Xylem Inc.
Form 10-K
February 25, 2013

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K
(Mark One)

þ	ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
	For the fiscal year ended December 31, 2012
	or
¨	TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to
Commission file number: 1-35229
Xylem Inc.
(Exact name of registrant as specified in its charter)

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

1133 Westchester Avenue, Suite N200
White Plains, NY, 10604
Telephone number: (914) 323-5700

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

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

Securities registered pursuant to Section 12(g) of the Act: None
Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes þ No ¨
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No þ
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No ¨
Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):
Large Accelerated Filer þ Accelerated Filer ¨ Non-Accelerated Filer ¨ Smaller reporting company ¨
(Do not check if a smaller reporting company)
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ¨ No þ

The aggregate market value of the common stock of the registrant held by non-affiliates of the registrant as of June 30, 2012 was approximately $4.7 billion. As of January 31, 2013, there were 186,159,624 outstanding shares of the registrant's common stock, par value $0.01 per share.

DOCUMENTS INCORPORATED BY REFERENCE

The information required by Part III of this Report is incorporated herein by reference from the registrant's definitive proxy statement relating to its annual meeting of shareholders to be held in May 2013.

Xylem Inc.
ANNUAL REPORT ON FORM 10-K
For the fiscal year ended December 31, 2012
Table of Contents

ITEM		PAGE
PART I		
1	Business	3
1A.	Risk Factors	16
1B.	Unresolved Staff Comments	24
2	Properties	24
3	Legal Proceedings	25
4	Mine Safety Disclosures	25
*	Executive Officers of the Registrant	26
PART II		
5	Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	27
6	Selected Financial Data	29
7	Management’s Discussion and Analysis of Financial Condition and Results of Operations	31
7A.	Quantitative and Qualitative Disclosures About Market Risk	51
8	Financial Statements and Supplementary Data	52
9	Changes In and Disagreements With Accountants on Accounting and Financial Disclosure	99
9A.	Controls and Procedures	100
9B.	Other Information	101
PART III		
10	Directors, Executive Officers and Corporate Governance	103
11	Executive Compensation	103
12	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	103
13	Certain Relationships and Related Transactions, and Director Independence	103
14	Principal Accounting Fees and Services	103
PART IV		
15	Exhibits, Financial Statement Schedules	104
Signatures		105
Exhibit Index		106

* Included pursuant to Instruction 3 of Item 401(b) of Regulation S-K.

PART I

This Report contains information that may constitute “forward-looking statements.” Forward-looking statements by their nature address matters that are, to different degrees, uncertain. Generally, the words “anticipate,” “estimate,” “expect,” “project,” “intend,” “plan,” “believe,” “target” and similar expressions identify forward-looking statements, which generally ar not historical in nature. However, the absence of these words or similar expressions does not mean that a statement is not forward-looking.

These forward-looking statements include, but are not limited to, statements about the separation of Xylem Inc. (the “Company”) from ITT Corporation in 2011, capitalization of the Company, future strategic plans and other statements that describe the Company’s business strategy, outlook, objectives, plans, intentions or goals, and any discussion of future operating or financial performance. All statements that address operating performance, events or developments that we expect or anticipate will occur in the future — including statements relating to orders, sales, operating margins and earnings per share growth, cash flows, and statements expressing general views about future operating results — are forward-looking statements.

Caution should be taken not to place undue reliance on any such forward-looking statements because they involve risks, uncertainties and other factors that could cause actual results to differ materially from those expressed or implied in, or reasonably inferred from, such statements. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, except as required by law. In addition, forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from the Company’s historical experience and its present expectations or projections. These risks and uncertainties include, but are not limited to, those set forth in this Report, and those described from time to time in subsequent reports filed with the U.S. Securities and Exchange Commission ("SEC").

The following discussion should be read in conjunction with the consolidated and combined financial statements, including the notes thereto, included in this Report. Except as otherwise indicated or unless the context otherwise requires, “Xylem,” “we,” “us,” “our” and “the Company” refer to Xylem Inc. and its subsidiaries. Xylem Inc. was incorporated in Indiana on May 4, 2011.

References in the consolidated and combined financial statements to “ITT” or “parent” refers to ITT Corporation and its consolidated subsidiaries (other than Xylem Inc.).

ITEM 1. BUSINESS

Business Overview

Xylem, with 2012 revenue of $3.8 billion, is a world leader in the design, manufacturing, and application of highly engineered technologies for the water industry with approximately 12,700 employees. We are a leading equipment and service provider for water and wastewater applications with a broad portfolio of products and services addressing the full cycle of water, from collection, distribution and use to the return of water to the environment. We have leading market positions among equipment and service providers in the core application areas of the water equipment industry: transport, treatment, test, building services, industrial processing and irrigation. Our Company’s brands, such as Bell & Gossett and Flygt, are well known throughout the industry and have served the water market for many years.

We operate in two segments, Water Infrastructure and Applied Water. The Water Infrastructure segment focuses on the transportation, treatment and testing of water, offering a range of products including water and wastewater pumps, treatment and testing equipment, and controls and systems. Key brands in this segment include Flygt, Wedeco, Godwin Pumps, WTW, Sanitaire, YSI and Leopold. The Applied Water segment encompasses the uses of water and focuses on the residential, commercial, industrial and agricultural markets. The segment’s major products include pumps, valves, heat exchangers, controls and dispensing equipment. Key brands in this segment include Goulds Water Technology, Bell & Gossett, AC Fire, Standard, Flojet, Lowara, Jabsco and Flowtronex. In both our segments, we benefit from a large and growing installed base of products driving growth in aftermarket revenue for replacement parts and services.

We serve a global customer base across diverse end markets while offering localized expertise. We sell our products in more than 150 countries through a balanced distribution network consisting of our direct sales force and independent channel partners. In 2012, approximately 63% of our revenues were generated outside the United States.

3

Our Industry

Our planet faces a serious water challenge. Less than 1% of the total water available on earth is fresh water, and this percentage is declining due to factors such as the draining of aquifers, increased pollution and climate change. In addition, demand for fresh water is rising rapidly due to population growth, industrial expansion, and increased agricultural development, with consumption estimated to double every 20 years. By 2025, over 30% of the world's population is expected to live in areas without adequate water supply. Even in developed countries with sufficient supply, existing infrastructure for water supply is relatively underfunded and aging. In the United States, degrading pipe systems leak one out of every six gallons of water, on average, on its way from a treatment plant to the customer. These challenges are driving opportunities for growth in the global water industry, which we estimate to have a total market size of approximately $500 billion.

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

Figure 1: Water Industry Supply Chain, based upon Global Water Intelligence's "Global Water Market 2011" and Management Estimates

Our business focuses on the beginning of the supply chain by providing technology-intensive equipment and services. We sell our equipment and services via direct and indirect channels that serve the needs of each customer type. On the utility side, we provide over 70% direct sales with strong application expertise, with the remaining amount going through distribution partners. To end users of water, we provide over 85% of our sales through long-standing relationships with the world's leading distributors, with the remainder going direct to customers. The total market opportunity for this Equipment and Services portion of the water industry supply chain is estimated at approximately $280 billion.

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

Figure 2: Cycle of Water

Our two operating segments are aligned with each of the sectors in the cycle of water: Water Infrastructure serves the Supply Infrastructure sector, and Applied Water serves the Usage Applications sector. Within the Supply Infrastructure sector, our pump systems Transport water from aquifers, lakes, rivers and seas. From there, our filtration, UV and ozone systems provide Treatment, making the water fit for use. After consumption, our pump lift stations move the wastewater to treatment facilities where our mixers, biological treatment, monitoring, and control systems provide the primary functions in the treatment process. Throughout each of these stages, our analytical systems Test to ensure quality of water for consumption as well as for return to nature. Our served market size in this sector is approximately $20 billion.

In the Usage Applications sector, we participate in all major areas of water demand. Agricultural Irrigation constitutes approximately 70% of all water usage globally. Examples of what we provide include: boosting systems for farming irrigation, pumps for dairy operations, and rainwater reuse systems for small scale crop and turf irrigation. Industrial Processing applications account for approximately 20% of global consumption. Our pumps, heat exchangers, valves and controls provide cooling to power plants and manufacturing facilities, as well as circulation for food and beverage processing. The remaining 10% of global water use resides in human and building consumption, where we deliver water boosting systems for drinking, heating, ventilation and air conditioning ("HVAC") and fire protection systems to Residential and Commercial Building Services. Our served market size in this sector is estimated at $15 billion.

Customers in the water industry vary by end market. Two end markets exist within the Supply Infrastructure sector: public utility and industrial, representing 85% and 15% of the total equipment and services market, respectively. The public utility market comprises public, private and public-private institutions that handle water and wastewater for mostly residential and commercial purposes. The industrial market involves the supply of water and removal of wastewater for industrial facilities. We view the main macro drivers of this sector to be water quality, the desire for energy-efficient products, water scarcity and infrastructure needs, for both the repair of aging systems in developed countries as well as new installations in emerging markets. These markets tend to be less cyclical and are estimated to grow annually in the low to mid-single digits through 2015, according to management estimates.

In the Usage Applications sector, end-use customers fall into four main markets: residential, commercial, industrial and agricultural. Homeowners represent the end users in the residential market. Owners and managers of properties such as apartment buildings, retail stores, restaurants, hospitals, and hotels are examples of end users in the commercial market. The industrial market is wide ranging, involving developers and managers of facilities operated by electrical power generators, chemical manufacturers, machine shops, clothing manufacturers, beverage production and dispensing firms, and car washes. The agricultural market end users are owners and operators of businesses such as crop and livestock farms, aquaculture, golf courses, and other turf applications. We believe population growth and urbanization are the two primary macro drivers of these markets, as these trends drive the need for housing, food, community services and retail goods within growing city centers. Water reuse and conservation are driving the need for new technologies. Annual total market growth in these industrial, commercial, residential, and agricultural markets is estimated to be in the low to mid-single digits through 2015, according to management estimates.

Business Strategy

Our strategy is focused on enhancing shareholder value by providing solutions for our customers and by growing revenues, both organically and through strategic acquisitions, as well as streamlining our cost structure. Key elements of our strategy are summarized below:

- Differentiated Portfolio of Offerings. We will continue to extend leading market positions where we have a strong competitive position, cost leadership and proven technology. In addition, we will invest in the differentiation of our core product lines to build on our strong product and application expertise. We also plan to expand into adjacent and complementary technologies, as demonstrated by our recent acquisitions of analytical instrumentation and dewatering solutions businesses.
- Drive Customer Excellence Initiatives. Our global customer excellence initiative, deploying people, processes and tools to make our sales and marketing teams more effective and efficient in serving our customers continues to drive commercial performance. We have trained approximately 80% of our front-line sales agents under this initiative and have a team of customer excellence leaders to support continued program roll-out and updating. In addition, we have launched digital selling tools, which improve our value propositions, and have built a strategic accounts program to focus on our most important customers. These efforts have already improved the revenue generated per sales agent across our businesses. We will continue to make investments in customer relationship management, mobile technologies, customer applications and other technologies that improve our knowledge of customers and the critical activities that drive growth.
- Investing in New Technology and Innovation. We will continue to make targeted investments in research and development activities to develop breakthrough products and solutions. We will continue to pursue and execute a robust pipeline of opportunities in core and emerging markets. We have established a wastewater Center of Excellence in Stockholm, Sweden, with more than 100 research, development and engineering employees. We have also established engineering Centers of Excellence in India and China, where we are accelerating the customization of our application expertise to local needs. Our engineers will continue to work closely with our customers in an effort to identify new applications for our products and develop new technologies and solutions to further expand our current portfolio.
- Build on Our Presence in Fast-Growing Emerging Markets. Urbanization trends and growth in the middle class in developing countries are generating significant demand for water applications. We intend to continue to capture this growth by further expanding into emerging markets, such as China, India and Latin America. We plan to leverage our strong global reach, manufacturing footprint and extensive distribution network to capitalize on growth opportunities in these regions. We will continue to establish and reinforce local capabilities by growing our local presence in these markets with investments in sales, marketing and manufacturing capabilities globally.
- Execute Disciplined Acquisitions. Acquisitions are an important part of our growth strategy. Certain segments of the global water industry we serve are highly fragmented, providing numerous acquisition opportunities. We have completed and integrated 15 acquisitions over the past five years, including Godwin Pumps, Nova Analytics, YSI Incorporated, OI Corporation, MJK Automation and Heartland Pumps and we will selectively pursue acquisitions that will broaden our core product portfolio, expand our geographic footprint and enhance our position in strategic markets.
-

Driving Business Efficiencies. We will continue to maintain focus on improving the efficiency and effectiveness in all we do. We are committed to optimizing our cost structure and simplifying the business by streamlining product relationships across our businesses. We have announced our plan to simplify our business in Europe through restructuring and realignment actions in 2013 which will better position the Company for the future. We will also continue to align the Company to leverage our existing cost structure and scale of product reach into a greater competitive advantage.

Business Segments

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

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

	Market Applications	2012 Revenue	% Revenue		Major Products	Primary Brands
Water Infrastructure	Transport	$1,745	73	%	• Water and wastewater pumps • Filtration, disinfection and biological treatment equipment • Test equipment • Controls	• Flygt • WEDECO • Godwin Pumps • WTW • Sanitaire • YSI • Leopold
	Treatment	366	15	%		
	Test	298	12	%		
		$2,409	100	%		
Applied Water	Building Services	$736	53	%	• Pumps • Valves • Heat exchangers • Controls • Dispensing equipment systems	• Goulds Water Technology • Bell & Gossett • AC Fire • Standard • Lowara • Jabsco • Flojet • Flowtronex
	Industrial Water	550	40	%		
	Irrigation	96	7	%		
		$1,382	100	%		

In recent years, we have expanded our capabilities in Treatment, the cleaning of water and wastewater, and Test, the measurement of water characteristics such as quality. Both of these application areas, Treatment and Test, reside within the Water Infrastructure segment.

Water Infrastructure

Water Infrastructure involves the process that collects water from a source and distributes it to users, and then returns the wastewater responsibly to the environment. Water Infrastructure serves three basic closely linked applications: Transport, Treatment and Test of water and wastewater for two types of customers: public utilities and industrial facilities.

Transport

The Transport application includes all of the equipment and services involved in the safe and efficient movement of water from sources such as oceans, lakes, rivers and ground water, to treatment facilities, and then to users. It also includes the movement of wastewater from the point of use to a treatment facility and then back into the environment. We serve the higher-value equipment markets, such as water and wastewater submersible pumps, monitoring controls, and application solutions; we do not serve the market for lower-value equipment such as pipes and fittings. We believe our business is the largest player in this served market based on management estimates. With operations on six continents, we also have the world's largest dewatering rental fleet, serviced with our Flygt and Godwin brands. In our Water Infrastructure Segment, Transport accounted for approximately 73% of our segment revenue in both 2012 and 2011.

Flygt — Flygt is the world's premier manufacturer of submersible pumps and mixers for use in environments such as water and wastewater treatment, raw water supply, abrasive or contaminated industrial processes, mining and crop irrigation. The Flygt brand was founded in 1901 in Lindås, Sweden and developed the world's first submersible close-coupled motor-driven pump. Flygt products have leading non-clogging capabilities and innovative N-technology, which provide customers with highly sustainable efficiencies and lowest total cost of ownership. Flygt products have applications in various markets, including wastewater lift stations, water and wastewater treatment facilities, pressurized sewage systems, oil and gas, steel, mining and leisure markets. Customers include public utility wastewater and clean water treatment facilities, oil and gas platforms, and steel manufacturing companies. As an example, Flygt recently served the village of Hartland, WI, population 8,350, located in Wisconsin's Lake Country. The Hartland Department of Public Works ("DPW") is, among other things, responsible for operation and maintenance of sanitary sewers, lift stations and manholes. The DPW had experienced a range of problems resulting from ongoing clogging of the pumps in their collection-system lift stations. Replacing the pumps with self-cleaning Flygt N-pumps eliminated the clogging as well as unscheduled and costly service calls.

Godwin Pumps — With more than 35 years as a leader in pump manufacturing and applications, Godwin Pumps ("Godwin") has established itself as a well-recognized, market leading brand in the global portable pump market. Godwin manufactures, sells, rents and services their products. Their quick response and 24/7 capabilities allow them to provide customized pumping solutions to meet the specific needs of their customers. Founded in Quenington, England, Godwin Pumps is currently headquartered in Bridgeport, NJ. Godwin Pumps' products include the fully automatic self-priming Dri-Prime pump, a full range of Flygt electric submersible pumps, Heidra hydraulic submersible pumps, Wet-Prime gasoline-powered contractor pumps and a broad line of generators and portable light towers, as well as a multitude of pumping accessories and pipe. Godwin products are primarily used in construction, industrial mining, municipal, oil & gas markets, fracking, as well as environmental marine, agriculture, temporary fire protection and water & wastewater transport. Godwin products are also instrumental in disaster relief and aversion efforts. Godwin's fleet of equipment is rented through 41 U.S. branches and a global network of distributors and Xylem rental & sales facilities.

Treatment

The Treatment application includes equipment and services that treat both water for consumption and wastewater to be returned responsibly to the environment. Primary served markets include public utilities and industrial operations. While there are several treatment solutions in the market today, we focus on three basic treatment types: (i) filtration, (ii) disinfection and (iii) biological treatment systems. Filtration uses gravity-based media filters and clarifiers to clean both water and wastewater. Leopold, with more than 80 years of experience, is our leading filtration brand. Disinfection systems, both ultraviolet ("UV") and ozone oxidation, treat both public utility drinking water and wastewater, as well as industrial process water, and are provided through our WEDECO brand. Biological treatment systems are key to the treatment of solids in wastewater plants, which are provided through our Sanitaire brand. We believe our business is the largest player in this served market based on management estimates. In our Water Infrastructure Segment, Treatment accounted for approximately 15% of our segment revenue in 2012 and 18% in 2011.

Leopold — Founded in 1924 in Pittsburgh, PA, Leopold is a leader in rapid gravity media filtration and clarification solutions for the water and wastewater industry. In potable drinking water treatment plants, the Clari-DAF system is used to clarify raw water to remove contaminants such as turbidity, algae, color, iron/ manganese, organics, and taste and odor compounds. Several years ago, we augmented our filtration products with membrane technology. Our filtration products include the rapid gravity media, membranes and reverse osmosis/ultrafine filtration. Leopold gravity media filtration is used in potable water treatment plants to remove particulate in the final filtration step. In public utility wastewater treatment plants, the ClariVAC system is used in final clarifiers to remove the sludge solids.

