June 2006, the Financial Accounting Standards Board published Interpretation 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), which is an interpretation of Statement 109, *Accounting for Income Taxes.* FIN 48 provides guidance on how entities should evaluate and report on uncertain tax positions. This interpretation requires that realization of an uncertain income tax position must be more likely than not (i.e. greater than 50% likelihood of receiving a benefit) before it can be recognized in the financial statements. Further, this interpretation prescribes the benefit to be recorded in the financial statements at the amount most likely to be realized assuming a review by tax authorities having all relevant information and applying current conventions. This interpretation also clarifies the financial statement classification of tax-related penalties and interest and sets forth new disclosures regarding unrecognized tax benefits. This interpretation is effective for fiscal years beginning after December 15, 2006, and we will be required to adopt this interpretation in the first quarter of 2007. We are currently evaluating the requirements of FIN 48 to determine the effects it will have, if any, on our accounting for income taxes.

In September 2006, the Financial Accounting Standards Board issued SFAS No. 157, *Fair Value Measurements*, which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles and expands disclosures about fair value measurements. The provisions of SFAS No. 157 are effective for financial statements issued for fiscal years beginning after November 5, 2007. We will adopt the guidance contained in SFAS No. 157 at the beginning of our fiscal year ending December 31, 2008. We do not believe that adoption of the guidance contained in SFAS No. 157 will have a material affect on our results of operations or financial condition.

12. Quarterly Dividends

In May 2004, our Board of Directors authorized the adoption of a quarterly dividend policy. Each quarter, our Board of Directors will determine the dividend amount per share, if any. During each of the fiscal quarters beginning with the quarter ended June 30, 2004 through the quarter ended March 31, 2005, our board declared a dividend of $0.0133 per share. During each of the fiscal quarters beginning with the quarter ended June 30, 2005 our Board declared a $0.02 per share dividend. The $0.02 per share dividend in the quarter ended September 30, 2006 was paid August 28, 2006 to stockholders of record as of August 14, 2006.

13. Comprehensive Income

Net income was our only component of comprehensive income for the three and nine months ended September 30, 2006 and 2005.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

FORWARD LOOKING STATEMENTS

The following discussion should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2005. The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. Certain information included in this Quarterly Report on Form 10-Q and other materials filed or to be filed by us with the Securities and Exchange Commission (as well as information included in oral statements or other written statements made or to be made by us) contain statements that are or will be forward-looking, such as statements relating to acquisitions and other business development activities, future capital expenditures and the anticipated or potential effects of future regulation and competition. Such forward-looking information involves important risks and uncertainties that could significantly affect anticipated results in the future and, accordingly, such results may differ from those expressed in any forward-looking statements made by us, or on our behalf. These risks and uncertainties include, but are not limited to, uncertainties affecting our businesses and our franchisees relating to acquisitions and divestitures (including continuing obligations with respect to completed transactions), sales and renewals of franchises, government and regulatory policies (including federal, state and local efforts to reform the delivery of and payment for healthcare services), changes in average wholesale price (AWP) and other benchmarks used to establish pricing for prescription drugs, general economic conditions (including economic conditions affecting the healthcare industry in particular), the pricing and availability of equipment and services, technological developments and changes in the competitive environment in which we operate. For a more comprehensive description of risks applicable to our business, see Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2005. We do not undertake any obligation to release publicly any revisions to such forward-looking statements to reflect events or circumstances occurring after the date of this Annual Report or to reflect the occurrence of unanticipated events.

OVERVIEW

We provide specialty pharmacy services and infusion pharmacy and other related healthcare services to patients at home or at alternate sites such as infusion suites and physician s offices. We contract with managed care organizations and other third party payors who reimburse us for the services we provide to their subscriber members. Our services are provided through our national network of 57 company-owned and managed locations, our 54 franchise-owned pharmacies and our two company-owned, high-volume distribution facilities.

We have three service lines: specialty pharmacy services, infusion and related healthcare services, and other. Specialty pharmacy services involve the distribution of injectable and infused pharmaceuticals to treat a wide range of chronic health conditions. We purchase specialty pharmaceuticals from manufacturers and wholesale distributors, fill prescriptions provided by physicians, and label, package and deliver the pharmaceuticals to patients homes or physicians offices, either ourselves or through contract couriers. These pharmaceuticals may require refrigeration during shipping as well as special handling to prevent potency degradation. Depending on therapy, we may also administer the specialty pharmaceuticals to the patient at one of our ambulatory infusion centers. Patients receiving treatment are often provided special counseling and education regarding their condition and treatment program. Infusion and related healthcare services typically involve the intravenous administration of medications at the patient s home or other non-hospital sites such as one of our ambulatory infusion suites. Infusion pharmacy services treat a wide range of acute and chronic health conditions, including infections, dehydration, cancer, pain and nutritional deficiencies. All of our company-owned pharmacies provide infusion pharmacy services. Several of our company-owned pharmacies also provide home health nursing services, respiratory therapy services and home medical equipment sales and rentals. We also have one location that provides home hospice services. Other revenue consists of royalties, franchise settlements and other fees generated from our franchised pharmacy network and, for the quarter and nine months ended September 30, 2005, software licensing and support revenue generated by our subsidiary, Management by Information, Inc. (MBI). MBI was sold during the fourth quarter of 2005 and no software license and support revenue was recorded during the three and nine months ended September 30, 2006.

RECENT DEVELOPMENTS

Specialty Pharmacy Agreement with Blue Cross and Blue Shield of Michigan

On June 15, 2006, we signed a Specialty Pharmacy Agreement (the Agreement) with Blue Cross and Blue Shield of Michigan (BCBSM) and Blue Care Network of Michigan (BCN) to be their exclusive provider of specialty pharmacy mail order services. We expect this contract to materially increase our revenue in future periods. Under the Agreement, we will provide specialty pharmacy medications, ancillary products and focused therapy management to BCBSM and BCN members. The Agreement shall remain in force for an initial term ending September 30, 2009, with an automatic one year renewal beyond that date unless written notice of termination is given by BCBSM, BCN, or us. The

Agreement may be terminated by BCBSM or BCN, without cause, on ninety (90) days written notice. We began delivering services under this contract in October 2006. We have incurred certain incremental implementation expenses of approximately $350,000 during the quarter ended September 30, 2006 and anticipate incurring additional expenses in the quarter ending December 31, 2006.