For those areas where nitrogen and phosphorus nutrient removal is required, we provide elimi-NITE systems which convert the filters to become biologically active so that the effluent meets the mandated nitrate and phosphorus levels. In desalination systems, Leopold Clari-DAF systems and Filterworx systems are provided to remove contaminants that will harm reverse osmosis membranes, so that salt can be removed from the seawater to make it potable. Primary customers are public utility water and wastewater systems, as well as desalination plant facilities.

WEDECO — WEDECO was founded in 1975 in Herford, Germany to develop chemical-free and environmentally friendly water treatment technologies, including ultraviolet light and ozone systems. There are more than 250,000 installed WEDECO systems for UV disinfection and ozone oxidation globally in private, public utility and industrial locations. WEDECO introduced ozone technology in 1988 and has been expanding internationally ever since. UV disinfection systems have a number of applications including water treatment and aquaculture. Ozone disinfection systems have applications in drinking water, wastewater, process water, product polishing, bleaching, ozonolysis/synthesis and desodoration. Customers include public utility wastewater and clean water treatment facilities, power plants, pulp and paper mills, food products manufacturers and aquaculture facilities.

Sanitaire — Launched in 1967, the Sanitaire brand provides complete biological wastewater treatment solutions for public utility and industrial applications. Sanitaire's comprehensive offering includes diffused aeration, sequencing batch reactors, drum filters and state-of-the-art controls that drive efficient operations. Sanitaire is regarded as a leading brand in diffused aeration, which is a process that introduces air into a liquid, providing an aerobic environment for degradation of organic matter. Fine-pore diffusion of air is highly competitive due to its high oxygen transfer efficiency and lower energy costs. Sanitaire wide-band aeration systems are used in applications such as grit chambers and sludge that require non-clogging, maintenance-free systems. Principal Sanitaire customers are public utility and industrial wastewater treatment facilities.

Test

Analytical instrumentation is used across most industries to ensure regulatory requirements are met. Growth in this market is primarily driven by increasing regulation of water and wastewater in North America, Europe and Asia. Our served market is predominately focused on water and the environment for quality levels throughout the water infrastructure loop. Analytical systems are applied in three primary ways: in the field, in a facility laboratory, or real time, online monitoring in a treatment facility process. We believe we have a leading position in this served market based on management estimates. In our Water Infrastructure Segment, Test accounted for approximately 12% of our segment revenue in 2012 and 9% in 2011.

WTW — In wastewater treatment facilities, WTW-branded systems monitor parameters such as dissolved oxygen, pH, and turbidity throughout the water process to ensure regulatory standards are met before water is discharged back into the environment. Founded in 1945 as a major brand in Europe, WTW has particularly strong market penetration in the environmental, water and wastewater segments. WTW holds leading market positions in both field and on-line instrumentation and manufactures premium positioned robust and reliable analysis products for the measurement of pH, dissolved oxygen, conductivity, total dissolved solids, turbidity, specific ions and biological oxygen demand. WTW's product offering includes meters, sensors, data-loggers, photometers and software providing customer solutions for even the most challenging applications.

YSI — Yellow Springs Instrument Company ("YSI"), founded in 1948, develops and manufactures sensors, instruments, software and data collection platforms for environmental and coastal water quality monitoring and testing. YSI also offers Life Sciences products including biochemical analyzers for bioprocess monitoring, food and beverage processing, and sports physiology. The main market areas are marine transportation, environmental and ocean research, oil and gas, aquaculture, road and traffic, and construction.

OI Analytical — Oceanography International Corporation ("OIC"), founded in 1969, provides innovative products used for chemical analysis. We develop, manufacture, sell, and service analytical instruments that detect, measure, analyze, and monitor chemicals in liquids, solids, and gases. OIC was originally focused on oceanography equipment. This led to OIC's production of water-quality measurement instrumentation, as oceanography equipment sales declined. OIC developed the Company's first total organic carbon analyzer. Since that time, the Company has become recognized worldwide as a provider of quality analytical instrumentation. We also provide products used to digest, extract, and separate components of chemical mixtures.

AADI — Aanderaa Data Instruments AS ("AADI"), founded in 1966 and headquartered in Bergen, Norway, offers sensors, instruments and systems for measuring and monitoring in the most demanding environments such as rivers, oceans and the polar regions through fully networked systems using wireless technology that monitors temperature, salinity, oxygen, turbidity, current and waves for ecosystem health. The main market areas are marine transportation, environmental and ocean research, oil and gas, aquaculture, road and traffic, and construction. AADI's new technologies underlie the most advanced distributed instrumentation for underwater and atmospheric measurements. Hydro-acoustic, electro-optical, electro-chemical, pressure, temperature and meteorological data are captured by observing networks and self-contained instrumentation using real-time communication. Key customers include many oceanographic institutes, universities, geophysical surveyors, navies, offshore oil and gas companies, drilling companies, port and harbor authorities, government agencies, water authorities and international electric power utilities.

Applied Water

Applied Water encompasses the uses of water. Since water is used to some degree in almost every aspect of human, economic and environmental activity, this segment has innumerable applications. Our served market today consists of the main uses of global water: Building Services, Industrial Water and Irrigation.

Building Services

This business is defined by four main uses of water in building services applications, such as in residential homes and commercial buildings, including offices, hotels, restaurants and malls. The first is the supply of potable water for consumption, such as for drinking and hygiene. The Goulds Water Technology brand is a leader in pumps and boosting systems utilized within buildings, sourcing water from distribution networks or from wells. The second application is wastewater removal with sump and sewage pumps. The third application is in HVAC, where Bell & Gossett specializes in pumps and valves that are used in water-based heating and cooling systems. The fourth water-related building service area is fire protection, where our AC Fire brand supplies full pump systems for emergency fire suppression. In Europe, Lowara is a leading brand in the commercial and residential water market with applications in the four main uses of water. We believe our business is the second largest player in this served market based on management estimates. In our Applied Water Segment, Building Services accounted for approximately 53% of our segment revenue in 2012 and 51% in 2011.

Industrial Water

Water is used in most industrial facilities to provide processing steps such as cooling, cleaning and mixing. Our Goulds Water Technology brand supplies vertical multistage pumps to boost pressure for purposes such as circulating water through a manufacturing facility to cool machine tools. Our Lowara brand focuses on water treatment, industrial washing equipment and machine tool cooling. Our Standard brand delivers heat exchangers for combined heat and power ("CHP") applications within power generation plants. We also provide niche applications such as flexible impeller pumps for wine processing facilities served by our Jabsco brand, and water-based detergent dispensing and water circulation within car washes served by Flojet and Goulds Water Technology air-operated diaphragm and end suction pumps. Across all these various end applications, we believe our business is the second largest player in this served market based on management estimates. In our Applied Water Segment, Industrial Water accounted for approximately 40% of our segment revenue in 2012 and 42% in 2011.

Irrigation

The irrigation business consists of irrigation-related equipment and services associated with bringing water from a source to the plant or livestock need, including hoses, sprinklers, center pivot and drip irrigation. We focus on the pumps and boosting systems that supply this ancillary equipment with water. Our Goulds Water Technology brand brings mixed flow pumps, and our Flowtronex group specializes in equipment solutions such as the Hydrovar boosting system, which incorporates monitoring and controls to optimize energy efficiency in irrigation delivery. Our Lowara brand also produces pumps for agriculture applications and irrigation of gardens and parks. We believe we have a leading position in this served market based on management estimates. In our Applied Water Segment, Irrigation accounted for approximately 7% of our segment revenue in 2012 and 7% in 2011.

As described above, the following brands and products are used across the applications in our Applied Water segment:

Our Brands

Goulds Water Technology — With origins dating back more than 150 years, Goulds Water Technology is a leading brand of centrifugal and turbine pumps, controllers, variable frequency drives and accessories for residential and commercial water supply and wastewater applications. Goulds Water Technology is a leader in the water technologies market with its line of residential water well pumps. The Goulds Water Technology product portfolio

includes submersible and line shaft turbine, 4” submersible, jet, sump, effluent, sewage and centrifugal pumps for residential, agriculture and irrigation, sewage and drainage, commercial and light industrial use. Goulds Water Technology submersible, deepwell or other pumps can be found in more than a quarter of the existing 15 million household wells and more than 380,000 public and community wells in the United States. Products for commercial wastewater include sewage, effluent and grinder pumps and packages. Agriculture products include pump and control products for irrigation, stockwater, wash systems, cooling systems and waste management, with turf irrigation products, including submersible and surface pumps for landscape and turf irrigation systems. We serve the building trades market with filtration, chilling, pressure boost, wash system, water supply, wastewater and boiler feed applications. We also have a range of standard cast iron and bronze end-suction and multistage pumps for various commercial applications.

Lowara — Founded in 1968, and headquartered in Vicenza, Italy, Lowara is a leader in stainless steel pump manufacturing technology for water technology applications. The Lowara range includes submersible, sump, effluent, sewage, centrifugal pumps and booster packages for water supply and water pumping needs in the residential, agriculture, industrial, public utility, building service and commercial markets worldwide, with particular strength in Europe. Residential applications include pumps for pressurization, conditioning, fire-fighting systems, lifting stations and dewatering. Agriculture applications include pumps for irrigation of gardens and parks. Industrial applications include drinking water, water treatment, industrial washing equipment and machine tool cooling. As an example of how Lowara has served the commercial building services market, seven Lowara water booster sets are used for even pressure water supply in the world’s tallest building, the “Burj Khalifa” in the United Arab Emirates.

Bell & Gossett — Founded in 1916 in Chicago, IL, Bell & Gossett ("B&G") has been headquartered in Morton Grove, IL since 1941. B&G is a leader in plumbing and water-based heating and air conditioning markets. Products are used in residential applications where single- or multi-family homes are heated with hot water or steam. Key products include circulating pumps, valves, and specialty products used in these systems. B&G also sells wastewater pumps for residential applications. In commercial applications, B&G provides a broad range of products, including a wide variety of pumps, heat exchangers, valves and controls for heating and air-conditioning systems, sump pumps for wastewater systems, condensate pumping systems for steam heating systems and a comprehensive line of energy-saving variable speed controls. Training is provided for Building System Design Engineers at B&G’s industry renowned Little Red Schoolhouse in Morton Grove. Key commercial building types include hospitals, schools, and data centers. B&G products are sold globally by independent manufacturer representatives and distributed locally by HVAC wholesalers. B&G recently sold some of its largest pumps to the new Children’s Memorial Hospital building in Chicago, IL. These pumps will circulate chilled water throughout the building to provide air-conditioning for the occupants.

A-C Fire Pump — Allis-Chalmers Company ("A-C Fire Pump") was founded in the 1840s in Milwaukee, WI. It offers turnkey fire pump systems for commercial, residential and industrial applications. A-C Fire Pump designs and custom-builds a wide range of fire pump systems, including prefabricated packages and house units that meet every fire protection need. A-C Fire Pump products include In-Line Pumps, Vertical Turbine, Package Systems, Split Case (various series) and 13D Home Defender for residential fire pump service. The 13D Home Defender is designed to boost water pressure for automatic residential sprinkler systems. In addition to residential applications, turnkey fire pumping systems from A-C Fire Pump protect an increasing number of petrochemical facilities, commercial buildings and factories around the world.

Flowtronex — Flowtronex, founded in 1974 as Pumping Systems, Inc., began by producing some of the golf industry’s first prefabricated water pumping systems. The Silent Storm package and Pace Integrated Pump Controller are our two primary products sold into the golf market. In landscape, Flowtronex products, primarily the Floboy system, are sold to customers such as cities and nurseries. In golf, Flowtronex products are sold to golf course superintendents through our Toro Distribution partnership. Retrofit sales of golf pumping systems are sold through our FlowNet Service Network, a group of factory authorized service technicians that provide set up and start up, and service and repair of Flowtronex pump stations.

Standard — For close to 90 years, Standard has been the leader in the design and manufacture of shell and tube heat exchangers. Standard is the brand of our complete line of heat transfer products used in industrial and process applications such as heating or cooling liquids or gases, heat recovery in chemical processing, power and co-generation, paper and pulp, OEM and commercial marine markets. Products include basic shell-and-tube heat exchangers, air coolers, heat transfer coils, compact brazed, welded, gasketed plate units and packaged steam condensers.

Jabsco — The Jabsco brand is known for its marine, industrial, and hygienic/sanitary pumps and systems that are used in many industries, including marine, industrial, healthcare and food processing. It was founded in 1941 by the inventors of the flexible impeller pump. Jabsco is a leader in the leisure marine market, with a broad range of products including water system, engine cooling pumps, searchlights and marine waste systems. Jabsco also offers industrial pumps for hygienic applications, fluid transfer in chemical processing, laboratory, paint processing, plating, and construction. Jabsco rotary lobe pumps offer outstanding performance with unique capabilities. Jabsco Hy-line and Ultima rotary lobe pumps support food and dairy product production, healthcare, chemical, pharmaceutical and biotech applications, whether the product is thin, viscous or fragile. Jabsco also offers multi-purpose and specialized flexible impeller, diaphragm and sliding vane pumps for chemical and general transfer applications.

Flojet — Established in 1975, the Flojet brand encompasses a broad range of small pumps, motors and dispensing pumps for the beverage, industrial, RV, marine and food processing markets. Flojet is a leader in the small pump market, offering a versatile range of products serving the beverage market, including both air- and motor-operated diaphragm pumps and centrifugal chilling pumps, as well as booster systems and accumulator tanks. Flojet's beverage pumps can be found in applications such as beer dispensing, syrup mixing for carbonated drinks, re-circulation in vending machines and refrigerators, bottled water dispensers, icemakers and coffee machines. In addition to significant beverage applications, Flojet's electric and air-operated diaphragm pumps are utilized in street sweepers, car washes, carpet cleaners, parts washers, agricultural spraying and road rollers. Flojet's positive displacement diaphragm pumps can be driven by air, electric motor or solenoid. The positive displacement diaphragm design of Flojet pumps makes them ideal for use in conditions that require self-priming and dry running capability for short periods of time. Additionally, the compact size of these pumps makes them very useful in tight spaces where one cannot ensure a flooded suction. Flojet pumps are designed to be more efficient and are often the choice of customers for applications where low power consumption is critical.

Geographic Profile

In addition to the traditional markets of the United States and Western Europe, opportunities in emerging markets within Asia Pacific, Eastern Europe, Latin America and other countries are growing. Revenue derived from emerging markets comprised 20% of our revenue in 2012 including growth in Latin America and the Middle East.

The table below illustrates the property, plant & equipment, by geographic area, and annual revenue for each of the three years ended December 31, 2012.

(in millions)	Revenue			Property, Plant & Equipment		
	2012	2011	2010	2012	2011	2010
United States	$1,400	$1,363	$1,125	$183	$178	$168
Europe	1,338	1,422	1,262	219	209	219
Asia Pacific	469	426	343	65	57	49
Other	584	592	472	20	19	18
Total	$3,791	$3,803	$3,202	$487	$463	$454

Percentage of revenue by geographic area

	2012	2011	2010
United States	37 %	36 %	35 %
Europe	35 %	37 %	39 %
Asia Pacific	12 %	11 %	11 %
Other	16 %	16 %	15 %

Distribution, Training and End Use

Water Infrastructure provides more than 70% of its sales through direct channels with remaining sales through indirect channels and service capabilities. Both public utility and industrial facility customers increasingly require our teams' global but locally proficient expertise to use our equipment in their specific applications. Several trends are increasing the need for this application expertise: (i) the increase in type and amount of contaminants in water supply, (ii) increasing environmental regulations, (iii) the need to increase system efficiencies due to rising energy costs, and (iv) the retirement of a largely aging water industry workforce not systematically replaced at utilities.

In the Applied Water segment, many end-use areas are widely different, so specialized distribution partners are often preferred. Our commercial teams have built long-standing relationships around our brands in many of these industries through which we can continue to leverage new product and service applications. Revenue opportunities are balanced between OEM and after-market customers. Our products in the Applied Water segment are sold through our global direct sales and world-class indirect channels with more than 85% of revenue going through indirect channels. We have long-standing relationships with the leading independent distributors in the markets we serve, and we provide incentives to distributors, such as specialized training programs, to sell our products exclusively.

Aftermarket Parts and Service

We have more than 120 service centers around the world which employ approximately 600 service employees to provide aftermarket parts and services to our customers. During their lifecycle, installed products require maintenance, repair services and parts due to the harsh environments in which they operate.

In addition, depending on the type of product, median lifecycles range from 5 years to over 50 years, at which time they must be replaced. Many of our products are precisely selected and applied within a larger network of equipment driving a strong preference by customers and installers to replace them with the same exact brand and model when they reach the end of their lifecycle. This dynamic establishes a large recurring revenue stream for our business.

Supply and Seasonality

We have a global manufacturing footprint, with production facilities in Europe, North America, Latin America, and Asia. In addition, we maintain a global network of service centers providing after-market customer care. Service centers offer an array of integrated service solutions for the industry including: preventive monitoring, contract maintenance, emergency field service, engineered upgrades, inventory management, and overhauls for pumps and other rotating equipment.

We offer a wide range of highly engineered products. We primarily employ configure-to-order capabilities to maximize manufacturing and logistics efficiencies by producing high volumes of basic product configurations. When we provide a configure-to-order solution, we configure a standard product to our customers' specifications. To a lesser extent, we provide engineer-to-order products to meet the customization requirements of our customers. This process requires that we apply our technical expertise and production capabilities to provide a non-standard solution to the customer.

Our inventory management and distribution practices seek to minimize inventory holding periods by taking delivery of the inventory and manufacturing immediately prior to the sale or distribution of products to our customers. All of our businesses require various parts and raw materials, of which the availability and prices may fluctuate. Parts and raw materials commonly used in our products include motors, fabricated parts, castings, bearings, seals, nickel, copper, aluminum, and plastics. While we may recover some cost increases through operational improvements, we are still exposed to some pricing risk. We attempt to control costs through fixed-priced contracts with suppliers and various other programs, such as our global strategic sourcing initiative.

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

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

Our Water Infrastructure and Applied Water segments experience some modest level of seasonality in its business. Water Infrastructure's revenue is generally higher in the fourth quarter and lower in the first quarter as a result of capital spending patterns of its customer base as well as weather patterns primarily in North America. Applied

Water's seasonality is primarily driven by its HVAC, Residential Pumps and Irrigations businesses, resulting in higher revenues during the second and third quarters of the year.

Customers

Our business is not dependent on any single customer or a few customers, the loss of which would have a material adverse effect on the respective market or on us as a whole. No individual customer accounted for more than 10% of our consolidated 2012 revenue.

Backlog

Delivery schedules vary from customer to customer based upon their requirements. Typically, large projects require longer lead production cycles and delays can occur from time to time. Total backlog was $647 million at December 31, 2012 and $651 million at December 31, 2011. We anticipate that in excess of 90% of the backlog at December 31, 2012 will be recognized as revenue during 2013.

Competition

Given the highly fragmented nature of the water industry, Water Infrastructure competes with a large number of businesses. Competition in the water transport and treatment technologies markets focuses on product performance, application expertise, design, quality, delivery, and price. In the sale of products and services, we benefit from our large installed base of pumps and complementary products, which require maintenance, repair and replacement parts due to the nature of the products and the conditions under which they operate. Timeliness of delivery, quality and the proximity of service centers are important customer considerations when selecting a provider for after-market products and services as well as equipment rentals. In geographic regions where we are locally positioned to provide a quick response, customers have historically relied on us, rather than our competitors, for after-market products relating to our highly engineered and customized solutions. Our key competitors within the Water Infrastructure segment include KSB Inc., Sulzer Ltd., Siemens AG, Danaher Corporation, Thermo Fisher Scientific Inc. and Pentair Ltd.

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

Research and Development

Research and development (“R&D”) is a key element of our engineering culture and is generally focused on the design and development of products and application know-how that anticipate customer needs and emerging trends. Our engineers are involved in new product development and improvement of existing products. Our businesses invest substantial resources for R&D. We anticipate we will continue to develop and invest in our R&D capabilities to promote a steady flow of innovative, high-quality and reliable products and applications to further strengthen our position in the markets we serve. We invested $106 million, $100 million, and $74 million for the years ended December 31, 2012, 2011 and 2010, respectively, towards R&D.

We have more than 600 engineering and research employees in more than 40 technology centers around the world. R&D activities are initially conducted in our technology centers, located in conjunction with some of our major manufacturing facilities to ensure an efficient development process. We have established a wastewater Center of Excellence in Stockholm, Sweden, with more than 100 research, development and engineering employees. We have launched Centers of Excellence in India and China, where we are accelerating the customization of our application expertise to local needs. In the scale-up process, our R&D activities are conducted at our piloting and testing facilities or at strategic customer sites. These piloting and testing facilities enable us to serve our strategic markets in each region of the world.

We generally seek patent protection for those inventions and improvements that we believe will improve our competitive position. We believe that our patents and applications are important for maintaining the competitive differentiation of our products and improving our return on research and development investments. While we own, control or license a significant number of patents, trade secrets, proprietary information, trademarks, trade names,

copyrights, and other intellectual property rights which, in the aggregate, are of material importance to our business, management believes that our business, as a whole, as well as each of our core business segments, is not materially dependent on any one intellectual property right or related group of such rights.

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

Environmental Matters and Regulation

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

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

Accruals for environmental matters are recorded on a site-by-site basis when it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated, based on current law and existing technologies. It can be difficult to estimate reliably the final costs of investigation and remediation due to various factors. Our accrued liabilities for these environmental matters represent the best estimates related to the investigation and remediation of environmental media such as water, soil, soil vapor, air and structures, as well as related legal fees based upon the facts and circumstances as currently known to us. These estimates, and related accruals, are reviewed quarterly and updated for progress of investigation and remediation efforts and changes in facts and legal circumstances. Liabilities for these environmental expenditures are recorded on an undiscounted basis. We do not anticipate these liabilities will have a material adverse effect on our consolidated and combined financial position, results of operations or cash flows. We cannot make assurances that other sites, or new details about sites known to us, that could give rise to environmental liabilities with such material adverse effects on us will not be identified in the future. At December 31, 2012, we had estimated and accrued $11 million related to environmental matters.

Employees

As of December 31, 2012, Xylem had approximately 12,700 employees worldwide. We believe that our facilities are in favorable labor markets with ready access to adequate numbers of workers, and we believe our relations with our employees are good.

Available Information

Xylem's website address is www.xyleminc.com. We make available free of charge on or through www.investors.xyleminc.com our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. Information contained on our website is not incorporated by reference unless specifically stated therein.

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

ITEM 1A. RISK FACTORS

Each of the following risks should be carefully considered, along with all of the other information in this Annual Report on Form 10-K. We believe these risks to be the principal ones we face and of which we are currently aware. Some of the risks described below relate to our operations, while others relate to residual risks from our Separation from ITT Corporation in 2011 ("the Spin-off"). Other risks relate principally to the securities markets and ownership of our common stock.

Should any of the following risks and uncertainties develop into actual events, our business, financial condition or results of operations could be materially and adversely affected, the trading price of our common stock could decline, and you could lose part or all of your investment.

Risks Related to Our Operations

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

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

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

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

Our strategy includes acquisitions, and we may not be able to make acquisitions of suitable candidates or integrate acquisitions successfully.

Our historical growth has included acquisitions. As part of our growth strategy, we plan to pursue the acquisition of other companies, assets and product lines that either complement or expand our existing business. We cannot make assurances, however, that we will be able to identify suitable candidates successfully, negotiate appropriate acquisition terms, obtain financing that may be needed to consummate those acquisitions, complete proposed acquisitions, successfully integrate acquired businesses into our existing operations or expand into new markets. In addition, we cannot make assurances that any acquisition, once successfully integrated, will perform as planned, be accretive to earnings, or prove to be beneficial to our operations or cash flow.

Acquisitions involve a number of risks and present financial, managerial and operational challenges, including: diversion of management attention from existing businesses and operations; integration of technology, operations personnel, and financial and other systems; potentially insufficient internal controls over financial activities or financial reporting at an acquired entity that could impact us on a combined basis; the failure to realize expected synergies; the possibility that we have acquired substantial undisclosed liabilities; and the loss of key employees of the acquired businesses.

Our business could be adversely affected by inflation and other manufacturing and operating cost increases.
Our operating costs are subject to fluctuations, particularly due to changes in commodity prices, raw materials, energy and related utilities, freight, and cost of labor. In order to remain competitive, we may not be able to recuperate all or a portion of these higher costs from our customers through product price increases. Further, our ability to realize financial benefits from Six Sigma and Lean projects may not be able to mitigate fully or in part these manufacturing and operating cost increases and, as a result, could negatively impact our profitability.

Our ability to successfully manage our restructuring and realignment actions could impact our business results.

We expect to incur approximately $60 to $70 million of restructuring and realignment costs in 2013, including costs related to the establishment of a European headquarters and management structure to better align Xylem to serve our customers and address market opportunities as well as optimize our cost base. Successfully executing and managing these actions, including establishing the most effective organizational structures and the retention of key employees, is critical to achieving our expected cost savings as well as effectively competing in the marketplace. Other factors that may impede an effective restructuring and realignment include the impact of regulatory matters and adverse economic market conditions. If this organizational redesign is not executed successfully, the Company's financial results could be adversely impacted.
Changes in our effective tax rates may adversely affect our financial results.
We sell our products in more than 150 countries and approximately 63% of our revenue was generated outside the United States in 2012. Given the global nature of our business, a number of factors may increase our future effective tax rates, including:

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

Any significant increase in our future effective tax rates could reduce net income for future periods.
Product defects and unanticipated use or inadequate disclosure with respect to our products could adversely affect our business, reputation and financial statements.

Manufacturing or design defects in (including in products or components that we source from third parties), unanticipated use of, or inadequate disclosure of risks relating to the use of products that we make or sell can lead to personal injury, death or property damage. These events could lead to recalls or safety alerts relating to our products, result in the removal of a product from the market and result in product liability claims being brought against us. Recalls, removals and product liability claims can result in significant costs, as well as negative publicity and damage to our reputation that could reduce demand for our products.
Failure to comply with the U.S. Foreign Corrupt Practices Act or other applicable anti-corruption legislation could result in fines, criminal penalties and an adverse effect on our business.
We operate in a number of countries throughout the world, including countries considered to have a high risk of corruption. We are committed to doing business in accordance with applicable anti-corruption laws. We are subject, however, to the risk that we or our affiliated entities or our representatives or their respective officers, directors, employees and agents, may take action determined to be in violation of such anti-corruption laws or regulations, including the U.S. Foreign Corrupt Practices Act of 1977, the U.K. Bribery Act of 2010 and others. Any such violation could result in substantial fines, sanctions, civil and/or criminal penalties, and curtailment of operations in certain jurisdictions, and might adversely affect our business, results of operations or financial condition. In addition, actual or alleged violations could damage our reputation and ability to do business. Furthermore, detecting,

investigating, and resolving actual or alleged violations is expensive and can consume significant time and attention of our senior management.

We may be negatively impacted by litigation and regulatory proceedings.

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

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

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

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

Our business operations rely on information technology and communications networks, and operations that are vulnerable to damage or disturbance from a variety of sources. Regardless of protection measures, essentially all systems are susceptible to disruption due to failure, vandalism, computer viruses, security breaches, natural disasters, power outages and other events. In addition, cybersecurity threats are evolving and include, among others, malicious software, attempts to gain unauthorized access to data, and other electronic security breaches that could lead to disruptions in our systems, unauthorized release of confidential or otherwise protected information and corruption of data. We also have a concentration of operations on certain sites, e.g. production and shared services centers, where business interruptions could cause material damage and costs. Transport of goods from suppliers, and to customers, could also be hampered for the reasons stated above. Although we continue to assess these risks, implement controls, and perform business continuity planning, we cannot be sure that interruptions with material adverse effects will not occur.

Risks Related to Liquidity

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

As of December 31, 2012, our total outstanding indebtedness was $1,205 million including our 3.55% Senior Notes of $600 million aggregate principal amount due September 2016 and 4.875% Senior Notes of $600 million aggregate principal amount due October 2021. We have an existing Four Year Competitive Advance and Revolving Credit Facility (the “Credit Facility”), which provides for an aggregate principal amount of up to $600 million. Additionally, effective December 14, 2012, we entered into a Risk Sharing Finance Facility Agreement (the "R&D Facility Agreement") with The European Investment Bank ("EIB") in an aggregate principal amount of up to €120 million (approximately $158 million).

Our indebtedness could:

- increase our vulnerability to general adverse economic and industry conditions;
- limit our ability to obtain additional financing or borrow additional funds;
- limit our ability to pay future dividends;
- limit our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate;
- require that a substantial portion of our cash flow from operations be used for the payment of interest on our indebtedness instead of funding working capital, capital expenditures, acquisitions or other general corporate purposes; and

- increase the amount of interest expense that we must pay because some of our borrowings are at variable interest rates, which, as interest rates increase, would result in higher interest expense.

In addition, there can be no assurance that future borrowings or equity financing will be available to us on favorable terms or at all for the payment or refinancing of our indebtedness. If we incur additional debt or raise equity through the issuance of preferred stock, the terms of the debt or preferred stock issued may give the holders rights, preferences and privileges senior to those of holders of our common stock, particularly in the event of liquidation. The terms of the debt may also impose additional and more stringent restrictions on our operations than we currently have. Also, regardless of the terms of our debt or equity financing, the amount of our stock that we can issue may be limited because the issuance of our stock may cause the distribution to be a taxable event for ITT under Section 355(e) of the Internal Revenue Code of 1986, as amended (the "Code"), and under the Tax Matters Agreement entered into by ITT in connection with the Spin-off (the "Tax Matters Agreement"), we could be required to indemnify ITT for that tax.

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

Risks Related to External Factors

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

We compete around the world in various geographic and product markets. In 2012, 37% and 35% of our total revenue was from customers located in the United States and Europe, respectively. We expect revenue from these markets to be significant for the foreseeable future. Important factors impacting our businesses include the overall strength of these economies and our customers' confidence in both local and global macro-economic conditions; industrial and federal, state, local and municipal governmental spending; the strength of the residential and commercial real estate markets; interest rates; availability of commercial financing for our customers and end-users; and unemployment rates. A slowdown or downturn in these financial or macro-economic conditions could have a significant adverse effect on our business, financial condition, results of operations and cash flow.

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

In 2012, 63% of our total revenue was from customers outside the United States. We expect our international operations and export sales to continue to be a significant portion of our revenue. Both our sales from international operations and export sales are subject in varying degrees to risks inherent to doing business outside the United States. These risks include the following:

- possibility of unfavorable circumstances arising from host country laws or regulations;
- currency exchange rate fluctuations and restrictions on currency repatriation;
- potential negative consequences from changes to taxation policies;
- disruption of operations from labor and political disturbances;
- changes in tariff and trade barriers and import and export licensing requirements; and
- insurrection or war.

Any payment of distributions, loans or advances to us by our foreign subsidiaries could be subject to restrictions on, or taxation of, dividends on repatriation of earnings under applicable local law, monetary transfer restrictions and foreign currency exchange regulations in the jurisdictions in which our subsidiaries operate. In addition to the general risks that we face outside the United States, we now conduct more of our operations in emerging markets than we have in the past, which could involve additional uncertainties for us, including risks that governments may impose limitations on our ability to repatriate funds; governments may impose withholding or other taxes on remittances and other payments to us, or the amount of any such taxes may increase; an outbreak or escalation of any insurrection or armed conflict may occur; governments may seek to nationalize our assets; or governments may impose or increase investment barriers or other restrictions affecting our business. In addition, emerging markets pose other uncertainties, including the protection of our intellectual property and other assets, pressure on the pricing of our products, and risks of political instability. We cannot predict the impact such future, largely unforeseeable events might have on our business, financial condition, results of operations and cash flow.

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

We are exposed to fluctuations in foreign currency exchange rates, particularly with respect to the Euro, Swedish Krona, British Pound, Australian Dollar, Canadian Dollar, Polish Zloty, and Hungarian Forint. Any significant change in the value of currencies of the countries in which we do business relative to the value of the U.S. Dollar or Euro could affect our ability to sell products competitively and control our cost structure, which could have a material adverse effect on our business, financial condition, results of operations and cash flow.

Weather conditions may adversely affect our financial results.

Weather conditions, particularly heavy flooding and droughts, can positively or negatively impact portions of our business. Within the dewatering space, our pumps provided through our Godwin brand are used to remove excess or unwanted water. Heavy flooding due to weather conditions drives increased demand for these applications. On the other hand, drought conditions drive higher demand for pumps used in agricultural and turf irrigation applications, such as those provided by our Goulds Water Technology, Flowtronex and Lowara brands. Given the unpredictable nature of weather conditions, this may result in volatility for certain portions of our business, as well as the operations of certain of our customers and suppliers.

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

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

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

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

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

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

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

Risks Relating to Our Common Stock
The following are risks in connection with ownership of our common stock:
There is a limited market history for our common stock and the market price of our common stock may fluctuate significantly.
We cannot predict the prices at which our common stock may trade. The market price of our common stock may fluctuate widely, depending on many factors, some of which may be beyond our control, including:

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

Stock markets in general have experienced volatility that has often been unrelated to the operating performance of a particular company. These broad market fluctuations could adversely affect the trading price of our common stock.
We cannot make assurances that we will pay dividends on our common stock, and our indebtedness could limit our ability to pay dividends on our common stock.
The timing, declaration, amount and payment of future dividends to our shareholders fall within the discretion of our Board of Directors and will depend on many factors, including our financial condition, results of operations and capital requirements, as well as applicable law, regulatory constraints, industry practice and other business considerations that our Board of Directors considers relevant. There can be no assurance that we will pay a dividend in the future or continue to pay dividends.
Additionally, if we cannot generate sufficient cash flow from operations to meet our debt-payment obligations, then our ability to pay dividends, if so determined by the Board of Directors, will be impaired and we may be required to attempt to restructure or refinance our debt, raise additional capital or take other actions such as selling assets, reducing or delaying capital expenditures or reducing our dividend. There can be no assurance, however, that any such actions could be effected on satisfactory terms, if at all, or would be permitted by the terms of our debt or our other credit and contractual arrangements.
Anti-takeover provisions in our organizational documents and Indiana law could delay or prevent a change in control.
Certain provisions of our amended and restated articles of incorporation and our amended and restated by-laws may delay or prevent a merger or acquisition part or all of our business operations For example, the amended and

restated articles of incorporation and the amended and restated by-laws, among other things, provide for a classified board of directors and require advance notice for shareholder proposals and nominations, do not permit shareholders to convene special meetings and do not permit action by written consent of the shareholders. In addition, the amended and restated articles of incorporation authorize our Board of Directors to issue one or more series of preferred stock. These provisions may also discourage acquisition proposals of our business operations or delay or prevent a change in control, which could harm our stock price. Indiana law also imposes some restrictions on mergers and other business combinations between any holder of 10% or more of our outstanding common stock and us, as well as certain restrictions on the voting rights of "control shares" of an "issuing public corporation."

Under the Tax Matters Agreement, we have agreed not to enter into any transaction involving an acquisition (including issuance) of Xylem common stock or any other transaction (or, to the extent we have the right to prohibit it, to permit any such transaction) that could cause the Spin-off to be taxable to ITT. We have also agreed to indemnify ITT for any tax resulting from any such transactions. Generally, ITT will recognize taxable gain on the Spin-off if there are one or more acquisitions (including issuances) of our capital stock, directly or indirectly, representing 50% or more, measured by vote or value, of our then-outstanding capital stock, and the acquisitions or issuances are deemed to be part of a plan or series of related transactions that include the Spin-off. Any such shares of our common stock acquired, directly or indirectly, within two years before or after the Spin-off (with exceptions, including public trading by less-than-5% shareholders and certain compensatory stock issuances) will generally be presumed to be part of such a plan unless that presumption is rebutted. As a result, our obligations may discourage, delay or prevent a change of control of our company.

Risks Related to our 2011 Separation from ITT Corporation

If the Spin-off were to fail to qualify as a tax-free transaction under the Internal Revenue Code, then we and/or our former parent and our stockholders could be subject to significant tax liability.

In connection with the Spin-off, we and our former parent, ITT Corporation, received an IRS ruling (the "IRS Ruling") stating that ITT and its shareholders will not recognize any taxable income, gain or loss for U.S. Federal income tax purposes as a result of the Spin-off. In addition, ITT received an opinion of tax counsel as to the satisfaction of certain requirements necessary for the Spin-off to receive tax-free treatment upon which the IRS did not rule. The IRS Ruling, while generally binding upon the IRS, was based on certain factual statements and representations. If any such factual statements or representations were incomplete or untrue in any material respect, or if the facts on which the IRS Ruling were based were materially different from the facts at the time of the Spin-off, the IRS could modify or revoke the IRS Ruling retroactively.

As discussed above, certain requirements for tax-free treatment that are not covered in the IRS Ruling were addressed in the opinion of counsel. The opinion of counsel is not binding on the IRS. Accordingly, the IRS may reach conclusions with respect to the Spin-off that are different from the conclusions reached in the opinion. Like the IRS Ruling, the opinion was based on certain factual statements and representations, which, if incomplete or untrue in any material respect, could alter counsel's conclusions.