Proposed Reductions to Average Wholesale Prices Published by First DataBank

The proposed settlement of a legal case involving First DataBank, the main publisher of average wholesale prices (AWP s), could potentially have a material adverse effect on our financial performance, results of operations and financial condition in future

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periods. The case New England Carpenters Health Benefits Fund, et al. v. First DataBank, et al., Civil Action No. 1:05-CV-11148-PBS (D. Mass.), is a civil class action case brought against First DataBank, alleging that the company colluded with a prescription drug wholesaler to artificially raise the average wholesale prices of various prescription drugs to increase pharmacy profits. As part of a proposed settlement in the case, First DataBank has agreed to reduce the reported AWP of over 8,000 specific pharmaceutical products by four percent. At this time the proposed settlement has received neither preliminary nor final court approval. We cannot predict the outcome of this case, or, if the settlement is approved, the precise timing of any of the proposed AWP changes.

Our contracts with managed care organizations and other commercial payers generally use AWP as a benchmark for establishing pricing for the drugs we provide to patients. In the absence of any mitigating action on our part, the proposed reduction in First DataBank s AWP could have a material adverse effect on the margin we earn on the home infusion and specialty drugs we sell, particularly those contracts that identify AWP published by First DataBank as the sole resource for pricing under that contract. However, most of our contracts with health insurers, third party administrators, self-insured companies and other third party payors contain terms that we believe will enable us to mitigate the adverse effect of this proposed reduction in First DataBank s reported AWP. Further, we are party to a number of contracts under which drug reimbursement is based on proprietary fee schedules which may or may not be referenced to AWP, limiting the impact of reductions to the AWPs published by First DataBank. If the proposed settlement should become final we would exercise our contractual rights so as to mitigate the adverse impact to us.

SUMMARIZED INFORMATION ABOUT REVENUE AND GROSS PROFIT

Summarized information about revenues and gross profit for each of our service lines is provided in the following table (amounts in thousands):

REVENUE

	Three months ended September 30,				**Nine months ended September 30,**			
	2006		**2005**		**2006**		**2005**	
	Revenue	**% of total**	**Revenue**	**% of total**	**Revenue**	**% of total**	**Revenue**	**% of total**
Specialty pharmacy services	$ 84,640	55.4 %	$ 67,239	55.2 %	$ 269,873	58.0 %	$ 209,736	57.9 %
Infusion and related healthcare services	66,657	43.6 %	51,178	42.0 %	188,292	40.5 %	141,716	39.1 %
Other	1,592	1.0 %	3,476	2.8 %	7,023	1.5 %	10,687	3.0 %
Total revenue	$ 152,889	100.0 %	$ 121,893	100.0 %	$ 465,188	100.0 %	$ 362,139	100.0 %

GROSS PROFIT

	Three months ended September 30,				**Nine months ended September 30,**			
	2006		**2005**		**2006**		**2005**	
	Gross Profit	**Gross profit margin**	**Gross Profit**	**Gross profit margin**	**Gross Profit**	**Gross profit margin**	**Gross Profit**	**Gross profit margin**
Specialty pharmacy services	$ 13,507	16.0 %	$ 11,507	17.1 %	$ 40,823	15.1 %	$ 33,367	15.9 %
Infusion and related healthcare services	29,361	44.0 %	21,623	42.3 %	83,315	44.2 %	60,892	43.0 %
Total gross profit, excluding other revenue	42,868	28.3 %	33,130	28.0 %	124,138	27.1 %	94,259	26.8 %
Other	1,592	100.0 %	3,365	96.8 %	7,023	100.0 %	10,375	97.1 %
Total gross profit	$ 44,460	29.1 %	$ 36,495	29.9 %	$ 131,161	28.2 %	$ 104,634	28.9 %

We derive most of our revenue from contracts with third party payors, such as managed care organizations, insurance companies, self-insured employers and Medicare and Medicaid programs. Our principal managed care contract is with Blue Cross and Blue Shield of Florida for the provision of specialty pharmacy services and infusion pharmacy services to their members. Approximately 14% of our revenue from continuing operations for the quarter ended September 30, 2006 and 13% for the nine months ended September 30, 2006 was generated from this contract compared to 14% for the corresponding prior year periods. As of September 30, 2006 and December 31, 2005, respectively, 8% and 9% of our accounts receivable was due from Blue Cross and Blue

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Shield of Florida. The contract may be terminated by either party on 90 days notice and, unless terminated, renews each September for an additional one-year term. Currently, no other single managed care payor represents more than 10% of our revenue.

We also provide services that are reimbursable through government healthcare programs such as Medicare and state Medicaid programs. For the three and nine months ended September 30, 2006, approximately 21% and 20% of our revenue, respectively, was generated from government healthcare programs compared to 15% and 17% in the corresponding prior year periods. The increase in percentage in the current year periods was primarily due to the impact of our 2006 acquisitions. As of September 30, 2006 and December 31, 2005, respectively, 20% and 22% of our total accounts receivable was due from government healthcare programs.