If all or a portion of the Spin-off does not qualify as a tax-free transaction because any of the factual statements or representations in the IRS Ruling or the legal opinion are incomplete or untrue, or because the facts upon which the IRS Ruling is based were materially different from the facts at the time of the Spin-off, ITT would recognize a substantial gain for U.S. Federal income tax purposes. In such case, under U.S. Treasury regulations each member of the ITT consolidated group at the time of the Spin-off (including us and our subsidiaries), would be jointly and severally liable for the entire amount of any resulting U.S. Federal income tax liability.

Notwithstanding the foregoing, the Spin-off will be taxable to ITT (but not to ITT shareholders) pursuant to Section 355(e) of the Internal Revenue Code if there are one or more acquisitions (including issuances) of the stock of either us or ITT, representing 50% or more, measured by vote or value, of the then-outstanding stock of either corporation and the acquisition or acquisitions are deemed to be part of a plan or series of related transactions that include the Spin-off. Any acquisition of our common stock within two years before or after the Spin-off (with exceptions, including public trading by less-than-5% shareholders and certain compensatory stock issuances) generally will be presumed to be part of such a plan unless that presumption is rebutted. The tax liability resulting from the application of Section 355(e) would be substantial. In addition, under U.S. Treasury regulations, each member of the ITT consolidated group at the time of the Spin-off (including us and our subsidiaries) would be

severally liable for the resulting U.S. Federal income tax liability.
We have agreed not to enter into any transaction that could cause any portion of the Spin-off to be taxable to ITT, including under Section 355(e). Pursuant to the Tax Matters Agreement, dated as of October 25, 2011 among ITT,

Exelis and Xylem, we have also agreed to indemnify ITT and Exelis for any tax liabilities resulting from such transactions, and ITT and Exelis have agreed to indemnify us for any tax liabilities resulting from such transactions entered into by ITT or Exelis. These obligations may discourage, delay or prevent a change of control of our Company.

We may be unable to achieve all of the benefits that we expect to achieve from the Spin-off.

As an independent, publicly traded company, we believe that our business will benefit from, among other things, (i) greater strategic focus of financial resources and management's efforts, (ii) enhanced customer focus, (iii) direct and differentiated access to capital resources, (iv) enhanced investor choices by offering investment opportunities in a separate entity from ITT, (v) improved management incentive tools, and (vi) utilization of stock as an acquisition currency. However, as a result of separating from ITT, we may be more susceptible to market fluctuations and other adverse events than we would have been as a part of ITT. In addition, we may not be able to achieve all of the benefits that we expect to achieve as an independent company in the time we expect, if at all.

We have a limited operating history as an independent company and our historical financial information may not be a reliable indicator of our future results.

Certain historical financial information we have included in this Annual Report has been prepared on a "carve-out" basis from ITT's consolidated financial statements and does not necessarily reflect what our financial position and results of operations would have been as a separate, stand-alone entity during the periods presented. ITT did not account for us, and we were not operated, as a single stand-alone entity or segment for all the periods presented. In addition, the historical information is not necessarily indicative of what our results of operations and financial position will be in the future. While we were profitable as part of ITT, we cannot assume that as a stand-alone company our profits will continue at a similar level.

The Spin-off may expose us to potential liabilities arising out of state and federal fraudulent conveyance laws and legal distribution requirements.

The Spin-off could be challenged under various state and federal fraudulent conveyance laws. An unpaid creditor or an entity vested with the power of such creditor (such as a trustee or debtor-in-possession in a bankruptcy) could claim that the Spin-off left us, ITT and/or Exelis insolvent or with unreasonably small capital or that we, ITT and/or Exelis intended or believed it would incur debts beyond its ability to pay as they mature and that ITT did not receive fair consideration or reasonably equivalent value in the Spin-off. If a court were to agree with such a plaintiff, then such court could void the Spin-off as a fraudulent transfer and could impose a number of different remedies, which could adversely affect our financial condition and our results of operations. Among other things, the court could require the return of assets or our shares to ITT, voiding the liens of Xylem and claims against ITT, or providing ITT with a claim for money damages against us.

The measure of insolvency for purposes of the fraudulent conveyance laws will vary depending on which jurisdiction's law is applied. Generally, however, an entity would be considered insolvent if either the fair saleable value of its assets is less than the amount of its liabilities (including the probable amount of contingent liabilities), or it is unlikely to be able to pay its liabilities as they become due. No assurance can be given as to what standard a court would apply to determine insolvency or that a court would determine that we, ITT or Exelis were solvent at the time of or after giving effect to the Spin-off.

The Spin-off could also be challenged under state corporate distribution statutes. Under the Indiana Business Corporation Law, a corporation may not make distributions to its shareholders if, after giving effect to the distribution, (i) the corporation would not be able to pay its debts as they become due in the usual course of business; or (ii) the corporation's total assets would be less than the sum of its total liabilities. No assurance can be given that a court will not later determine that the distribution of our shares in connection with the Spin-off was unlawful.

Under the Distribution Agreement, from and after the Spin-off, we will be responsible for the debts, liabilities and other obligations related to the business or businesses which we own and operate following the consummation of the Spin-off. Although we do not expect to be liable for any of these or other obligations not expressly assumed by us pursuant to the Distribution Agreement, it is possible that we could be required to assume responsibility for certain obligations retained by ITT or Exelis should ITT or Exelis fail to pay or perform its retained obligations (for example, tax, asbestos and/or environmental liabilities).

23

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

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

ITEM 1B. UNRESOLVED STAFF COMMENTS.

None.

ITEM 2. PROPERTIES

We have more than 350 locations in more than 40 countries. These properties total approximately 10.2 million square feet, of which more than 320 locations, or approximately 5.4 million square feet, are leased. We consider the many offices, plants, warehouses, and other properties that we own or lease to be in good condition and generally suitable for the purposes for which they are used. The following table shows the significant locations by segment.

Location	State or Country	Principal Business Activity	Approx. Square Feet	Owned or Expiration Date of Lease
Water Infrastructure				
Emmaboda	Sweden	Administration and Manufacturing	1,156,000	Owned
Stockholm	Sweden	Administration and Research & Development	172,000	2019
Shenyang	China	Manufacturing	125,000	Owned
Applied Water				
Morton Grove	IL	Administration and Manufacturing	530,000	Owned
Montecchio	Italy	Administration and Manufacturing	379,000	Owned
Nanjing	China	Manufacturing	363,000	Owned
Nogales	Mexico	Manufacturing	358,000	2013
Auburn	NY	Manufacturing	296,000	Owned
Lubbock	TX	Manufacturing	229,000	Owned
Cheektowaga	NY	Manufacturing	200,000	Owned
Corporate Headquarters				
White Plains	NY	Administration	46,000	2013

Our corporate headquarters is currently located at 1133 Westchester Avenue, Suite N200, White Plains, New York. We are currently located in the same building as our former parent, ITT, but occupy an independent space on separate floors with each company having its own entrance, security and maintenance systems. We have agreed to lease this space directly from the third-party building owner at market rates through 2013. During 2013, we will be moving our corporate headquarters to 1 International Drive, Rye Brook, NY. The new headquarters will consist of approximately 67,000 square feet of office space for a lease period ending in 2024.

ITEM 3. LEGAL PROCEEDINGS

From time to time, we are involved in legal proceedings that are incidental to the operation of our businesses, including acquisitions and divestitures, environmental matters, intellectual property matters, product liability and personal injury claims, employment and pension matters, government and commercial contract disputes. Although we cannot predict the outcome of these and other proceedings, including the cases below, with certainty, we believe that they will not have a material adverse effect on our consolidated financial position, results of operations or cash flows.

On October 26, 2011, the Company and ITT filed a declaratory judgment action against Xylem Group LLC in the U.S. District Court for the Northern District of Georgia, seeking a declaration of non-infringement regarding the Company's use of the name Xylem. The suit was filed in response to a letter received in July 2011 from Xylem Group LLC, a supplier of bath furniture, faucets and fixtures, demanding that the Company cease and desist using the "XYLEM" mark worldwide for its water treatment business. The Company seeks an order declaring its use of "XYLEM" does not infringe upon Xylem Group LLC's trademark rights, and Xylem Group LLC, in its counterclaim, seeks an order enjoining the Company from further use of the "XYLEM" mark in certain markets and unspecified monetary damages. Discovery is complete and Summary Judgment motions are fully briefed.

On or about February 17, 2009, following a statement submitted to the Spanish Competition Authority (Comision Nacional de la Competencia, "CNC") by Grupo Industrial Ercole Marelli, S.A. regarding a cartel in which it said it had been participating, the CNC conducted an investigation at the offices of ITT Water & Wastewater España S.A. (now named Xylem Water Solutions España S.A.) and the offices of other members of the Spanish Association of Fluid Pump Manufacturers. On September 16, 2009, the Investigations Division of the CNC commenced formal proceedings for alleged restrictive practices, such as agreement on general terms and conditions of sale, prohibited under applicable law. Following the conclusion of the formal proceedings, the CNC Council imposed fines on nineteen Spanish manufacturers and distributors of fluid pumps, including a fine of Euro 2,373,675 applied to ITT Water & Wastewater España S.A. and ITT Corporation. The Company has appealed the findings to the court, Audiencia Nacional, and is vigorously defending the case. The Company, along with the other defendants, has submitted its defense to the Court and a ruling is expected in due course.

ITEM 4. MINE SAFETY DISCLOSURES

None.

EXECUTIVE OFFICERS OF THE REGISTRANT

The following information is provided regarding the executive officers of Xylem:

NAME	AGE	CURRENT TITLE	OTHER BUSINESS EXPERIENCE DURING PAST 5 YEARS
Gretchen W. McClain	50	President and Chief Executive Officer (2011)	• President, ITT Fluid and Motion Control (2008) • President, ITT Fluid Technology (2007)
Michael T. Speetzen	43	Senior VP and Chief Financial Officer (2011)	• VP of Finance, ITT Fluid and Motion Control (2009) • Executive VP and Chief Financial Officer, Standard Aero Company (2007)
Michael L. Kuchenbrod	48	Senior VP and President, Water Solutions (2011)	• President, ITT Water and Wastewater (2011) • President, ITT China Operations (2008)
Christopher R. McIntire	49	Senior VP and President, Analytics (2011)	• President and Chief Operating Officer, Nova Analytics (2006)
Kenneth Napolitano	51	Senior VP and President, Applied Water Systems (2012)	• Senior VP and President, Residential and Commercial Water (2011) • President, Residential and Commercial Water (2009) • President, ITT Industrial Process (2006)
Angela A. Buonocore	55	Senior VP and Chief Communications Officer (2011)	• Senior VP and Chief Communications Officer, ITT Corporation (2008)
Nicholas R. Colisto	46	Senior VP and Chief Information Officer (2012)	• VP and Chief Information Officer, Hovnanian Enterprises, Inc. (2008)
Robyn T. Mingle	47	Senior VP and Chief Human Resources Officer (2011)	• Senior VP of Human Resources, Hovnanian Enterprises, Inc. (2003)
Christian S. Na	41	Senior VP, General Counsel and Corporate Secretary (2012)	• Deputy General Counsel, CIRCOR International, Inc. (2010) • Group VP and General Counsel, Danaher Corporation, Product Identification Division (2007)
Colin R. Sabol	45	Senior VP and Chief Strategy and Growth Officer (2011)	• VP of Marketing and Business Development, ITT Fluid and Motion Control (2009)

• VP of Marketing and Business Development, ITT Fluid Technology (2008)

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

PART II

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

2012 Market Price and Dividends

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

	High	Low	Dividend
Fiscal Year ended December 31, 2012			
First Quarter	$28.87	$24.82	$0.1012
Second Quarter	28.54	23.02	0.1012
Third Quarter	26.00	22.43	0.1012
Fourth Quarter	27.67	23.41	0.1012

The closing price of our common stock on the NYSE on January 31, 2013 was $27.93 per share. As of January 31, 2013, there were 17,575 holders of record of our common stock.

Dividends are declared and paid on the common stock at the discretion of our Board of Directors and depend on our profitability, financial condition, capital needs, future prospects, and other factors deemed relevant by our Board. Therefore, there can be no assurance as to what level of dividends, if any, will be paid in the future. In the first quarter of 2013, we declared a dividend of $0.1164 per share to be paid on March 20, 2013 for shareholders of record on February 20, 2013.

There have been no unregistered offerings of our common stock during 2012.

Fourth Quarter 2012 Share Repurchase Activity

The following table summarizes our purchases of our common stock for the quarter ended December 31, 2012:

(in millions, except per share amounts)

Period	Total Number of Shares Purchased	Average Price Paid per Share (a)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (b)	Maximum Number of shares that may yet be purchased under the plans or programs (b)
10/1/12 - 10/31/12	—	—	—	1.9
11/1/12 - 11/30/12	0.3	$25.27	0.3	1.6
12/1/12 - 12/31/12	—	—	—	1.6

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

(b) On August 18, 2012, the Board of Directors authorized the repurchase of up to two million shares of common stock with no expiration date. The program's objective is to offset dilution associated with various Xylem employee stock plans by acquiring shares in the open market from time to time.

PERFORMANCE GRAPH

CUMULATIVE TOTAL RETURN

The following graph compares the relative performance of our common stock, the S&P 500 Index and the S&P 500 Industrials Index. This graph covers the period from October 13, 2011 (the first day our common stock began “when-issued” trading on the NYSE) through December 31, 2012. Our common stock began “regular-way” trading following the Spin-off on November 1, 2011.

	XYL	S&P 500	S&P 1500 Industrials Index
October 13, 2011	100	100	100
October 31, 2011	110	104	106
December 31, 2011	106	105	108
December 31, 2012	114	121	124

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

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

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth selected consolidated and combined financial data for the five years ended December 31, 2012. This selected consolidated financial data should be read in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and the financial statements and the notes thereto.

	Year Ended December 31,				
	2012 (4)	2011 (3)	2010 (2)	2009	2008
	(in millions, except per share data)				
Results of Operations Data:					
Revenue	$3,791	$3,803	$3,202	$2,849	$3,291
Gross profit	1,502	1,461	1,214	1,037	1,141
Gross margin	39.6 %	38.4 %	37.9 %	36.4 %	34.7 %
Operating income	443	395	388	276	315
Operating margin	11.7 %	10.4 %	12.1 %	9.7 %	9.6 %
Net income	297	279	329	263	224
Per Share Data:					
Earnings per share:					
Basic	$1.60	$1.51	$1.78	$1.42	$1.22
Diluted	1.59	1.50	1.78	1.42	1.22
Basic shares outstanding (1)	185.8	185.1	184.6	184.6	184.6
Diluted shares outstanding (1)	186.2	185.3	184.6	184.6	184.6
Cash dividends per share	$0.4048	$0.1012	—	—	—
Balance Sheet Data (at period end):					
Cash and cash equivalents	$504	$318	$131	$81	$81
Working capital*	859	834	759	636	647
Total assets	4,679	4,400	3,742	2,542	2,537
Total debt	1,205	1,206	4	4	5

* The Company calculates Working Capital as follows: Net Accounts Receivable + Net Inventory - Accounts Payable - Customer Advances. This calculation has been revised from prior years to reduce working capital for advances received from customers to fund inventory purchases on large projects. Prior periods have been restated accordingly.

(1) On October 31, 2011, the Spin-off from ITT was completed through a tax-free stock dividend to ITT’s shareholders. ITT shareholders received one share of Xylem common stock for each share of ITT common stock. As a result on October 31, 2011, we had 184.6 million shares of common stock outstanding and this share amount is being utilized to calculate earnings per share and diluted earnings per share for all prior periods presented.

(2) In 2010, we acquired Godwin Pumps of America, Inc. and Nova Analytics Corporation. These businesses in the aggregate contributed revenue of $247 million in 2010 and $1,070 million of total assets on date of acquisition.

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

(4) In 2012, we acquired Heartland Pump Rental & Sales, Inc. and MJK Automation which were not material individually or in the aggregate to our results of operations or financial position.

Additionally, during the fourth quarter of 2012, the Company changed its method of accounting for those inventories which were accounted for under the last-in, first-out (“LIFO”) method to the first-in, first-out ("FIFO") method. The Company believes that this change is preferable as it provides uniformity across the Company's operations with respect to the method of inventory accounting, better reflects the current value of inventories on the Consolidated Balance Sheet, aligns the flow of physical inventory with the accounting, better matches revenues with associated expenses, and improves comparability with the Company's peers.

The overall impact of this change is immaterial to Xylem's financial results for all periods presented. The retrospective impact of this change for periods prior to those presented resulted in a cumulative effect increase of $7 million in total assets, which then impacts the same balance sheet accounts for each of the years presented. See Note 1, "Summary of Significant Accounting Policies," in the notes to the consolidated and combined financial statements.

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

The following discussion should be read in conjunction with our consolidated and combined financial statements and the notes thereto. This discussion summarizes the significant factors affecting our results of operations and the financial condition of our business during each of the fiscal years in the three-year period ended December 31, 2012. Except as otherwise indicated or unless the context otherwise requires, "Xylem," "we," "us," "our" and "the Company" refer to Xylem Inc. and its subsidiaries. References in the consolidated and combined financial statements to "ITT" or "parent" refer to ITT Corporation and its consolidated subsidiaries (other than Xylem).

On and prior to October 31, 2011, our financial position and results of operations consisted of the water equipment and services businesses of ITT Corporation ("WaterCo") and have been derived from ITT's historical accounting records and are presented on a carve-out basis through our Distribution Date, while our financial results for Xylem post Spin-off are prepared on a stand-alone basis. In addition, financial information for the twelve months ended December 31, 2011 consists of the consolidated results of Xylem on a stand-alone basis for the two months of November and December and the combined results of operations of WaterCo for ten months on a carve-out basis. The twelve months ended December 31, 2010 consist entirely of the combined results of WaterCo on a carve-out basis. See section below entitled "Separation from ITT" for additional details regarding the Spin-off.

Overview

Xylem is a leading equipment and service provider for water and wastewater applications with a broad portfolio of products and services addressing the full cycle of water, from collection, distribution and use to the return of water to the environment. Our business focuses on providing technology-intensive equipment and services. Our product and service offerings are organized into two segments: Water Infrastructure and Applied Water. Our segments are aligned with each of the sectors in the cycle of water, supply infrastructure and usage applications. The Water Infrastructure segment focuses on the transportation, treatment and testing of water, offering a range of products including water and wastewater pumps, treatment and testing equipment, and controls and systems. The Applied Water segment serves many of the primary uses of water and focuses on the residential, commercial, industrial and agricultural markets. The segment's major products include pumps, valves, heat exchangers, controls and dispensing equipment.