RESULTS OF OPERATIONS

The following table shows the results of our operations for the three and nine months ended September 30, 2006 and 2005, expressed in amounts and percentages of revenue (amounts in thousands):

	Three months ended September 30,				**Nine months ended September 30,**			
	2006		**2005**		**2006**		**2005**	
	Amount	**% of Revenue**	**Amount**	**% of Revenue**	**Amount**	**% of Revenue**	**Amount**	**% of Revenue**
Revenue:								
Specialty pharmacy services	$ 84,640	55.4 %	$ 67,239	55.2 %	$ 269,873	58.0 %	$ 209,736	57.9 %
Infusion and related healthcare services	66,657	43.6 %	51,178	42.0 %	188,292	40.5 %	141,716	39.1 %
Other	1,592	1.0 %	3,476	2.9 %	7,023	1.5 %	10,687	3.0 %
Total revenue	152,889	100.0 %	121,893	100.0 %	465,188	100.0 %	362,139	100.0 %
Cost of revenue:								
Cost of goods sold	90,709	59.3 %	71,680	58.8 %	282,721	60.8 %	219,122	60.5 %
Cost of services provided	17,720	11.6 %	13,718	11.3 %	51,306	11.0 %	38,383	10.6 %
Total cost of revenue	108,429	70.9 %	85,398	70.1 %	334,027	71.8 %	257,505	71.1 %
Gross profit	44,460	29.1 %	36,495	29.9 %	131,161	28.2 %	104,634	28.9 %
Selling, general and administrative expenses	30,627	20.1 %	25,318	20.8 %	90,846	19.5 %	72,165	19.9 %
Provision for doubtful accounts	3,542	2.3 %	2,248	1.8 %	10,461	2.3 %	6,727	1.9 %
Depreciation and amortization	1,227	0.8 %	915	0.8 %	3,597	0.8 %	2,668	0.7 %
Total operating expenses	35,396	23.2 %	28,481	23.4 %	104,904	22.6 %	81,560	22.5 %
Operating income	9,064	5.9 %	8,014	6.6 %	26,257	5.6 %	23,074	6.4 %
Interest income (expense), net	(261)	(0.2)%	108	0.1 %	(470)	(0.1)%	258	%
Other expense, net	(260)	(0.1)%	(73)	(0.1)%	(688)	(0.1)%	(20)	%

Basic

54.7

53.7

1.0

1.9
%

54.7

54.2

0.5

0.9
%
Diluted
55.9

54.8

1.1

2.0
%

56.0

55.1

0.9

1.5
%

NM - Not meaningful

Basic and diluted income from continuing operations per common share increased for the three- and six- month periods as compared to 2013. The increases were directly attributable to the increases in income from continuing operations for the periods. Basic weighted average common shares outstanding increased due to the issuance of additional shares for employee stock plans and the issuance of 1,032,493 shares in connection with the acquisition of the Manner Business. The impact of these issuances was partially offset by the repurchase of 220,794 and 225,202 shares during the first half of 2014 and the second half of 2013, respectively, as part of the repurchase program. Diluted weighted average common shares outstanding increased primarily as a result of the increase in basic weighted average common shares outstanding and was also impacted by an increase in the dilutive effect of potentially issuable shares given an increase in the Company's stock price.

Financial Performance by Business Segment

Industrial

	Three months ended June 30,				Six months ended June 30,			
(in millions)	2014	2013	Change		2014	2013	Change	
Sales	$212.8	$170.6	$42.2	24.7 %	$416.7	$336.1	$80.6	24.0 %
Operating profit	28.8	20.9	7.8	37.5 %	48.1	35.5	12.6	35.5 %
Operating margin	13.5 %	12.3 %			11.6 %	10.6 %		

Sales at Industrial were $212.8 million in the second quarter of 2014, a $42.2 million increase from the second quarter of 2013. The acquisition of the Männer Business in 2013 provided $35.7 million of sales. Organic sales increased by $3.8 million, or 2.2%, during the 2014 period, primarily due to favorable light vehicle and tool and die end-markets. Sales benefited from foreign currency translation which increased sales by approximately $2.7 million as the U.S. dollar weakened against foreign currencies. In the first half of 2014, this segment reported sales of $416.7 million, a 24.0% increase from the first half of 2013. The Männer Business contributed $73.7 million of sales. Organic sales increased by $3.4 million, or 1.0%, during the 2014 period. The impact of foreign currency translation increased sales by approximately $3.5 million.

Operating profit in the second quarter of 2014 at Industrial was $28.8 million, an increase of $7.8 million from the second quarter of 2013. Operating profit benefited primarily from the profit contributions of the Männer Business and increased organic sales, partially offset by unfavorable pricing, $1.9 million of short-term purchase accounting adjustments related to the acquisition and $2.3 million of pre-tax restructuring charges related to the Closure of the Saline operations. Operating profit in the first half of 2014 was $48.1 million, an increase of $12.6 million from the first half of 2013. The increase was also driven by the profit contribution of the Männer Business and increased organic sales, partially offset by $6.8 million of short-term purchase accounting adjustments related to the acquisition and $5.1 million of pre-tax restructuring charges related to the Closure of the Saline operations. Operating income during the first quarter of 2013 included CEO transition costs of $6.6 million that were allocated to the Industrial segment.

Outlook: In the Industrial manufacturing businesses, management is focused on generating organic sales growth through the introduction of new products and by leveraging the benefits of the diversified products and industrial end-markets in which its businesses have a global presence. The Company also remains focused on sales growth through acquisition and expanding geographic reach. Synventive, acquired in 2012, adds innovative products and services and has expanded the Company's global marketplace presence. The Männer Business, acquired in 2013, further provides additional differentiated products and services through the manufacture of high precision molds, valve gate hot runner systems, and system solutions for the medical/pharmaceutical, packaging, and personal care/health care industries. Our ability to generate sales growth is subject to economic conditions in the global markets served by all of our businesses. Order activity in certain end-markets may provide extended sales growth. Strategic investments in new technologies, manufacturing processes and product development are expected to provide incremental benefits in the long term.

Operating profit is largely dependent on the sales volumes and mix within all businesses of the segment. Management continues to focus on improving profitability through leveraging organic sales growth, acquisitions, pricing initiatives, and productivity and process improvements. Costs associated with increases in new product and process introductions, strategic investments and the integration of acquisitions may negatively impact operating profit.

Aerospace

	Three months ended June 30,				Six months ended June 30,			
(in millions)	2014	2013	Change		2014	2013	Change	
Sales	$109.3	$96.8	$12.5	12.9 %	$217.5	$194.9	$22.6	11.6 %
Operating profit	16.6	15.2	1.4	9.1 %	32.4	25.6	6.8	26.6 %
Operating margin	15.2 %	15.7 %			14.9 %	13.1 %		

The Aerospace segment reported sales of $109.3 million in the second quarter of 2014, a 12.9% increase from the second quarter of 2013. Sales increases within the original equipment manufacturing ("OEM") business were partially offset by a decrease within the aftermarket business. Within aftermarket, a sales increase within the repair and overhaul business ("MRO") was more then offset by lower sales in the spare parts business. Increased sales within the OEM business reflected continued strength in demand for new engines, driven by increased commercial aircraft production. In the first half of 2014, this segment reported sales of $217.5 million, a 11.6% increase from the first half of 2013, primarily as a result of increased sales in the OEM manufacturing and the aftermarket repair and overhaul businesses, partially offset by lower sales within the spare parts business.

Operating profit at Aerospace in the second quarter of 2014 increased 9.1% from the second quarter of 2013 to $16.6 million, driven primarily by the profit contributions of increased sales in the OEM business, partially offset by lower profits in the spare parts business and increased employee related costs, primarily due to incentive compensation as a result of the level of the Company's pre-established annual performance targets. Operating margin decreased from 15.7% in the 2013 period to 15.2% in the 2014 period. Operating profit in the first half of 2014 increased 26.6% from

the first half of 2013 to $32.4 million, driven primarily by the profit contributions of increased sales in the OEM business, partially offset by lower profits in the spare parts business and increased employee related costs, primarily due to incentive compensation. Operating income during the first quarter of 2013 included CEO transition costs of $3.9 million that were allocated to the Aerospace segment.

Outlook: Sales in the Aerospace OEM business are based on the general state of the aerospace market driven by the worldwide economy and are supported by its order backlog through participation in certain strategic commercial and military engine and airframe programs. Backlog in this business was $521.2 million at June 30, 2014, of which approximately 64% is expected to be shipped in the next 12 months. The Aerospace OEM business may be impacted by adjustments of customer inventory levels, commodity availability and pricing, changes in the content levels on certain platforms, including insourcing, changes in production schedules of specific engine and airframe programs, as well as the pursuit of new programs. Sales levels in the

Aerospace aftermarket business are expected to be impacted by fluctuations in end-market demand, adjustments of customer inventory levels and changes in customer sourcing, such as deferred or limited maintenance activity during engine shop visits and the use of used material during the engine repair and overhaul process. Management continues to believe its Aerospace aftermarket business is competitively positioned based on well-established long-term customer relationships, including maintenance and repair contracts in the repair and overhaul business and long-term RSPs and CRPs, expanded capabilities and current capacity levels.

Management is focused on growing operating profit at Aerospace primarily through leveraging organic sales growth, productivity initiatives, new product and process introductions and continued cost management. Operating profit is expected to be affected by the impact of changes in sales volume, mix and pricing, particularly as they relate to the highly profitable aftermarket RSP spare parts business, and investments made in each of its businesses. Management actively manages commodity price increases through pricing actions and other productivity initiatives. Costs associated with increases in new product and process introductions and the physical transfer of work to lower cost manufacturing regions may negatively impact operating profit.

LIQUIDITY AND CAPITAL RESOURCES

Management assesses the Company's liquidity in terms of its overall ability to generate cash to fund its operating and investing activities. Of particular importance in the management of liquidity are cash flows generated from operating activities, capital expenditure levels, dividends, capital stock transactions, effective utilization of surplus cash positions overseas and adequate lines of credit.

The Company's ability to generate cash from operations in excess of its internal operating needs is one of its financial strengths. Management continues to focus on cash flow and working capital management, and anticipates that operating activities in 2014 will generate adequate cash. The Company closely monitors its cash generation, usage and preservation including the management of working capital to generate cash.

As of March 20, 2014, the 3.375% Convertible Notes ("Notes") were subject to redemption at their par value at any time, at the option of the Company. The Notes are also eligible for conversion upon meeting certain conditions as provided in the indenture agreement including the closing stock price for 20 of the last 30 trading days in the preceding quarter being greater than or equal to 130% of the conversion price (the "conversion price eligibility requirement"). The eligibility for conversion is determined quarterly. During the first quarter of 2014, the Notes were not eligible for conversion. During the second quarter of 2014, the Notes were eligible for conversion due to meeting this conversion price eligibility requirement. On June 16, 2014, $0.2 million of the Notes (par value) were surrendered for conversion. On June 24, 2014, the Company exercised its right to redeem the remaining $55.4 million principal amount of the Notes, effective July 31, 2014. As such, the balance of these Notes and the related deferred tax balances are classified as current in the accompanying balance sheet as of June 30, 2014. The Company has elected to pay cash to holders of the Notes surrendered for conversion, including the value of any residual value shares of common stock that might be payable to the holders electing to convert their Notes into an equivalent share value. Under the terms of the indenture, the conversion value will be measured based upon a 20-day valuation period of the Company's stock price. An average stock price in excess of $28.31 during the valuation period would require a cash payment in excess of $55.6 million. For each $0.50 that the average stock price during the valuation period exceeds $28.31, the cash payment in excess of par would be approximately $1.0 million. As of July 16, holders of $32.9 million (par value) of Notes have surrendered their Notes for conversion. The Company intends to use borrowings under its Amended Credit facility to finance the redemption or conversion of the Notes.

In September 2013, the Company entered into a second amendment to its fifth amended and restated revolving credit agreement (the "Amended Credit Agreement") and retained Bank of America, N.A. as Administrative Agent for the lenders. The Amended Credit Agreement extends the maturity date of the debt facility by two years from September

2016 to September 2018 and includes an option to extend the maturity date for an additional year, subject to certain conditions. The Amended Credit Agreement added a new foreign subsidiary borrower in Germany, Barnes Group Acquisition GmbH, maintained the borrowing availability of the Company at $750.0 million and added an accordion feature to increase this amount to $1,000.0 million. The borrowing availability of $750.0 million, pursuant to the terms of the Amended Credit Agreement, allows for Euro-denominated borrowings equivalent to $500.0 million. Euro-denominated borrowings are subject to foreign currency translation adjustments that are included within accumulated other non-owner changes to equity. The Company may exercise the accordion feature upon request to the Administrative Agent as long as an event of default has not occurred or is continuing. Borrowings under the Amended Credit Agreement continue to bear interest at LIBOR plus a spread ranging from 1.10% to 1.70%. The Company paid fees and expenses of $1.3 million in conjunction with executing the Amended Credit Agreement; such fees will be deferred and amortized into interest expense on the accompanying Consolidated Statements of Income through its maturity.