- Water Infrastructure serves the supply infrastructure sector with pump systems that transport water from aquifers, lakes, rivers and seas; with filtration, ultraviolet and ozone systems that provide treatment, making the water fit to use; and pumping solutions that move the wastewater to treatment facilities where our mixers, biological treatment, monitoring, and control systems provide the primary functions in the treatment process. We provide analytical instrumentation used to measure water quality, flow, and level in wastewater, surface water, and coastal environments.
- Applied Water serves the usage applications sector with water pressure boosting systems for heating, ventilation and air conditioning and for fire protection systems to the residential and commercial building services markets. In addition, our pumps, heat exchangers, valves and controls provide cooling to power plants and manufacturing facilities, as well as circulation for food and beverage processing. We also provide boosting systems for farming irrigation, pumps for dairy operations, and rainwater reuse systems for small scale crop and turf irrigation.

We sell our equipment and services via direct and indirect channels that serve the needs of each customer type. In the Water Infrastructure segment for the year ended 2012, we provided more than 70% direct sales with strong application expertise, with the remaining amount going through distribution partners. In the Applied Water segment, we provided more than 85% of our sales in 2012 through long-standing relationships with the world's leading distributors, with the remainder going direct to customers. The total market opportunity for this equipment and services portion of the water industry supply chain is estimated at $280 billion.

Separation from ITT

On October 31, 2011, ITT completed the Spin-off (the “Spin-off”) of Xylem, formerly ITT’s water equipment and services businesses. Effective as of 12:01 a.m., Eastern time on October 31, 2011 (the “Distribution Date”), the common stock of Xylem was distributed, on a pro rata basis, to ITT’s shareholders of record as of the close of business on October 17, 2011 (the “Record Date”). On the Distribution Date, each of the shareholders of ITT received one share of Xylem common stock for every one share of common stock of ITT held on the Record Date. The Spin-off was completed pursuant to the Distribution Agreement, dated as of October 25, 2011, among ITT, Exelis Inc. and Xylem. After the Distribution Date, ITT does not beneficially own any shares of Xylem common stock and, following such date, financial results of Xylem will not be consolidated in ITT’s financial reporting. Xylem’s Registration Statement on Form 10 filed with the U.S. Securities and Exchange Commission was declared effective on October 6, 2011. Xylem’s common stock began “regular-way” trading on the New York Stock Exchange on November 1, 2011 under the symbol “XYL”.

Executive Summary

Xylem reported revenue for 2012 of $3,791 million, a decrease of 0.3% from $3,803 million reported in 2011. Revenue grew 2.5% on a constant currency basis due to the acquisitions of YSI Incorporated ("YSI"), MJK Automation ("MJK") and Heartland Pump Rental & Sales, Inc. ("Heartland") within our Water Infrastructure segment, combined with strong performance in emerging markets. Operating income for the year ended 2012 was $443 million, reflecting an increase of $48 million or 12.2% compared to $395 million in 2011, which was primarily due to reduced separation costs. Operating income in 2012 also included measures taken to reduce operating costs, including $17 million of restructuring costs. Additionally, on February 5, 2013 we acquired PIMS Group (“PIMS”), a wastewater services company based in the United Kingdom, for approximately $57 million, including a cash payment of $55 million and the assumption of certain liabilities.

Additional financial highlights for 2012 include the following:

- Net income of $297 million, or $1.59 per diluted share ($330 million or $1.77 on an adjusted basis)
- Free cash flow generation of $312 million, and net cash from operating activities of $396 million
- Orders of $3,782 million (a 1.3% increase on a constant currency basis)

Key Performance Indicators and Non-GAAP Measures

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

- “organic revenue” and “organic orders” defined as revenue and orders, respectively, excluding the impact of foreign currency fluctuations, intercompany transactions and contributions from acquisitions and divestitures. Divestitures include sales of insignificant portions of our business that did not meet the criteria for classification as a discontinued operation. The period-over-period change resulting from foreign currency fluctuations assumes no change in exchange rates from the prior period.
- “constant currency” defined as financial results adjusted for currency translation impacts by translating current period and prior period activity using the same currency conversion rate. This approach is used for countries whose functional currency is not the U.S. dollar.

- "adjusted net income" and "adjusted earnings per share" defined as net income and earnings per share, respectively, adjusted to exclude non-recurring separation costs from the Spin-off, restructuring and realignment costs and tax-related special items. A reconciliation of adjusted net income is provided below.

(in millions, except per share data)	2012	2011
Net income	$297	$279
Separation costs, net of tax	16	72
Restructuring and realignment, net of tax	17	—
Tax-related special items	—	7
Adjusted net income	$330	$358
Weighted average number of shares - Diluted	186.2	185.3
Adjusted earnings per share	$1.77	$1.93

- "operating expenses excluding separation costs" defined as operating expenses, adjusted to exclude non-recurring costs incurred in connection with the separation.
- "adjusted segment operating income" defined as segment operating income, adjusted to exclude non-recurring separation, restructuring and realignment costs and "adjusted segment operating margin" defined as adjusted segment operating income divided by total segment revenue.
- "free cash flow" defined as net cash provided by operating activities less capital expenditures, as well as adjustments for other significant items that impact current results that management believes are not related to our ongoing operations and performance. Our definition of free cash flow does not consider certain non-discretionary cash payments, such as debt. The following table provides a reconciliation of free cash flow.

(in millions)	2012	2011
Net cash provided by operating activities	$396	$449
Capital expenditures	(112)	(126)
Separation cash payments (a)	28	65
Free cash flow	$312	$388

(a) Includes the separation costs allocated by ITT in 2011 that have been treated as though they were settled in cash, and capital expenditures associated with the spin-off of $4 million and $11 million for 2012 and 2011, respectively.

2013 Business Outlook

Throughout 2012, the Company was faced with challenging market conditions with the volatile global economic environment, especially in Europe, as well as dry weather conditions in North America. We expect these conditions to begin to stabilize in 2013 and are projecting low-single digit revenue growth for the year as the end markets start to improve. On a geographic basis, while we expect modest improvement in the U.S. economy and reacceleration in emerging markets growth, we believe that Europe will continue to be challenged. In light of our projected modest revenue growth, we will continue to focus on optimizing our cost structure as well as improving our operational efficiency and effectiveness resulting in our beginning to implement restructuring and realignment actions, primarily in Europe. In 2013, we expect to incur approximately $40 to $50 million in restructuring costs and approximately $20 million in realignment costs to reposition our European business as well as other targeted actions to better positioning us for the future. We anticipate approximately $13 to $15 million of net savings to be realized in 2013 from these actions.

Additionally, we currently generate approximately two-thirds of our revenue outside the United States, which is impacted by changes in foreign currency exchange rates, particularly the Euro, Swedish Krona, British Pound, Australian Dollar, Canadian Dollar, Polish Zloty, and Hungarian Forint. Upon consolidation, as exchange rates vary, our revenue and other operating results may differ from expectations. In this uncertain economy, significant fluctuations in foreign exchange rates may continue.

Results of Operations

(in millions)	2012		2011		2010		2012 v. 2011		2011 v. 2010	
Revenue	$3,791		$3,803		$3,202		(0.3	)%	18.8	%
Gross profit	1,502		1,461		1,214		2.8	%	20.3	%
Gross margin	39.6	%	38.4	%	37.9	%	120bp		50bp	
Operating expenses excluding separation, restructuring and realignment costs	1,013		979		811		3.5	%	20.7	%
Expense to revenue ratio	26.7	%	25.7	%	25.3	%	100bp		40bp	
Restructuring and realignment costs	24		—		15		NM*		NM*	
Separation costs	22		87		—		(74.7	)%	NM*	
Total operating expenses	1,059		1,066		826		(0.7	)%	29.1	%
Operating income	443		395		388		12.2	%	1.8	%
Operating margin	11.7	%	10.4	%	12.1	%	130bp		(170)bp	
Interest and other non-operating expense (income), net	55		12		—		358.3	%	NM*	
Income tax expense	91		104		59		(12.5	)%	76.3	%
Tax rate	23.4	%	27.4	%	15.2	%	(400)bp		1,220bp	
Net income	$297		$279		$329		6.5	%	(15.2	)%

* NM - Not Meaningful

2012 versus 2011

Revenue

Revenue generated for 2012 was $3,791 million, a decrease of $12 million, or 0.3%, compared to $3,803 million in 2011. On a constant currency basis, revenue grew 2.5%. The following table illustrates the impact from organic growth, recent acquisitions, and fluctuations in foreign currency, in relation to revenue during the annual 2012 period.

(in millions)	$ Change		% Change	
2011 Revenue	$3,803			
Organic Growth	2		0.1	%
Acquisitions	94		2.4	%
Constant Currency	96		2.5	%
Foreign currency translation (a)	(108	)	(2.8	)%
Total change in revenue	(12	)	(0.3	)%
2012 Revenue	$3,791			

(a) Foreign currency impact primarily due to fluctuations of the Euro against the US Dollar.

The following table summarizes revenue by segment for 2012 and 2011:

(in millions)	2012		2011		As Reported Change		Constant Currency Change	
Water Infrastructure	$2,425		$2,416		0.4	%	3.7	%
Applied Water	1,424		1,444		(1.4	)%	0.8	%
Eliminations	(58	)	(57	)				
Total	$3,791		$3,803		(0.3	)%	2.5	%

Water Infrastructure

Water Infrastructure's revenue increased $9 million, or 0.4% in 2012 (3.7% on a constant currency basis), including incremental revenue of $94 million from acquisitions, consisting of YSI in 2011 and MJK and Heartland in 2012. The acquisitions of YSI and MJK contributed $90 million of the incremental revenue as we continued our expansion in the analytical instrumentation market.

Organic revenue decreased $6 million or 0.2% during the year which was primarily attributable to weakness in the transport and treatment markets, as well as sustained drought conditions within the United States. Transport and treatment decreased mostly due to a decline in the public utility sector of developed markets caused by a weak capital project environment and delays on shipments. These declines were partially offset by strength in emerging markets, specifically in the Latin America and Asia Pacific regions. The results also reflect decreases in the dewatering rental and equipment sales as a result of the unfavorable dry weather conditions within North America and lower coal and gas prices, offset slightly by a benefit from Super Storm Sandy. Overall growth was also muted by continued weakness in Europe as a result of challenging economic conditions.

Foreign currency translation was favorable by $80 million for 2012 as compared to 2011.

Applied Water

Applied Water's revenue decreased $20 million, or 1.4% in 2012 (a 0.8% increase on a constant currency basis). The growth on a constant currency basis was driven by organic revenue growth.

Organic revenue grew $9 million or 0.6% for the year and was principally due to strength in the industrial water sector from a favorable general industrial market across most regions, especially within the United States, Russia and Asia Pacific markets. The residential and commercial pumps business increased slightly due to favorable growth in the United States but was mostly eclipsed by declines from the weak economic conditions in Europe. The warm, dry weather conditions in North America also drove an increase in the agriculture end market for the year.

Foreign currency translation was favorable by $32 million for 2012 as compared to 2011.

Orders/Backlog

Orders received during 2012 decreased by $65 million, or 1.7% to $3,782 million (a 1.3% increase on a constant currency basis). These amounts include a benefit of $95 million from acquisitions. Organic order decline was $46 million for the year.

The Water Infrastructure segment orders decreased $33 million, or 1.3% to $2,421 million (2.2% growth on a constant currency basis), including $95 million from acquisitions. Organic order volume decreased primarily due to the delays in public utility capital expenditure orders coupled with reduced dewatering volumes from dry weather conditions and slowdowns in the oil, gas and mining markets. Orders declined in our Applied Water segment $29 million, or 2.0% to $1,423 million (0.1% growth on a constant currency basis), driven by declining organic orders of 0.4%. The decline in organic order volume is primarily a result of the warm winter weather conditions in the United States and Asia Pacific markets impacting the building services end markets, partially offset by strength in the industrial and agriculture markets.

Delivery schedules vary from customer to customer based upon their requirements. Typically, large projects require longer lead production cycles and delays can occur from time to time. Total backlog was $647 million at December 31, 2012 and $651 million at December 31, 2011. We anticipate that approximately 90% of the backlog at December 31, 2012 will be recognized as revenue during 2013.

Gross Margin

Gross margins as a percentage of consolidated revenue increased to 39.6% in 2012 from 38.4% in 2011. The increase is attributable to benefits from price realization initiatives and cost improvements offset, in part, by an unfavorable sales mix and inflation.

Operating Expenses

(in millions)	2012		2011		Change	
Selling, General and Administrative (SG&A)	$914		$877		4.2	%
SG&A as a % of revenue	24.1	%	23.1	%	100bp	
Research and Development (R&D)	106		100		6.0	%
R&D as a % of revenue	2.8	%	2.6	%	20bp	
Restructuring and asset impairment charges	17		2		750	%
Separation Costs	22		87		(74.7	)%
Operating expenses	$1,059		$1,066		0.7	%
Expense to revenue ratio	27.9	%	28.0	%	(10)bp	

Selling, General and Administrative Expenses

SG&A increased by $37 million or 4.2% to $914 million or 24.1% of revenue in 2012, as compared to $877 million or 23.1% of revenue in 2011. The increase in SG&A expenses is principally due to the impact of incremental costs as a standalone Company and costs related to the MJK and Heartland acquisitions.

Additionally, in 2012 we incurred $7 million of realignment costs relating to realigning our European businesses to improve our operational efficiencies.

Research and Development Expenses

R&D spending increased $6 million or 6.0% to $106 million or 2.8% of revenue for 2012 as compared to $100 million or 2.6% of revenue in 2011. These increases were primarily due to the impact from recent acquisitions, as well as costs associated with the launching of new products.

Restructuring and Asset Impairment Charges

During 2012, we incurred restructuring costs of $17 million primarily related to restructuring-related severance payments for reductions in force initiatives primarily within our Water Infrastructure segment. During 2011, we incurred a $2 million charge related to the impairment of a facility in our Applied Water segment. As of December 31, 2012, we consider those restructuring initiatives commenced to date to be substantially completed, with a remaining liability of $9 million related to the 2012 restructuring actions.

We estimate annual future net savings beginning in 2013 from our 2012 restructuring actions will be approximately $12 to 13 million.

Separation Costs

We had non-recurring pre-tax separation costs of $22 million and $87 million, or $16 million and $72 million after tax during 2012 and 2011, respectively. The components of separation costs incurred during these periods are presented below.

(in millions)	2012	2011
Rebranding and marketing costs	$8	$13
Advisory and professional fees	7	18
Information and technology costs	3	19
Employee retention and hiring costs	1	14
Lease termination and other real estate costs	1	10
Non-cash asset impairments (a)	—	8
Other	2	5
Total separation costs in operating income	22	87
Tax-related separation costs	—	6
Income tax benefit	(6)	(21)
Total separation costs, net of tax	$16	$72

(a) During the third quarter of 2011, we recorded an impairment charge of $8 million on one of our facilities in China within our Applied Water segment. Prior to the separation this was a shared facility among certain Xylem and ITT businesses and in connection with the separation, the removal of certain ITT operations triggered an impairment evaluation. The fair value of the applicable assets was calculated using the cost approach.

Operating Income

We generated operating income of $443 million during 2012, a 12.2% increase from the prior year, primarily reflecting the benefits achieved from cost reductions and price improvements offset, in part, by an unfavorable sales mix, acquisition costs and non-recurring separation costs. The following table illustrates operating income results by business segments for 2012 and 2011.

(in millions)	2012	2011	Change
Water Infrastructure	$342	$343	(0.3)%
Applied Water	170	160	6.3%
Segment operating income	512	503	1.8%
Corporate and Other	(69)	(108)	
Total operating income	$443	$395	12.2%
Operating margin	11.7%	10.4%	130bp

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

(in millions)	2012		2011		Change	
Water Infrastructure						
Operating income	$342		$343		(0.3	)%
Separation costs	4		16			
Restructuring and realignment costs	19		—			
Adjusted operating income	$365		$359		1.7	%
Adjusted operating margin	15.1	%	14.9	%	20bp	
Applied Water						
Operating income	$170		$160		6.3	%
Separation costs	2		13			
Restructuring and realignment costs	5		—			
Adjusted operating income	$177		$173		2.3	%
Adjusted operating margin	12.4	%	12.0	%	40bp	
Total Xylem						
Operating income	$443		$395		12.2	%
Separation costs (a)	22		87			
Restructuring and realignment costs	24		—			
Adjusted operating income	$489		$482		1.5	%
Adjusted operating margin	12.9	%	12.7	%	20bp	

(a) Comprising non-recurring separation costs of $6 million and $29 million in our business segments and $16 million and $58 million within Corporate for 2012 and 2011, respectively.

Water Infrastructure

Operating income for our Water Infrastructure segment decreased $1 million or 0.3% (increased $6 million or 1.7% excluding separation, restructuring and realignment costs) compared with the prior year. The 1.7% increase was predominately driven by incremental operating income of $20 million from the acquisitions of YSI, MJK and Heartland combined with price realization efforts and operating cost reductions. These benefits were largely offset by inflation costs on labor and material as well as unfavorable mix from lower dewatering revenues and higher sales in emerging markets.

Applied Water

Operating income for our Applied Water segment increased $10 million or 6.3% ($4 million or 2.3% excluding separation, restructuring and realignment costs) compared to the prior year. The 2.3% increase is primarily attributable to operating cost reductions put in place by the Company and savings achieved from restructuring actions in the latter part of 2011. The increases were offset, in part, by lower sales volume, an unfavorable sales mix and inflationary pressures on labor and materials.

Interest Expense

Interest expense was $55 million and $17 million for 2012 and 2011, respectively. The increase during the current year reflected a full year of interest expense related to the issuance of $1.2 billion aggregate principal amount of senior notes issued in September 2011. Refer to Note 14, “Credit Facilities and Long-Term Debt,” for further details.

Income Tax Expense

The income tax provision for 2012 was $91 million at an effective tax rate of 23.4% compared to $104 million at an effective tax rate of 27.4% in 2011. The 2012 effective tax rate is lower than 2011 as a result of the decrease in non-deductible separation costs and a change in the mix of earnings.

Effective January 1, 2013, the Swedish government enacted legislation that will increase the effective tax rate of the Company. The Company is currently implementing strategies to address the impact of this legislation.