The Company's borrowing capacity remains limited by various debt covenants in the Amended Credit Agreement, certain of which were amended in September 2013. The Amended Credit Agreement requires the Company to maintain a ratio of Consolidated Senior Debt, as defined in the Amended Credit Agreement, to Consolidated EBITDA, as defined, of not more than 3.25 times at the end of each fiscal quarter ("Senior Debt Ratio"), a ratio of Consolidated Total Debt, as defined, to Consolidated EBITDA of not more than 4.00 times at the end of each fiscal quarter, and a ratio of Consolidated EBITDA to Consolidated Cash Interest Expense, as defined, of not less than 4.25 times at the end of each fiscal quarter. The Amended Credit Agreement also provides that in connection with certain permitted acquisitions with aggregate consideration in excess of $150.0 million, the Consolidated Senior Debt to EBITDA ratio and the Consolidated Total Debt to EBITDA ratio are permitted to increase to 3.50 times and 4.25 times, respectively, for a period of the four fiscal quarters ending after the closing of the acquisition. In October 2013, the Company completed the acquisition of the Männer Business, a permitted transaction pursuant to the terms of the Amended Credit Agreement. At June 30, 2014, the Company was in compliance with all financial covenants under the Amended Credit Agreement. The Company's most restrictive financial covenant is the Senior Debt Ratio which requires the Company to maintain a ratio of Consolidated Senior Debt to Consolidated EBITDA of not more than 3.50 times at June 30, 2014. The actual ratio at June 30, 2014 was 2.08 times.

Operating cash flow may be supplemented with external borrowings to meet near-term business expansion needs and the Company's current financial commitments. The Company has assessed its credit facilities in conjunction with the September 27, 2013 refinancing and currently expects that its bank syndicate, comprised of 17 banks, will continue to support its Amended Credit Agreement which matures in September 2018. At June 30, 2014, the Company had $251.2 million unused and available for borrowings under its $750.0 million Amended Credit Facility, subject to covenants in the Company's debt agreements. At June 30, 2014, additional borrowings of $482.8 million of Total Debt and $352.5 million of Senior Debt would have been allowed under the financial covenants. The Company intends to use borrowings under its Amended Credit Facility to finance the redemption or conversion of the Notes. Additional funds may be used, as needed, to support the Company's ongoing growth initiatives. The Company believes its credit facilities and access to capital markets, coupled with cash generated from operations, are adequate for its anticipated future requirements.

In 2012, the Company entered into five-year interest rate swap agreements transacted with three banks which together convert the interest on the first $100.0 million of borrowings under the Company’s Credit Agreement from a variable rate plus the borrowing spread to a fixed rate of 1.03% plus the borrowing spread for the purpose of mitigating its exposure to variable interest rates.

Any future acquisitions are expected to be financed through internal cash, borrowings and equity, or a combination thereof. Additionally, we may from time to time seek to retire or repurchase our outstanding debt through cash purchases and/or exchanges for equity securities, in open market purchases, under a Rule 10b5-1 trading plan, privately negotiated transactions or otherwise. Such repurchases or exchanges, if any, will depend on prevailing market conditions, our liquidity requirements, contractual restrictions and other factors.

Cash Flow

	Six months ended June 30,		
(in millions)	2014	2013	Change
Operating activities	$64.9	$65.5	$(0.6)
Investing activities	(68.4)	519.0	(587.4)
Financing activities	(5.1)	(471.3)	466.2
Exchange rate effect	(0.1)	(2.2)	2.1
(Decrease)/increase in cash	$(8.6)	$111.0	$(119.7)

Operating activities provided $64.9 million in cash in the first six months of 2014 and $65.5 million in the first six months of 2013. In the 2014 period, operating cash flows were positively impacted by improved operating performance, however this benefit was offset by an increase in cash used for working capital that was generated primarily by higher levels of sales growth relative to 2013. Higher levels of sales growth in 2014 resulted in an increase in receivables which generated a higher use of cash than in the comparable period.

Investing activities in the 2014 period included a cash outflow of $41.0 million related to the CRP. See Note 6 of the Consolidated Financial Statements. Net cash proceeds of $541.0 million from the sale of BDNA are included in investing activities for the 2013 period. Investing activities in the 2014 and 2013 periods also included capital expenditures of $25.8 million and $20.4 million, respectively. The Company expects capital spending in 2014 to approximate $60 million.

Financing activities in the first six months of 2014 included a net increase in borrowings of $23.1 million compared to a net decrease in borrowings of $403.4 million in the comparable 2013 period. The decrease in the 2013 period reflects the utilization of proceeds from the BDNA sale to reduce borrowings. Financing activities in the 2014 period included the payment of an assumed liability to the seller in connection with the acquisition of the Männer Business. Proceeds from the issuance of common stock were $9.4 million and $3.8 million in the 2014 and 2013 periods, respectively. During the six months ended June 30, 2014 and June 30, 2013, the Company repurchased 0.2 million and 2.1 million shares, respectively, of the Company's stock. The cost of the repurchases was $8.4 million in the 2014 period and $61.4 million in the 2013 period. Total cash used to pay dividends was $11.9 million in the 2014 period compared to $10.7 million in the 2013 period, primarily due to a dividend rate increase that was effective during the 2014 period.

At June 30, 2014, the Company held $62.2 million in cash and cash equivalents, the majority of which was held by foreign subsidiaries. These amounts have no material regulatory or contractual restrictions and are expected to primarily fund international investments. During the second quarter of 2014, the Company repatriated $12.5 million of current year foreign earnings to the U.S.

The Company maintains borrowing facilities with banks to supplement internal cash generation. At June 30, 2014, $498.8 million was borrowed at an interest rate of 1.47% under the Company's amended $750.0 million Credit Facility which matures in September 2018. In addition, as of June 30, 2014, the Company had $10.5 million in borrowings under short-term bank credit lines. At June 30, 2014, the Company's total borrowings were comprised of approximately 28% fixed rate debt and approximately 72% variable rate debt. The interest payments on approximately $100.0 million of the variable rate interest debt have been converted into payment of fixed interest plus the borrowing spread under the terms of the respective interest rate swaps that were executed in April 2012.

Debt Covenants

Borrowing capacity is limited by various debt covenants in the Company's debt agreements. As of June 30, 2014, the most restrictive financial covenant is included within the Amended Credit Agreement and requires the Company to maintain a maximum ratio of Consolidated Senior Debt, as defined, to Consolidated EBITDA, as defined, of not more than 3.25 times for the four fiscal quarters then ending. The Company's Amended Credit Agreement also contains other financial covenants that require the maintenance of a certain other debt ratio, Consolidated Total Debt, as defined, to Consolidated EBITDA of not more than 4.00 times and a certain interest coverage ratio, Consolidated EBITDA to Consolidated Cash Interest Expense, as defined, of at least 4.25 times, at June 30, 2014. The Amended Credit Agreement also provides that in connection with certain permitted acquisitions with aggregate consideration in excess of $150.0 million, the Consolidated Senior Debt to EBITDA ratio and the Consolidated Total Debt to EBITDA ratio are permitted to increase to 3.50 times and 4.25 times, respectively, for a period of the four fiscal quarters ending after the closing of the acquisition. On October 31, 2013, the Company completed the acquisition of the Männer Business, a permitted transaction pursuant to the terms of the Amended Credit Agreement. Following is a reconciliation of Consolidated EBITDA to the Company's net income (in millions):

	Four fiscal quarters ended June 30, 2014
Net income	$100.7
Add back:	
Interest expense	11.6
Income taxes	28.2
Depreciation and amortization	76.5
Adjustment for non-cash stock based compensation	7.4
Amortization of Männer acquisition inventory step-up	7.2
Due diligence and transaction expenses	1.5
Adjustment for acquired businesses	12.4
Restructuring charges	3.4
Other adjustments	(0.9)
Consolidated EBITDA, as defined	$247.9
Consolidated Senior Debt, as defined, as of June 30, 2014	$515.3
Ratio of Consolidated Senior Debt to Consolidated EBITDA	2.08
Maximum	3.50
Consolidated Total Debt, as defined, as of June 30, 2014	$570.9
Ratio of Consolidated Total Debt to Consolidated EBITDA	2.30
Maximum	4.25
Consolidated Cash Interest Expense, as defined, as of June 30, 2014	$10.7
Ratio of Consolidated EBITDA to Consolidated Cash Interest Expense	23.20
Minimum	4.25

The Amended Credit Agreement allows for certain adjustments within the calculation of the financial covenants. The adjustment for acquired businesses reflects the unaudited pre-acquisition operations of the Männer business for the four-month period ended October 31, 2013. The restructuring charges represent charges recorded in the first six months of 2014 related to the closure of production operations at the Associated Spring facility located in Saline, Michigan. Other adjustments primarily consist of net gains on the sale of assets. The Company's financial covenants are measured as of the end of each fiscal quarter. At June 30, 2014, additional borrowings of $482.8 million of Total Debt and $352.5 million of Senior Debt would have been allowed under the covenants. Senior Debt includes primarily the borrowings under the Credit Facility and the borrowings under lines of credit. The Company's unused credit facilities at June 30, 2014 were $251.2 million.

OTHER MATTERS

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant accounting policies are disclosed in Note 1 of the Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2013. The most significant areas involving management judgments and estimates are described in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the year ended December 31, 2013. There have been no material changes to such judgments and estimates. Actual results could differ from those estimates.

Business Acquisitions and Goodwill: Goodwill is subject to impairment testing annually or earlier testing if an event or change in circumstances indicates that the fair value of a reporting unit has been reduced below its carrying value. Management completes their annual impairment assessment during the second quarter of each year. The Company

utilizes the option to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test in accordance with the applicable accounting standards. Under the qualitative assessment, management considers relevant events and circumstances including but not limited to macroeconomic conditions, industry and market considerations, overall unit performance and events directly affecting a unit. If the Company determines that the two-step

quantitative impairment test is required, management estimates the fair value of the reporting unit primarily using the income approach, which reflects management's cash flow projections, and also evaluates the fair value using the market approach. Inherent in management's development of cash flow projections are assumptions and estimates, including those related to future earnings and growth and the weighted average cost of capital. Based on this second quarter assessment, the estimated fair values of the Synventive and Männer reporting units, which were acquired in August 2012 and October 2013, respectively, exceeded their carrying values and the estimated fair value of the remaining reporting units significantly exceeded their carrying values. There was no goodwill impairment at any reporting units through June 30, 2014. Many of the factors used in assessing fair value are outside the control of management, and these assumptions and estimates can change in future periods as a result of both Company-specific and overall economic conditions. Management's quantitative assessment during the second quarter of 2014 included a review of the potential impacts of current and projected market conditions from a market participant's perspective on reporting units' projected cash flows, growth rates and cost of capital to assess the likelihood of whether the fair value would be less than the carrying value. While management expects future operating improvements at certain reporting units to result from improving end-market conditions, new product introductions and further market penetration, there can be no assurance that such expectations will be met or that the fair value of the reporting units will continue to exceed their carrying values. If the fair values were to fall below the carrying values, a non-cash impairment charge to income from operations could result.