2011 versus 2010

Revenue

Revenue generated for 2011 was $3,803 million, an increase of $601 million, or 18.8%, compared to $3,202 million in the same period of 2010. The following table illustrates the impact from organic growth, recent acquisitions, and fluctuations in foreign currency, in relation to revenue during the annual 2011 period.

(in millions)	$ Change	% Change	
2010 Revenue	$3,202		
Organic Growth	226	7.1	%
Acquisitions	264	8.2	%
Constant Currency	490	15.3	%
Foreign currency translation (a)	111	3.5	%
Total change in revenue	601	18.8	%
2011 Revenue	$3,803		

(a) Foreign currency impact primarily due to fluctuations of the Euro against the US Dollar.

The following table summarizes revenue by segment for 2011 and 2010:

(in millions)	2011		2010		Change	
Water Infrastructure	$2,416		$1,930		25.2	%
Applied Water	1,444		1,327		8.8	%
Eliminations	(57	)	(55	)		
Total	$3,803		$3,202		18.8	%

Water Infrastructure

Water Infrastructure's revenue increased $486 million, or 25.2% in 2011, including incremental revenue of $264 million from acquisitions, including Godwin and Nova in 2010 and YSI in September 2011. Our 2011 acquisition of YSI contributed $35 million and continued our expansion in the analytical instrumentation market.

Organic revenue growth of $137 million or 7.1% during the year was primarily attributable to transport and treatment applications. Transport increased due to dewatering equipment volume from both the public utility and industrial sectors. The results also reflect increased public utility investment in treatment projects in Latin America and the Middle East. Overall growth was partially offset by decreased volume in Southern Europe, which continues to present challenging economic conditions.

Foreign currency translation was favorable by $87 million for the annual period ended December 31, 2011, as compared to 2010.

Applied Water

Applied Water's revenue increased $117 million, or 8.8% in 2011, driven by organic revenue growth of $88 million or 6.6%. The organic revenue growth reflects gains across all regions lead by double-digit growth rates in Eastern Europe, Latin America, China and the Middle East, primarily due to increased volume in light industrial and building service applications as a result of new products such as e-SV, a high-efficiency vertical multi-stage pump, and increased volume in the irrigation applications as a result of favorable weather conditions in the United States. Pricing initiatives executed throughout the period also contributed to the revenue growth.

Foreign currency translation was favorable by $28 million for 2011, as compared to 2010.

Orders/Backlog

Orders received during 2011 increased by $610 million, or 18.8% to $3,847 million, including benefits of $272 million from acquisitions and $120 million from foreign currency translation adjustments. Organic order growth was 6.7% for the year. The Water Infrastructure segment generated order growth of $513 million, or 26.4% to $2,454 million, including $272 million and $96 million from acquisitions and favorable foreign currency, respectively. Order growth in our Applied Water segment was $100 million or 7.4% to $1,452 million, driven by 5.3% organic order growth and $27 million of favorable foreign currency translation due to increased activity in the light industrial, agriculture and heat transfer markets.

Delivery schedules vary from customer to customer based upon their requirements. Typically, large projects require longer lead production cycles and delays can occur from time to time. Total backlog was $651 million at December 31, 2011 and $620 million at December 31, 2010. We anticipate that in excess of 80% of the backlog at December 31, 2011 will be recognized as revenue during 2012.

Gross Margin

Gross margins, as a percentage of consolidated revenue, increased to 38.4% in 2011 from 37.9% in 2010. The increase is attributable to benefits from productivity and price realization initiatives offset, in part, by rising commodity costs and higher labor and overhead costs due to increased spending related to additional volume.

Operating Expenses excluding Separation Costs

(in millions)	2011		2010		Change	
Selling, General and Administrative (SG&A)	$877		$737		19.0	%
SG&A as a % of revenue	23.1	%	23.0	%	10bp	
Research and Development (R&D)	100		74		35.1	%
R&D as a % of revenue	2.6	%	2.3	%	30bp	
Restructuring and asset impairment charges	2		15		(86.7	)%
Operating expenses excluding separation costs	979		826		18.5	%
Expense to revenue ratio	25.7	%	25.8	%	(10)bp	

Selling, General and Administrative Expenses

SG&A increased by $140 million to $877 million or 23.1% of revenue in 2011, as compared to $737 million or 23.0% of revenue in 2010. The increase in SG&A expenses is principally due to sales volume related increases in selling, marketing and distribution expenses, including the impact of recent acquisitions.

Research and Development Expenses

R&D spending increased $26 million to $100 million or 2.6% of revenue for 2011 as compared to $74 million or 2.3% of revenue in 2010. These increases were primarily due to $11 million incremental expense from recent acquisitions and programs as we continued to invest in new product developments.

Restructuring and Asset Impairment Charges

During 2011, we incurred a $2 million charge related to the impairment of a facility in our Applied Water segment. During 2010, we recognized restructuring charges totaling $15 million as part of an initiative to improve effectiveness and efficiency of operations. As of December 31, 2011, we considered these restructuring initiatives to be substantially completed, with a remaining liability of $1 million.

Separation Costs

We had non-recurring pre-tax separation costs of $87 million, or $72 million after tax, during 2011. The components of separation costs incurred during these periods are presented below (in millions).

(in millions)	2011
Rebranding and marketing costs	$13
Advisory and professional fees	18
Information and technology costs	19
Employee retention and hiring costs	14
Lease termination and other real estate costs	10
Non-cash asset impairments (a)	8
Other	5
Total separation costs in operating income	87
Tax-related separation costs	6
Income tax benefit	(21)
Total separation costs, net of tax	$72

(a) During the third quarter, we recorded an impairment charge of $8 million on one of our facilities in China within our Applied Water segment. Prior to the separation, this was a shared facility among certain Xylem and ITT businesses and in connection with the separation, the removal of certain ITT operations triggered an impairment evaluation. The fair value of the applicable assets was calculated using the cost approach.

Operating Income

We generated operating income of $395 million during 2011, a 1.8% increase from the prior year, primarily reflecting increased revenues offset, in part, by non-recurring separation costs of $87 million. The following table illustrates operating income results by business segments for 2011 and 2010.

(in millions)	2011	2010	Change
Water Infrastructure	$343	$276	24.3 %
Applied Water	160	158	1.3 %
Segment operating income	503	434	15.9 %
Corporate and Other	(108)	(46)	
Total operating income	$395	$388	1.8 %
Operating Margin	12.7 %	12.1 %	60bp

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

(in millions)	2011	2010	Change
Water Infrastructure			
Operating income	$343	$276	24.3 %
Separation costs	16	—	
Restructuring costs	—	12	
Adjusted operating income	$359	$288	24.7 %
Adjusted operating margin	14.9 %	14.9 %	0bp
Applied Water			
Operating income	$160	$158	1.3 %
Separation costs	13	—	
Restructuring costs	—	3	
Adjusted operating income	$173	$161	7.5 %
Adjusted operating margin	12.0 %	12.1 %	(10)bp
Total Xylem			
Operating income	$395	$388	1.8 %
Separation costs (a)	87	—	
Restructuring costs	—	15	
Adjusted operating income	$482	$403	19.6 %
Adjusted operating margin	12.7 %	12.6 %	10bp

(a) Comprising non-recurring separation costs of $29 million in our business segments and $58 million within Corporate.

Water Infrastructure

Operating income for our Water Infrastructure segment increased $67 million or 24.3% ($71 million or 24.7% excluding separation and restructuring costs) compared with the prior year. This increase is led by incremental operating income of $42 million from acquisitions over the same period. Also contributing to the increase were higher sales volumes, lower restructuring expense and benefits from productivity and material costs savings initiatives, partially offset by higher labor and overhead costs, material inflation and unfavorable mix.

Applied Water

Operating income for our Applied Water segment increased $2 million or 1.3% ($12 million or 7.5% excluding separation and restructuring costs) compared to the prior year as higher sales volume and price realization were partially offset by increased spend on research and development and the unfavorable impacts of inflation, and customer and product mix.

Interest Expense

Interest expense increased to $17 million in 2011, primarily reflecting interest related to the issuance of $1.2 billion aggregate principal amount of senior notes issued in September 2011. Refer to Note 14, “Credit Facilities and Long-Term Debt,” for further details.

Income Tax Expense

The income tax provision for 2011 was $104 million at an effective tax rate of 27.4% compared to $59 million at an effective tax rate of 15.2% in 2010. The 2011 effective tax rate is higher than 2010 as a result of the unfavorable impact of recording a deferred tax liability on the excess of financial reporting over the tax basis of investments in certain foreign subsidiaries that has not been permanently reinvested, non deductible separation costs, and an increase in valuation allowances on certain foreign losses, offset in part by tax examination settlements and increased tax exempt interest.

Liquidity and Capital Resources

The following table summarizes our sources and uses of cash:

	Year Ended December 31,		
(in millions)	2012	2011	2010
Operating activities	$396	$449	$395
Investing activities	(147)	(423)	(1,093)
Financing activities	(74)	172	745
Foreign exchange	11	(11)	3
Total	$186	$187	$50

Sources and Uses of Liquidity

Operating Activities

During 2012, net cash provided by operating activities was $396 million, compared to $449 million in 2011. The $53 million year-over-year decrease is primarily the result of interest payments on debt of $53 million in 2012, higher tax payments of $40 million and additional contributions to postretirement benefit plans, partially offset by an increase in receivable collections and a decline in payments for separation costs.

During 2011, net cash provided by operating activities was $449 million, compared to $395 million in 2010. The $54 million year-over-year increase is primarily the result of lower tax and restructuring payments. This increase was partially offset by net increased uses of cash in working capital driven by spending to support increased sales volumes.

Investing Activities

Cash used in investing activities was $147 million for 2012, compared to $423 million in 2011 and $1,093 million in 2010. The changes in investing activities are driven almost entirely by cash used for acquisitions and, to a lesser extent, from changes in spending on capital expenditures. We invested $41 million for the acquisitions of MJK and Heartland during 2012 while $309 million was used in 2011 for the acquisition of YSI in 2011 and $1,004 million in 2010 predominately related to the acquisitions of Nova ($385 million) and Godwin Pumps ($580 million). Capital expenditures for 2012 of $112 million were $14 million less than in 2011 primarily due to a reduction in dewatering asset purchases to align with current rental demand. In 2011 we spent $126 million on capital expenditures, an increase of $32 million over 2010, primarily due to investments to increase productivity and the expansion of the Godwin business.

Financing Activities

During 2012, cash used by financing activities was $74 million, compared to cash provided by financing activities of $172 million and $745 million in 2011 and 2010, respectively. Cash used for financing activities during 2012 was driven by dividend payments of $75 million and share repurchases of $13 million, partially offset by $24 million of proceeds from the exercise of stock options. For 2011, net proceeds from the issuance of $1.2 billion in Senior Notes funded a net cash transfer of $1 billion to our former parent, ITT, which included the repayment of funds used in the acquisition of YSI. In general, the components of net transfers include: (i) cash transfers from the Company to parent, (ii) cash investments from our parent used to fund operations, capital expenditures and acquisitions, (iii) charges (benefits) for income taxes, and (iv) allocations of the parent company’s corporate expenses described in this Report.

Funding and Liquidity Strategy

As a result of the Spin-off, our capital structure and sources of liquidity changed significantly. Our ability to fund our capital needs depends on our ongoing ability to generate cash from operations, and access to the bank and capital markets.

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

Historically, we have generated operating cash flow sufficient to fund our primary cash needs centered on operating activities, working capital, capital expenditures, and strategic investments. If our cash flows from operations are less than we expect, we may need to incur debt or issue equity. From time to time, we may need to access the long-term and short-term capital markets to obtain financing. Our access to, and the availability of, financing on acceptable terms and conditions in the future will be impacted by many factors, including: (i) our credit ratings or absence of a credit rating, (ii) the liquidity of the overall capital markets, and (iii) the current state of the economy. There can be no assurance that we will continue to have access to the capital markets on terms acceptable to us. We cannot assure that such financing will be available to us on acceptable terms or that such financing will be available at all.

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

Senior Notes

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

The issuance resulted in gross proceeds of $1.2 billion, offset by $9 million in debt issuance costs which were capitalized and are included within other assets. The Senior Notes include covenants which restrict our ability, subject to exceptions, to incur debt secured by liens and engage in sale and lease-back transactions, as well as provide for customary events of default (subject, in certain cases, to receipt of notice of default and/or customary grace and cure periods), including but not limited to, (i) failure to pay interest for 30 days, (ii) failure to pay principal when due, (iii) failure to perform any other covenant for 90 days after receipt of notice from the trustee or from holders of 25% of the outstanding principal amount and (iv) certain events of bankruptcy, insolvency or reorganization. We may redeem the Senior Notes, as applicable, in whole or in part, at any time at a redemption price equal to the principal amount of the Senior Notes to be redeemed, plus a make-whole premium. As of December 31, 2012, we were in compliance with all covenants. If a change of control of Xylem triggering event occurs, we will be required to make an offer to purchase the Senior Notes at a price equal to 101% of their principal amount plus accrued and unpaid interest to the date of repurchase.

On July 26, 2012, the Company completed its offers to exchange the Senior Notes for new registered notes, with terms identical in all material respects to the Senior Notes except the new notes are freely transferable and not subject to any covenant regarding registration.

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

Credit Facility

Effective October 31, 2011, Xylem and its subsidiaries entered into a Four Year Competitive Advance and Revolving Credit Facility (the “Credit Facility”) with JPMorgan Chase Bank, N.A., as administrative agent, and a syndicate of lenders. The credit facility provides for an aggregate principal amount of up to $600 million of (i) a competitive advance borrowing option which will be provided on an uncommitted competitive advance basis through an auction mechanism (the “competitive loans”), (ii) revolving extensions of credit (the “revolving loans”) outstanding at any time and (iii) the issuance of letters of credit in a face amount not in excess of $100 million outstanding at any time.

At our election, the interest rate per annum applicable to the competitive advances will be based on either (i) a Eurodollar rate determined by reference to LIBOR, plus an applicable margin offered by the lender making such loans and accepted by us or (ii) a fixed percentage rate per annum specified by the lender making such loans. At our election, interest rate per annum applicable to the revolving loans will be based on either (i) a Eurodollar rate determined by reference to LIBOR, adjusted for statutory reserve requirements, plus an applicable margin or (ii) a fluctuating rate of interest determined by reference to the greatest of (a) the prime rate of JPMorgan Chase Bank, N.A., (b) the U.S. Federal Funds effective rate plus half of 1% or (c) the Eurodollar rate determined by reference to LIBOR, adjusted for statutory reserve requirements, in each case, plus an applicable margin.

In accordance with the terms, we may not exceed a maximum leverage ratio of 3.50 (based on a ratio of total debt to earnings before interest, taxes, depreciation and amortization) throughout the term. The Credit Facility also contains limitations on, among other things, incurring debt, granting liens, and entering sale and leaseback transactions. In addition, the Credit Facility contains other terms and conditions such as customary representations and warranties, additional covenants and customary events of default.

As of December 31, 2012, this credit facility remains undrawn.

Research and Development Facility Agreement

Effective December 14, 2012, we entered into a Risk Sharing Finance Facility Agreement (the "R&D Facility Agreement") with The European Investment Bank ("EIB") in an aggregate principal amount of up to €120 million (approximately $158 million) to finance research projects and research infrastructures in the European Union. The Company's wholly-owned subsidiary in Luxembourg, Xylem Holdings S.a.r.l., is the borrower under the R&D Facility Agreement. The funds are made available to finance research and development projects during the period of 2013 through 2016 at the Company's R&D facilities in Sweden, Germany, Italy, the United Kingdom, Austria, Norway and Hungary.

Under the R&D Facility Agreement, the borrower can, starting no later than 18 months from the date of the R&D Facility Agreement, draw loans with a maturity of no longer than 12 years. The R&D facility Agreement provides for Fixed Rate loans and Floating Rate loans. The interest rate per annum applicable to Fixed Rate loans will be at a fixed percentage rate per annum specified by EIB which includes the applicable margin. The interest rate per annum applicable to Floating Rate loans will be at the rate determined by reference to EURIBOR for loans drawn in Euros and LIBOR for loans drawn in Sterling or US Dollars plus an applicable spread specified by EIB which includes the applicable margin. The applicable margin for both Fixed Rate loans and Floating Rate loans shall be determined by reference to the credit rating of the Company.

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

As of December 31, 2012, the R&D Facility Agreement remains undrawn.

Non-U.S. Operations

For 2012 and 2011, we generated approximately 63% and 64%, respectively, of our revenue from non-U.S. operations. As we continue to grow our operations in the emerging markets and elsewhere outside of the United States, we expect to continue to generate significant revenue from non-U.S. operations and we expect our cash will be predominately held by our foreign subsidiaries. We expect to manage our worldwide cash requirements considering available funds among the many subsidiaries through which we conduct business and the cost effectiveness with which those funds can be accessed. We may transfer cash from certain international subsidiaries to the U.S. and other international subsidiaries when it is cost effective to do so. Our intent is to indefinitely reinvest all but $100 million of these funds outside of the United States. However, we continually review our domestic and foreign cash profile, expected future cash generation and investment opportunities that support our current designation of these funds as being indefinitely reinvested and reassess whether there is a demonstrated need to repatriate funds held internationally to support our U.S. operations. If, as a result of our review, it is determined that all or a portion of the funds may be needed for our operations in the United States, we would be required to accrue U.S. taxes related to future tax payments associated with the repatriation of these funds. As of December 31, 2012, our foreign subsidiaries were holding $401 million in cash or marketable securities.

As of December 31, 2012, our excess of financial reporting over the tax basis of investments in certain foreign subsidiaries totaled $1.7 billion. We have not asserted that $100 million of our excess basis difference will be indefinitely reinvested and have therefore provided for United States or additional foreign withholding taxes for that portion. Generally, such amounts become subject to U.S. taxation upon the remittance of dividends and under certain other circumstances.

Contractual Obligations

The following table summarizes our contractual commitments as of December 31, 2012:

(in millions)	2013	2014 - 2015	2016 - 2017	Thereafter	Total
Debt and capital lease obligations (1)	$6	$—	$600	$600	$1,206
Interest payments (2)	51	101	79	117	348
Operating lease obligations	58	74	40	20	192
Purchase obligations (3)	61	12	1	—	74
Other long-term obligations reflected on the balance sheet (4)	8	21	15	9	53
Total commitments	$184	$208	$735	$746	$1,873

In addition to the amounts presented in the table above, we have recorded liabilities for uncertain tax positions of $8 million. These amounts have been excluded from the contractual obligations table due to an inability to reasonably estimate the timing of such payments in individual years. Further, benefit payments which reflect expected future service related to the Company's pension and other postretirement employee benefit obligations are presented in Note 15, "Postretirement Benefit Plans" and not included in the above table.

(1) Refer to Note 14, "Credit Facilities and Long-Term Debt," in the notes to the consolidated financial statements for discussion of the use and availability of debt and revolving credit agreements. Amounts represent principal payments of long-term debt including current maturities and exclude unamortized discounts.

(2) Amounts represent estimate of future interest payments on long-term debt outstanding as of December 31, 2012.

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

(4) Other long-term obligations include estimated environmental payments. We estimate, based on historical experience, that we will spend between $2 million and $6 million per year on environmental investigation and remediation. At December 31, 2012, we had estimated and accrued $11 million related to environmental matters.

Off-Balance Sheet Arrangements

As of December 31, 2012, we have issued guarantees for the debt and other obligations of consolidated subsidiaries. We do not consider the maximum exposure to be material either individually or in the aggregate.

Critical Accounting Estimates

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

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

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

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

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

Warranty Accrual. Accruals for estimated expenses related to warranties are made at the time products are sold or services are rendered and are recorded as a component of cost of revenue. These accruals are established using historical information on the nature, frequency and average cost of warranty claims and consider any factors that may cause differences in expected future warranty costs as compared to historical claim experience. While we engage in extensive product quality programs and processes, we base our estimated warranty obligation on product warranty terms offered to customers, ongoing product failure rates, material usage and service delivery costs incurred in correcting a product failure, as well as specific product class failures outside of our baseline experience. We assess the adequacy of our recorded warranty liabilities quarterly and adjust amounts as necessary.

Income Taxes. Deferred tax assets and liabilities are determined based on temporary differences between the financial reporting and tax bases of assets and liabilities, applying enacted tax rates in effect for the year in which we expect the differences will reverse. Based on the evaluation of available evidence, we recognize future tax benefits, such as net operating loss carryforwards, to the extent that we believe it is more likely than not we will realize these benefits. We periodically assess the likelihood that we will be able to recover our deferred tax assets and reflect any changes to our estimate of the amount we are more likely than not to realize in the valuation allowance, with a corresponding adjustment to earnings or other comprehensive income, as appropriate.

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

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

The calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax regulations in a multitude of jurisdictions across our global operations. We recognize potential liabilities and record tax liabilities for anticipated tax audit issues in the U.S. and other tax jurisdictions based on our estimate of whether, and to the extent to which, additional taxes will be due. Furthermore, we recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. The tax benefits recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement.

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

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

Determining the fair value of a reporting unit or an indefinite-lived intangible asset is judgmental in nature and involves the use of significant estimates and assumptions, particularly related to future operating results and cash flows. These estimates and assumptions include, but are not limited to, revenue growth rates and operating margins used to calculate projected future cash flows, risk-adjusted discount rates, assumed royalty rates, future economic and market conditions and identification of appropriate market comparable data. In addition, the identification of reporting units and the allocation of assets and liabilities to the reporting units when determining the carrying value of each reporting unit also require judgment. Goodwill is tested for impairment at either the operating segment identified in Note 20, "Industry Segment and Geographic Data," of the consolidated and combined financial statements, or one level below. The fair value of our reporting units and indefinite-lived intangible assets is based on estimates and assumptions that are believed to be reasonable. Significant changes to these estimates and assumptions could adversely impact our conclusions. Actual future results may differ from those estimates.

Our 2012 annual goodwill impairment analysis indicated the estimated fair value of our reporting units significantly exceeded their carrying value, and accordingly, no impairment charges were recorded. In order to evaluate the sensitivity of the fair value estimates on the goodwill impairment test, we applied a hypothetical 100 basis point increase to the discount rates utilized, a ten percent reduction in expected future cash flows, and reduced the assumed future growth rates of each reporting unit by 100 basis points. These hypothetical changes did not result in any reporting unit failing step one of the impairment test. Further, our 2012 annual indefinite-lived intangible asset impairment test did not result in an impairment charge as the estimated fair value of the assets exceeded their carrying value.

Postretirement Plans. Prior to the Spin-off, employees who met certain eligibility requirements participated in various retirement plans administered by ITT. In connection with the Spin-off, we entered into a Benefit and Compensation

Matters Agreement with ITT whereby Xylem agreed to adopt or assume sponsorship of certain defined benefit plans and replicate certain ITT defined contribution plans to allow for continuation of those benefits. Under this agreement, assets and liabilities attributable to Xylem employees were transferred from ITT to our qualified defined benefit and defined contribution plans.

Company employees around the world participate in numerous defined benefit pension plans. The determination of projected benefit obligations and the recognition of expenses related to these pension plans are dependent on various assumptions. These major assumptions primarily relate to discount rates, expected long-term rates of return on plan assets, rate of future compensation increases, mortality, health care inflation and termination (some of which are disclosed in Note 15, "Postretirement Benefit Plans," in the notes to the consolidated and combined financial statements) and other factors. Actual results that differ from our assumptions are accumulated and are amortized generally over the estimated future working life of the plan participants, or for plans with all or substantially all inactive participants, over the average remaining life expectancy.

Significant Assumptions

Management develops each assumption using relevant Company experience, in conjunction with market-related data for each individual country in which such plans exist. All assumptions are reviewed annually with third-party consultants and adjusted as necessary. The table included below provides the weighted average assumptions used to estimate our defined benefit pension obligations and costs as of and for the years 2012 and 2011.

	2012		2011	
	U.S.	Int'l	U.S.	Int'l
Benefit Obligation Assumptions				
Discount rate	4.13%	4.04%	4.87%	4.76%
Rate of future compensation increase	4.50%	3.50%	4.50%	3.58%
Net Periodic Benefit Cost Assumptions				
Discount rate	4.87%	4.76%	5.83%	5.53%
Expected long-term return on plan assets	8.00%	7.35%	9.00%	7.34%
Rate of future compensation increase	4.50%	3.58%	4.50%	3.37%

We determine the expected long-term rate of return on plan assets by evaluating both historical returns and estimates of future returns. Specifically, the Company analyzes the estimated future returns based on independent estimates of asset class returns and evaluates historical broad market returns over long-term timeframes based on the strategic asset allocation, which is detailed in Note 15, "Postretirement Benefit Plans," in the notes to the consolidated financial statements.

Based on the approach described above, the chart below shows weighted average actual returns versus the weighted average expected long-term rates of return for our pension plans that were utilized in the calculation of the net periodic pension cost for each respective year.

	2012	2011	2010 (a)
Expected long-term rate of return on plan assets	7.42%	7.52%	8.20%
Actual rate of return on plan assets	10.09%	(1.40)%	15.34%

(a) Represents pre Spin-off from ITT and does not include returns on plans transferred from ITT upon Spin-off.

For the recognition of net periodic pension cost, the calculation of the expected long-term rate of return on plan assets is generally derived using a market-related value of plan assets based on average asset values at the measurement date over the last five years. The use of fair value, rather than a calculated value, could materially affect net periodic pension cost. Our weighted average expected long-term rate of return on plan assets for all pension plans, effective January 1, 2013 is 7.40%. We estimate that every 25 basis point change in the expected return on plan assets impacts the expense by $1 million.

The discount rate reflects our expectation of the present value of expected future cash payments for benefits at the measurement date. A decrease in the discount rate increases the present value of benefit obligations and increases pension expense. We base the discount rate assumption on current investment yields of high-quality fixed income investments during the retirement benefits maturity period. The pension discount rate was determined by considering an interest rate yield curve comprising AAA/AA bonds, with maturities between zero and thirty years, developed by the plan's actuaries. Annual benefit payments are then discounted to present value using this yield curve to develop a single-point discount rate matching the plan's characteristics. Our weighted average discount rate for all pension plans effective January 1, 2013, is 4.05%. We estimate that every 25 basis point change in the discount rate impacts the expense by $2 million.

49

The rate of future compensation increase assumption reflects our long-term actual experience and future and near-term outlook. Effective January 1, 2013, our expected rate of future compensation is 3.57% for all pension plans. The estimated impact of a 25 basis point change in the expected rate of future compensation is less than $1 million.
The assumed rate of future increases in the per capita cost of health care (the health care trend rate) is 7.68% for 2013, decreasing ratably to 5% in 2020. An increase or decrease in the health care trend rates by one percent per year would impact the aggregate annual service and interest components by less than $1 million, and impact the benefit obligation by approximately $8 million. To the extent that actual experience differs from these assumptions, the effect will be amortized over the average future service of the covered active employees.

Funded Status

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

Fair Value of Plan Assets

The plan assets of our pension plans comprise a broad range of investments, including domestic and foreign equity securities, interests in private equity and hedge funds, fixed income investments, insurance contracts, real estate, and cash and cash equivalents.
A portion of our pension benefit plan assets portfolio comprises investments in private equity and hedge funds. The private equity and hedge fund investments are generally measured at net asset value. However, in certain instances, the values reported by the asset managers were not current at the measurement date. Accordingly, we made estimate adjustments to the last reported value where necessary to measure the assets at fair value at the measurement date. These adjustments consider information received from the asset managers, as well as general market information. The adjustment recorded at December 31, 2012 for these assets represented less than one half of one percent of total plan assets. There were no adjustments for these assets at December 31, 2011. Asset values for other positions were generally measured using market observable prices. We estimate that a 5% change in asset values will impact funded status by approximately $22 million.

New Accounting Pronouncements

See Note 2, “Recently Issued Accounting Pronouncements,” in the notes to the consolidated and combined financial statements for a complete discussion of recent accounting pronouncements. There were no new pronouncements which we expect to have a material impact on our financial condition and results of operations in future periods.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Foreign Currency Exchange Rate Risk

Our foreign currency exchange rate risk relates to receipts from customers, payments to suppliers and intercompany transactions denominated in foreign currencies. We may use derivative financial instruments to offset risk related to receipts from customers and payments to suppliers, when it is believed that the exposure will not be limited by our normal operating and financing activities. In January 2012, we began to enter into currency forward contracts periodically in order to manage the exchange rate fluctuation risk on certain intercompany transactions associated with third party sales and purchases. Our principal currency exposures relate to the Euro, Swedish Krona, British Pound, Australian Dollar, Canadian Dollar, Polish Zloty, and Hungarian Forint. We estimate that a hypothetical 10% adverse movement in foreign currency exchange rates would not be material to Xylem’s financial position, results of operations or cash flows.

Interest Rate Risk

As of December 31, 2012, we do not have a material exposure to interest rate risk as our debt portfolio entirely comprises long-term, fixed-rate instruments. We do not account for our long-term debt using the fair value option.

Commodity Price Exposures

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

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INDEX TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS

	Page No.
Audited Consolidated and Combined Financial Statements:	
Report of Independent Registered Public Accounting Firm	53
Consolidated and Combined Income Statements for the Years Ended December 31, 2012, 2011 and 2010	54
Consolidated and Combined Statements of Comprehensive Income for the Years Ended December 31, 2012, 2011 and 2010	55
Consolidated Balance Sheets as of December 31, 2012 and December 31, 2011	56
Consolidated and Combined Statements of Cash Flows for the Years Ended December 31, 2012, 2011 and 2010	57
Consolidated and Combined Statements of Changes in Stockholders' Equity for the Years Ended December 31, 2012, 2011 and 2010	58
Notes to Consolidated and Combined Financial Statements	59
Note 1 Summary of Significant Accounting Policies	59
Note 2 Recently Issued Accounting Pronouncements	66
Note 3 Acquisitions	68
Note 4 Restructuring and Asset Impairment Charges	71
Note 5 Separation Costs	72
Note 6 Other Non-Operating Income, Net	72
Note 7 Income Taxes	72
Note 8 Earnings Per Share	77
Note 9 Inventories	77
Note 10 Property, Plant and Equipment	78
Note 11 Goodwill and Other Intangible Assets	78
Note 12 Derivative Financial Instruments	79
Note 13 Accrued and Other Current Liabilities	80
Note 14 Credit Facilities and Long-Term Debt	81
Note 15 Postretirement Benefit Plans	82
Note 16 Stock-Based Compensation	91
Note 17 Accumulated Other Comprehensive Income (Loss)	93
Note 18 Commitment and Contingencies	93
Note 19 Related Party Transactions	95
Note 20 Industry Segment and Geographic Data	97
Note 21 Subsequent Event	99
Note 22 Supplemental Information	99
Note 23 Quarterly Financial Data	99

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Xylem Inc.
White Plains, New York

We have audited the accompanying consolidated balance sheets of Xylem Inc. and subsidiaries (the "Company") as of December 31, 2012 and 2011, and the related consolidated and combined statements of income, comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2012. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Xylem Inc. and subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2012, in conformity with accounting principles generally accepted in the United States of America.

As described in Note 1 to the consolidated and combined financial statements, prior to October 31, 2011, the accompanying financial statements were derived from the accounting records of the water equipment and services businesses of ITT Corporation. For periods prior to October 31, 2011, the financial statements include expense allocations for certain corporate functions historically provided by ITT Corporation. These allocations may not be reflective of the actual expenses that would have been incurred had the Company operated as a separate entity apart from ITT Corporation. Included in Note 19 to the consolidated and combined financial statements is a summary of transactions with related parties.

As discussed in Note 2, the accompanying consolidated and combined financial statements have been retrospectively adjusted for the presentation of separate consolidated and combined statements of comprehensive income.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2012, based on the criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 25, 2013 expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ Deloitte & Touche LLP
Stamford, Connecticut
February 25, 2013

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

Year Ended December 31,	2012	2011	2010
Revenue	$3,791	$3,803	$3,202
Cost of revenue	2,289	2,342	1,988
Gross profit	1,502	1,461	1,214
Selling, general and administrative expenses	914	877	737
Research and development expenses	106	100	74
Separation costs	22	87	—
Restructuring and asset impairments charges	17	2	15
Operating income	443	395	388
Interest expense	55	17	—
Other non-operating income, net	—	5	—
Income before taxes	388	383	388
Income tax expense	91	104	59
Net income	$297	$279	$329
Earnings per share:			
Basic	$1.60	$1.51	$1.78
Diluted	$1.59	$1.50	$1.78
Weighted average number of shares – Basic	185.8	185.1	184.6
Weighted average number of shares – Diluted	186.2	185.3	184.6

See accompanying notes to consolidated and combined financial statements.

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

December 31,	2012	2011	2010
Net income	$ 297	$ 279	$ 329
Other comprehensive income, before tax:			
Foreign currency translation adjustment	48	(61)	(31)
Net change in cash flow hedges:			
Unrealized gains	4	—	—
Amount of gains reclassified into net income	(3)	—	—
Net change in postretirement benefit plans:			
Net loss	(84)	(74)	(6)
Prior service cost	1	—	(2)
Amortization of prior service cost	(1)	1	1
Amortization of net actuarial loss	11	2	1
Settlement	2	—	—
Foreign exchange	(8)	—	—
Other comprehensive (loss), before tax	(30)	(132)	(37)
Income tax benefits related to other comprehensive loss	(23)	(14)	(2)
Other comprehensive (loss), net of tax	(7)	(118)	(35)
Comprehensive income	$ 290	$ 161	$ 294

See accompanying notes to consolidated and combined financial statements.

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

December 31,	2012	2011
ASSETS		
Current assets:		
Cash and cash equivalents	$504	$318
Receivables, less allowances for discounts and doubtful accounts of $34 and $37 in 2012 and 2011, respectively	776	756
Inventories, net	443	433
Prepaid and other current assets	110	97
Deferred income tax assets	41	45
Total current assets	1,874	1,649
Property, plant and equipment, net	487	463
Goodwill	1,647	1,610
Other intangible assets, net	484	505
Other non-current assets	187	173
Total assets	$4,679	$4,400
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Current liabilities:		
Accounts payable	$332	$322
Accrued and other current liabilities	443	490
Short-term borrowings and current maturities of long-term debt	6	5
Total current liabilities	781	817
Long-term debt	1,199	1,201
Accrued postretirement benefits	400	316
Deferred income tax liabilities	173	168
Other non-current accrued liabilities	52	67
Total liabilities	2,605	2,569
Commitment and Contingencies (Note 18)		
Stockholders’ equity:		
Common Stock — par value $0.01 per share:		
Authorized 750.0 shares, issued 186.2 and 184.6 shares in 2012 and 2011, respectively	2	2
Capital in excess of par value	1,706	1,663
Retained earnings	264	44
Treasury stock – at cost 0.5 shares and 0 shares in 2012 and 2011, respectively	(13)	—
Accumulated other comprehensive income	115	122
Total stockholders’ equity	2,074	1,831
Total liabilities and stockholders’ equity	$4,679	$4,400

See accompanying notes to consolidated and combined financial statements.

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

Year Ended December 31,	2012	2011	2010
Operating Activities			
Net income	$297	$279	$329
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	142	137	92
Deferred income taxes	1	8	(31)
Share-based compensation	22	13	9
Non-cash separation costs	—	10	—
Restructuring and asset impairment charges, net	17	2	15
Payments of restructuring	(9)	(7)	(22)
Contributions to postretirement benefit plans	(46)	(16)	(3)
Changes in assets and liabilities (net of acquisitions):			
Changes in receivables	2	(61)	(45)
Changes in inventories	5	(18)	7
Changes in accounts payable	(4)	(9)	41
Changes in accrued liabilities	(28)	53	12
Changes in accrued taxes	(17)	56	(17)
Net changes in other assets and liabilities	14	2	8
Net Cash — Operating activities	396	449	395
Investing Activities			
Capital expenditures	(112)	(126)	(94)
Proceeds from the sale of property, plant and equipment	5	11	4
Acquisitions of businesses and assets, net of cash acquired	(41)	(309)	(1,004)
Other, net	1	1	1
Net Cash — Investing activities	(147)	(423)	(1,093)
Financing Activities			
Net transfer (to)/from former parent	(9)	(995)	745
Issuance of short-term debt	13	5	—
Issuance of senior notes, net of discount	—	1,198	—
Principal payments of debt and capital lease obligations	(14)	(8)	—
Purchase of Xylem common stock	(13)	—	—
Proceeds from exercise of employee stock options	24	1	—
Payments of debt issuance costs	—	(10)	—
Dividends paid	(75)	(19)	—
Net Cash — Financing activities	(74)	172	745
Effect of exchange rate changes on cash	11	(11)	3
Net change in cash and cash equivalents	186	187	50
Cash and cash equivalents at beginning of year	318	131	81
Cash and cash equivalents at end of year	$504	$318	$131
Supplemental disclosure of cash flow information:			
Cash paid during the year for:			
Interest	$53	$—	$—
Income taxes (net of refunds received)	$104	$64	$110

See accompanying notes to consolidated and combined financial statements.