Recent Accounting Changes

In April 2014, the Financial Accounting Standards Board (FASB) amended its guidance related to reporting discontinued operations. The amended guidance changes the criteria for determining which disposals can be presented as discontinued operations and modifies the related disclosure requirements. Under the amended guidance, a disposal of a component of an entity or a group of components of an entity is required to be reported in discontinued operations if the disposal represents a strategic shift that has (or will have) a major effect on an entity's operations and financial results and is disposed of or classified as held for sale. The guidance also requires several new disclosures. The guidance applies prospectively to new disposals and new classifications of disposal groups as held for sale after the effective date and is effective for annual and interim periods beginning after December 15, 2014, with early adoption permitted. The Company is evaluating this guidance and will apply the guidance in the event that the Company has a future disposal that qualifies as a discontinued operation or is classified as held for sale.
In May 2014, the FASB amended its guidance related to revenue recognition. The amended guidance establishes a single comprehensive model for companies to use in accounting for revenue arising from contracts with customers and will supersede most of the existing revenue recognition guidance, including industry-specific guidance. The amended guidance clarifies that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In applying the amended guidance, an entity will (1) identify the contract(s) with a customer; (2) identify the performance obligations in the contract; (3) determine the transaction price; (4) allocate the transaction price to the contract's performance obligations; and (5) recognize revenue when (or as) the entity satisfies a performance obligation. The amended guidance applies to all contracts with customers except those that are within the scope of other topics in the FASB Accounting Standards Codification. The amended guidance is effective for annual reporting periods (including interim periods within those periods) beginning after December 15, 2016 for public companies. Early adoption is not permitted. Entities have the option of using either a full retrospective or modified approach to the amended guidance. The Company is evaluating this guidance and has not determined the impact that it may have on its financial statements nor decided upon the method of adoption.
EBITDA

EBITDA for the first six months of 2014 was $122.0 million compared to $409.2 million in the first six months of 2013. EBITDA is a measurement not in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The Company defines EBITDA as net income plus interest expense, income taxes and

depreciation and amortization which the Company incurs in the normal course of business. The Company does not intend EBITDA to represent cash flows from operations as defined by GAAP, and the reader should not consider it as an alternative to net income, net cash provided by operating activities or any other items calculated in accordance with GAAP, or as an indicator of the Company's operating performance. The Company's definition of EBITDA may not be comparable with EBITDA as defined by other companies. Accordingly, the measurement has limitations depending on its use. The Company believes EBITDA is commonly used by financial analysts and others in the industries in which the Company operates and, thus, provides useful information to investors.

Following is a reconciliation of EBITDA to the Company's net income (in millions):

	Six months ended June 30,	
	2014	2013
Net income	$53.0	$222.8
Add back:		
Interest expense	6.1	7.6
Income taxes	20.4	147.7
Depreciation and amortization	42.5	31.1
EBITDA (1)	$122.0	$409.2

(1) EBITDA of $409.2 million in 2013 includes a pre-tax gain of $313.5 million related to the sale of BDNA.

FORWARD-LOOKING STATEMENTS

Certain of the statements in this quarterly report contain forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements often address our expected future operating and financial performance and financial condition, and often contain words such as "anticipate," "believe," "expect," "plan," "strategy," "estimate," "project," and similar terms. These forward-looking statements do not constitute guarantees of future performance and are subject to a variety of risks and uncertainties that may cause actual results to differ materially from those expressed in the forward-looking statements. These include, among others: difficulty maintaining relationships with employees, including unionized employees, customers, distributors, suppliers, business partners or governmental entities; potential strikes or work stoppages; difficulties leveraging market opportunities; changes in market demand for our products and services; rapid technological and market change; the ability to protect intellectual property rights; introduction or development of new products or transfer of work; higher risks in international operations and markets; the impact of intense competition; and other risks and uncertainties described in documents filed with or furnished to the Securities and Exchange Commission ("SEC") by the Company, including, among others, those in the Management's Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors sections of the Company's filings. The risks and uncertainties described in our periodic filings with the SEC include, among others, uncertainties relating to conditions in financial markets; currency fluctuations and foreign currency exposure; future financial performance of the industries or customers that we serve; our dependence upon revenues and earnings from a small number of significant customers; a major loss of customers; inability to realize expected sales or profits from existing backlog due to a range of factors, including insourcing decisions, material changes, production schedules and volumes of specific programs; the impact of government budget and funding decisions; changes in raw material or product prices and availability; integration of acquired businesses including the Männer business; restructuring costs or savings including those related to the closure of production operations at the Company’s facility in Saline, Michigan; the continuing impact of strategic actions, including acquisitions, divestitures, restructurings, or strategic business realignments, and our ability to achieve the financial and operational targets set in connection with any such actions; the outcome of pending and future legal, governmental, or regulatory proceedings and contingencies and uninsured claims; future repurchases of common stock; future levels of indebtedness; and numerous other matters of a global, regional or national scale, including those of a political, economic, business, competitive, environmental, regulatory and public health nature. The Company assumes no obligation to update our forward-looking statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

For discussion of the Company’s exposure to market risk, refer to the Company’s Annual Report on Form 10-K for the year ended December 31, 2013.

Item 4. Controls and Procedures

Management, including the Company's President and Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based upon, and as of the date of, our evaluation, the President and Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were effective, in all material respects and designed to provide reasonable assurance that information required to be disclosed in the reports the Company files and submits under the Securities Exchange Act of 1934, as amended, is (i) recorded, processed, summarized and reported as and when required and (ii) is accumulated and communicated to the Company's management, including our President and Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There has been no change in our internal control over financial reporting during the Company's second fiscal quarter of 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

On April 16, 2013, the United States Tax Court rendered an unfavorable decision in the matter Barnes Group Inc. and Subsidiaries v. Commissioner of Internal Revenue ("Tax Court Decision"). The Tax Court rejected the Company's objections and imposed penalties. The case involved IRS proposed adjustments of approximately $16.4 million, plus a 20% penalty and interest for the tax years 1998, 2000 and 2001.

The case arose out of an Internal Revenue Service ("IRS") audit for the tax years 2000 through 2002. The adjustment relates to the federal taxation of foreign income of certain foreign subsidiaries. The Company filed an administrative protest of these adjustments. In the third quarter of 2009, the Company was informed that its protest was denied and a tax assessment was received from the Appeals Office of the IRS. Subsequently, in November 2009, the Company filed a petition against the IRS in the United States Tax Court, contesting the tax assessment. A trial was held and all briefs were filed in 2012. In April 2013 the Tax Court Decision was then issued rendering an unfavorable decision against the Company and imposing penalties. As a result of the unfavorable Tax Court Decision, the Company recorded an additional tax charge during 2013 for $16.4 million.

In November 2013, the Company made a cash payment of approximately $12.7 million related to tax, interest and penalties and utilized a portion of its net operating losses. The Company also submitted a notice of appeal of the Tax Court Decision to the United States Court of Appeals for the Second Circuit. The Company filed its opening brief with the United States Court of Appeals for the Second Circuit on February 13, 2014. During the second quarter of 2014, the parties filed additional briefs. The Company does not expect a decision until 2015.

In addition, we are subject to litigation from time to time in the ordinary course of business and various other suits, proceedings and claims are pending against us and our subsidiaries. While it is not possible to determine the ultimate disposition of each of these proceedings and whether they will be resolved consistent with our beliefs, we expect that the outcome of these proceedings, individually or in the aggregate, will not have a material adverse effect on our consolidated financial position, cash flows or results of operations.

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

(c) Issuer Purchases of Equity Securities

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid Per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs[1]
April 1-30, 2014	679	$38.31	—	2,428,509
May 1-31, 2014	6,097	$38.11	—	2,428,509
June 1-30, 2014	2,183	$38.63	—	2,428,509

Total	8,959	(2)	$38.25	—

(1) The Program was publicly announced on October 20, 2011 (the "2011 Program") authorizing repurchase of up to 5.0 million shares of common stock. At December 31, 2012, 3.8 million shares of common stock had not been purchased under the 2011 Program. On February 21, 2013, the Board of Directors of the Company increased the number of shares authorized for repurchase under the 2011 Program by 1.2 million shares of common stock. The 2011 Program permits open market purchases, purchases under a Rule 10b5-1 trading plan and privately negotiated transactions.

(2) All acquisitions of equity securities during the second quarter of 2014 were the result of the operation of the terms of the Company's stockholder-approved equity compensation plans and the terms of the equity rights granted pursuant to

those plans to pay for the related income tax upon issuance of shares. The purchase price of a share of stock used for tax withholding is the market price on the date of issuance.

Item 6. Exhibits

(a) Exhibits

Exhibit 10.1	2014 Barnes Group Inc. Stock and Incentive Award Plan.
Exhibit 10.2	Form of Barnes Group Inc. Stock and Incentive Award Plan Restricted Stock Unit Summary of Grant and Restricted Stock Unit Agreement for Directors dated May 9, 2014 (for non-management directors).
Exhibit 10.3	Form of Barnes Group Inc. Stock and Incentive Award Plan Restricted Stock Unit Summary of Grant for Employees and Restricted Stock Unit Agreement dated May 9, 2014.
Exhibit 10.4	Form of Barnes Group Inc. Stock and Incentive Award Plan Stock Option Summary of Grant and Stock Option Agreement for Employees in Grade 21 and up dated May 9, 2014.
Exhibit 10.5	Form of Barnes Group Inc. Stock and Incentive Award Plan Performance Share Award Summary of Grant and Performance Share Award Agreement for Officers and Other Individuals as Designated by the Compensation and Management Development Committee dated July 21, 2014.
Exhibit 15	Letter regarding unaudited interim financial information.
Exhibit 31.1	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
Exhibit 31.2	Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
Exhibit 32	Certification pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
Exhibit 101.INS	XBRL Instance Document.
Exhibit 101.SCH	XBRL Taxonomy Extension Schema Document.
Exhibit 101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.
Exhibit 101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.
Exhibit 101.LAB	XBRL Taxonomy Extension Label Linkbase Document.
Exhibit 101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

	Barnes Group Inc. (Registrant)
Date: July 28, 2014	/s/ CHRISTOPHER J. STEPHENS, JR. Christopher J. Stephens, Jr. Senior Vice President, Finance Chief Financial Officer (Principal Financial Officer)
Date: July 28, 2014	/s/ MARIAN ACKER Marian Acker Vice President, Controller (Principal Accounting Officer)

EXHIBIT INDEX
Barnes Group Inc.
Quarterly Report on Form 10-Q
For the Quarter ended June 30, 2014

Exhibit No.	Description	Reference
10.1	2014 Barnes Group Inc. Stock and Incentive Award Plan.	Incorporated by reference to Annex A to the Company's definitive Proxy Statement filed with the Securities and Exchange Commission on March 25, 2014.
10.2	Form of Barnes Group Inc. Stock and Incentive Award Plan Restricted Stock Unit Summary of Grant and Restricted Stock Unit Agreement for Directors dated May 9, 2014 (for non-management directors).	Filed with this report.
10.3	Form of Barnes Group Inc. Stock and Incentive Award Plan Restricted Stock Unit Summary of Grant for Employees and Restricted Stock Unit Agreement dated May 9, 2014.	Filed with this report.
10.4	Form of Barnes Group Inc. Stock and Incentive Award Plan Stock Option Summary of Grant and Stock Option Agreement for Employees in Grade 21 and up dated May 9, 2014.	Filed with this report.
10.5	Form of Barnes Group Inc. Stock and Incentive Award Plan Performance Share Award Summary of Grant and Performance Share Award Agreement for Officers and Other Individuals as Designated by the Compensation and Management Development Committee dated July 21, 2014.	Filed with this report.
15	Letter regarding unaudited interim financial information.	Filed with this report.
31.1	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	Filed with this report.
31.2	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.	Filed with this report.
32	Certification pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	Furnished with this report.
Exhibit 101.INS	XBRL Instance Document.	Filed with this report.
Exhibit 101.SCH	XBRL Taxonomy Extension Schema Document.	Filed with this report.
Exhibit 101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document.	Filed with this report.
Exhibit 101.DEF	XBRL Taxonomy Extension Definition Linkbase Document.	Filed with this report.
Exhibit 101.LAB	XBRL Taxonomy Extension Label Linkbase Document.	Filed with this report.
Exhibit 101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document.	Filed with this report.

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