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

	Common Stock	Add'l Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Parent Company Investment	Total
BALANCE AT JANUARY 1, 2010	$—	$—	$4	$72	$—	$1,615	$1,691
Net income						329	329
Other comprehensive loss, net				(35)			(35)
Change in parent company investment						738	738
BALANCE AT DECEMBER 31, 2010	—	—	4	37	—	2,682	2,723
Net income to October 30, 2011						220	220
Net income from October 31, 2011			59				59
Other comprehensive loss, net				(118)			(118)
Assumption of accumulated unrealized gains (losses) on postretirement benefit plans				(73)			(73)
Contributed currency translation adjustment				276			276
Change in parent company investment						(1,240)	(1,240)
Conversion of net investment	2	1,660				(1,662)	—
Dividends declared ($0.1012 per share)			(19)				(19)
Stock incentive plan activity		3					3
BALANCE AT DECEMBER 31, 2011	2	1,663	44	122	—	—	1,831
Net income			297				297
Other comprehensive loss, net				(7)			(7)
Dividends declared ($0.4048 per share)			(77)				(77)
Stock incentive plan activity		43					43
Repurchase of common stock					(13)		(13)
BALANCE AT DECEMBER 31, 2012	$2	$1,706	$264	$115	$(13)	$—	$2,074

See accompanying notes to consolidated and combined financial statements.

NOTES TO CONSOLIDATED AND COMBINED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies

Xylem Inc. ("Xylem" or the "Company") is a leading equipment and service provider for water and wastewater applications with a broad portfolio of products and services addressing the full cycle of water, from collection, distribution and use to the return of water to the environment. Xylem operates in two segments, Water Infrastructure and Applied Water. The Water Infrastructure segment focuses on the transportation, treatment and testing of water, offering a range of products including water and wastewater pumps, treatment and testing equipment, and controls and systems. The Applied Water segment encompasses all the uses of water and focuses on the residential, commercial, industrial and agricultural markets. The Applied Water segment's major products include pumps, valves, heat exchangers, controls and dispensing equipment. Xylem Inc. was incorporated in Indiana on May 4, 2011.

On October 31, 2011, ITT Corporation ("ITT") completed the Spin-off (the "Spin-off") of Xylem, formerly ITT's water equipment and services businesses. Effective as of 12:01 a.m., Eastern time on October 31, 2011 (the "Distribution Date"), the common stock of Xylem was distributed, on a pro rata basis, to ITT's shareholders of record as of the close of business on October 17, 2011 (the "Record Date"). On the Distribution Date, each of the shareholders of ITT received one share of Xylem common stock for every one share of common stock of ITT held on the Record Date.

The Spin-off was completed pursuant to the Distribution Agreement, dated as of October 25, 2011 (the "Distribution Agreement"), among ITT, Exelis Inc. ("Exelis") and Xylem. After the Distribution Date, ITT did not beneficially own any shares of Xylem common stock and, following such date, financial results of Xylem have not been consolidated in ITT's financial reporting. Xylem's Registration Statement on Form 10 filed with the U.S. Securities and Exchange Commission ("SEC") was declared effective on October 6, 2011. Xylem's common stock began "regular-way" trading on the New York Stock Exchange on November 1, 2011 under the symbol "XYL".

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

Basis of Presentation

The consolidated and combined financial statements reflect our financial position and results of operations in conformity with accounting principles generally accepted in the United States of America ("GAAP"). All intracompany transactions between our businesses have been eliminated. On and prior to the Distribution Date, our financial position and results of operations consisted of the water equipment and services businesses of ITT Corporation ("WaterCo") and have been derived from ITT's historical accounting records and are presented on a carve-out basis through our Distribution Date, while our financial results for Xylem post Spin-off are prepared on a stand-alone basis. As such, our Consolidated and Combined Statements of Income, Comprehensive Income and Cash Flows for the periods ended December 31, 2012 consist of the consolidated results of Xylem on a stand-alone basis. The Consolidated and Combined Statements of Income, Comprehensive Income and Cash Flows for the twelve months ended December 31, 2011 consist of the consolidated results of Xylem on a stand-alone basis for two months of November and December and the combined results of operations of WaterCo for ten months on a carve-out basis. The twelve months ended December 31, 2010 consist entirely of the combined results of WaterCo on a carve-out basis.

For periods prior to the Spin-off, our consolidated and combined financial statements include expense allocations for (i) certain corporate functions historically provided by ITT, including, but not limited to, finance, legal, information technology, human resources, communications, ethics and compliance, and shared services, (ii) employee benefits and incentives, and (iii) share-based compensation. These expenses have been allocated to us on the basis of direct usage when identifiable, with the remainder allocated on the basis of revenue, headcount or other measures.

We consider the basis on which the expenses have been allocated to be a reasonable reflection of the utilization of services provided to or the benefit received by us during the periods presented. The allocations may not, however, reflect the expense we would have incurred as an independent, publicly traded company for the periods presented prior to the Distribution Date. Actual costs that may have been incurred if we had been a stand-alone company would depend on a number of factors, including the chosen organizational structure, what functions were outsourced or performed by employees and strategic decisions made in areas such as information technology and infrastructure. Subsequent to the Spin-off, we have performed these functions using our own resources or

59

purchased services, certain of which have been provided by ITT under the Transition Services Agreement, at a cost of approximately $1 million that is expected to extend for a period of 3 to 24 months from the Distribution Date in most circumstances.

Use of Estimates

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

Consolidation Principles

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

Foreign Currency Translation

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

Revenue Recognition

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

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

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

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

Shipping and Handling Costs

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

Share-Based Compensation

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

Research and Development

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

Exit and Disposal Costs

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

Deferred Financing Costs

Deferred financing costs represent costs incurred in conjunction with our debt financing activities and are capitalized in other assets and amortized over the life of the related financing arrangements. If the debt is retired early, the related unamortized deferred financing costs are written off in the period the debt is retired and are recorded in the statement of operations under the caption “other non-operating income, net.”

Income Taxes

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

We maintain valuation allowances when it is more likely than not that all or a portion of a deferred asset will not be realized. The valuation allowance is intended in part to provide for the uncertainty regarding the ultimate utilization of our U.S. capital loss carryforwards, U.S. foreign tax credit carryovers, and foreign net operating loss carryforwards. In determining whether a valuation allowance is warranted, we consider all positive and negative evidence and all sources of taxable income such as prior earnings history, expected future earnings, carryback and carryforward periods and tax strategies to estimate if sufficient future taxable income will be generated to realize the deferred tax asset. The assessment of the adequacy of our valuation allowance is based on our estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be

recoverable. In the event that actual results differ from these estimates, or we adjust these estimates in future periods for current trends or expected changes in our estimating assumptions, we may need to modify the level of valuation allowance that could materially impact our business, financial condition and results of operations.
Our effective tax rate reflects the impact of certain undistributed foreign earnings for which we have not provided U.S. taxes because we plan to reinvest such earnings indefinitely outside the United States. We plan foreign earnings remittance amounts based on projected cash flow needs, as well as the working capital and long-term investment requirements of our foreign subsidiaries and our domestic operations. Based on these assumptions, we estimate the amount we will distribute to the United States and provide the U.S. federal taxes due on these amounts. Material changes in our estimates of cash, working capital and long-term investment requirements in the various jurisdictions in which we do business could impact our effective tax rate.
Tax benefits are recognized for an uncertain tax position when, in management's judgment, it is more likely than not that the position will be sustained upon examination by a taxing authority. For a tax position that meets the more-likely-than-not recognition threshold, the tax benefit is measured as the largest amount that is judged to have a greater than 50% likelihood of being realized upon ultimate settlement with a taxing authority. The liability associated with unrecognized tax benefits is adjusted periodically due to changing circumstances and when new information becomes available. Such adjustments are recognized in the period in which they are identified. The effective tax rate includes the net impact of changes in the liability for unrecognized tax benefits and subsequent adjustments as considered appropriate by management. While it is often difficult to predict the final outcome or the timing of resolution of any particular tax matter, we believe our liability for unrecognized tax benefits is adequate. We classify interest relating to unrecognized tax benefits as a component of other non-operating income, net and tax penalties as a component of income tax expense in our Consolidated and Combined Income Statements.

Earnings Per Share

We present two calculations of earnings per share ("EPS"). "Basic" earnings per share equals net income divided by weighted average shares outstanding during the period. "Diluted" earnings per share equals net income divided by the sum of weighted average common shares outstanding during the period plus potentially dilutive shares. Potentially dilutive common shares that are anti-dilutive are excluded from net earnings per share.
Basic and Diluted EPS for all periods prior to the Spin-off reflect the number of distributed shares on the Distribution Date, or 184.6 million shares. For our 2011 year to date calculations, these shares are treated as issued and outstanding from January 1, 2011 for purposes of calculating historical basic EPS. At the time of the Spin-off, ITT stock options and restricted stock awards were converted to awards of Xylem, and therefore there were no dilutive securities outstanding for historical periods. For 2011, the Company determined our weighted average dilutive shares outstanding assuming that the date of our separation from ITT was the beginning of the period.

Cash Equivalents

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

Receivables and Allowance for Doubtful Accounts and Cash Discounts

Trade receivables primarily comprise uncollected amounts owed to us from transactions with customers and are presented net of allowances for doubtful accounts and cash discounts.
We determine our allowance for doubtful accounts using a combination of factors to reduce our trade receivable balances to their estimated net realizable amount. We maintain an allowance for doubtful accounts based on a variety of factors, including the length of time receivables are past due, macroeconomic trends and conditions, significant one-time events, historical experience and the financial condition of customers. We record a specific reserve for individual accounts when we become aware of specific customer circumstances, such as in the case of bankruptcy filings or deterioration in the customer's operating results or financial position. The past due or delinquency status of a receivable is based on the contractual payment terms of the receivable. If circumstances related to the specific customer change, we adjust estimates of the recoverability of receivables as appropriate. We determine our allowance for cash discounts primarily based on historical experience with customers.
Credit risk with respect to accounts receivable is generally diversified due to the large number of entities comprising our customer base and their dispersion across many different geographical regions. We perform ongoing credit evaluations of the financial condition of our third-party distributors, resellers and other customers and require

collateral, such as letters of credit and bank guarantees, in certain circumstances. As of December 31, 2012 and 2011 we do not believe we have any significant concentrations of credit risk.

Inventories

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

During the fourth quarter of 2012, the Company changed its method of accounting for those inventories which were accounted for under the last-in, first-out (“LIFO”) method (9% of total 2011 inventories) to the FIFO method. The Company believes that this change is preferable as it provides uniformity across the Company's operations with respect to the method of inventory accounting, better reflects the current value of inventories on the Consolidated Balance Sheet, aligns the flow of physical inventory with the accounting, better matches revenues with associated expenses, and improves comparability with the Company's peers.

We applied the change retrospectively to the earliest period presented. The resulting impact to our Consolidated Balance Sheet as of December 31, 2011 is as follows:

(in millions)	December 31, 2011		
Consolidated Balance Sheet	As Originally Reported	LIFO to FIFO Adjustment	Retrospectively Adjusted
Inventories, net	$426	$7	$433
Deferred income tax liabilities	165	3	168
Retained earnings	40	4	44

No retrospective adjustments were made to the Consolidated and Combined Statements of Income as they were immaterial for all periods presented, resulting in an immaterial adjustment recorded to the Consolidated Statement of Income and Consolidated Balance Sheet during the fourth quarter of 2012 of less than $1 million.

Property, Plant and Equipment

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

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

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

Goodwill and Intangible Assets
Goodwill represents purchase consideration paid in a business combination that exceeds the values assigned to the net assets of acquired businesses. Intangible assets include customer relationships, proprietary technology, brands and trademarks, patents and other intangible assets. Intangible assets with a finite life are amortized on a straight-line basis over an estimated economic useful life which ranges from 10 to 40 years and is included in selling, general and administrative expense. Certain of our intangible assets have an indefinite life and are not amortized, namely certain brands and trademarks.
Long-Lived Asset Impairment
Long-lived assets, including intangible assets with finite lives, are amortized and tested for impairment whenever events or changes in circumstances indicate their carrying value may not be recoverable. We assess the recoverability of long-lived assets based on the undiscounted future cash flow the assets are expected to generate and recognize an impairment loss when estimated undiscounted future cash flows expected to result from the use of the asset plus net proceeds expected from disposition of the asset, if any, are less than the carrying value of the asset. When an impairment is identified, we reduce the carrying amount of the asset to its estimated fair value based on a discounted cash flow approach or, when available and appropriate, to comparable market values.
Goodwill and indefinite-lived intangible assets are not amortized, but rather are tested for impairment annually (or more frequently if impairment indicators arise, such as changes to the reporting unit structure, significant adverse changes in the business climate or an adverse action or assessment by a regulator). We conduct our annual impairment testing on the first day of our fourth quarter. For goodwill, the impairment test is a two-step test. In the first step, the estimated fair value of each reporting unit is compared to the carrying value of the net assets assigned to that reporting unit. If the estimated fair value of the reporting unit exceeds its carrying value, goodwill is not impaired and the second step of the impairment test is not performed. If the carrying value of the reporting unit exceeds its estimated fair value, then the second step of the impairment test is performed in order to measure the impairment loss to be recorded, if any. If the carrying value of a reporting unit’s goodwill exceeds its implied fair value, then we record an impairment loss equal to the difference. We estimate the fair value of our reporting units and indefinite-lived intangible assets using an income approach. Under the income approach, we estimate fair value based on the present value of estimated future cash flows.
Product Warranties
We accrue for the estimated cost of product warranties at the time revenue is recognized and record it as a component of cost of revenue. Our product warranty liability reflects our best estimate of probable liability under the terms and conditions of our product warranties offered to customers. We estimate the liability based on our standard warranty terms, the historical frequency of claims and the cost to replace or repair our products under warranty. Factors that impact our warranty liability include the number of units sold, the length of warranty term, historical and anticipated rates of warranty claims and cost per claim. We assess the adequacy of our recorded warranty liabilities quarterly and adjust amounts as necessary.
Postretirement Benefit Plans
The determination of defined benefit pension and postretirement plan obligations and their associated costs requires the use of actuarial computations to estimate participant plan benefits to which the employees will be entitled. The significant assumptions primarily relate to discount rates, expected long-term rates of return on plan assets, rate of future compensation increases, mortality, termination, and other factors. We develop each assumption using relevant company experience in conjunction with market-related data for each individual country in which such plans exist. All actuarial assumptions are reviewed annually with third-party consultants and adjusted as necessary. For the recognition of net periodic postretirement cost, the calculation of the expected long-term rate of return on plan assets is generally derived using a market-related value of plan assets based on average asset values at the measurement date over the last five years. Actual results that differ from our assumptions are accumulated and amortized on a straight line basis only to the extent they exceed 10% of the higher of the market-related value or the projected benefit obligation, over the estimated remaining service period of active participants, or for plans with all or substantially all inactive participants, over the average remaining life expectancy. The fair value of plan assets is determined based on market prices or estimated fair value at the measurement date.

64

Business Combinations

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

Derivative Financial Instruments

We record all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on whether we have elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, including forecasted transactions, are considered cash flow hedges. Derivatives may also be designated as hedges of the foreign currency exposure of a net investment in a foreign operation. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. We may enter into derivative contracts that are intended to hedge certain risks economically, even though hedge accounting does not apply or we elect not to apply hedge accounting.

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

Commitments and Contingencies

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

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

Concentrations of Credit Risk

Financial instruments that potentially subject us to significant concentrations of credit risk consist principally of cash and cash equivalents, and accounts receivable from trade customers. We maintain cash and cash equivalents and derivative contracts with various financial institutions. These financial institutions are located in many different

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

Substantially all of the cash and cash equivalents, including foreign cash balances, at December 31, 2012 and 2011 were uninsured. Foreign cash balances at December 31, 2012 and 2011 were $401 million and $279 million, respectively.

Fair Value Measurements

We determine fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. We use a hierarchical structure to prioritize the inputs to valuation techniques used to measure fair value into three broad levels. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1), then to quoted market prices for similar assets or liabilities in active markets (Level 2) and gives the lowest priority to unobservable inputs (Level 3).

Note 2. Recently Issued Accounting Pronouncements

Pronouncements Not Yet Adopted

In February 2013, the Financial Accounting Standards Board (“FASB”) issued guidance regarding new disclosures for items reclassified out of accumulated other comprehensive income (“AOCI”). The guidance requires entities to present information about items reclassified out of AOCI by component. Additionally, entities will be required to present either on the face of the statement where net income is presented or as a separate disclosure in the notes to the financial statements, significant amounts reclassified out of AOCI by the respective line items of net income. This guidance is effective for fiscal years beginning after December 15, 2012. The adoption of this guidance is not expected to have a material impact on our financial statement presentation and disclosures.

In July 2012, the FASB provided companies with the option to make an initial qualitative evaluation, based on events and circumstances, to determine the likelihood of an impairment of an indefinite-lived intangible asset. The results of this qualitative assessment determine whether it is necessary to perform the currently required quantitative comparison of the indefinite-lived intangible asset’s fair value to its carrying amount. If it is more likely than not that the fair value of the intangible asset is less than its carrying amount, a company would be required to perform the quantitative assessment. This guidance is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012 with early adoption permitted. The adoption of the guidance is not expected to have a material impact on our financial condition, results of operations or cash flows.

Recently Adopted Pronouncements

In September 2011, in conjunction with the assessment of the impairment of goodwill, the FASB provided companies with the option to make an initial qualitative evaluation, based on the entity’s events and circumstances, to determine the likelihood of goodwill impairment. The results of this qualitative assessment determine whether it is necessary to perform the currently required two-step impairment test. If it is more likely than not that the fair value of a reporting unit is less than its carrying amount, a company would be required to perform the two-step impairment test. We adopted this new guidance effective January 1, 2012. The adoption of this guidance did not have a material impact on our financial condition, results of operations or cash flows.

In June 2011, the FASB issued authoritative guidance surrounding the presentation of comprehensive income, with an objective of increasing the prominence of items reported in other comprehensive income (“OCI”). The guidance requires most entities to present items of net income and other comprehensive income either in one continuous statement, referred to as the statement of comprehensive income, or in two separate, but consecutive, statements of net income and other comprehensive income. We have adopted this guidance with retrospective application effective January 1, 2010, and have presented total comprehensive income in our Consolidated and Combined Statements of Comprehensive Income.

In May 2011, the FASB issued guidance intended to achieve common fair value measurements and related disclosures between U.S. GAAP and international accounting standards. The amendments primarily clarify existing fair value guidance and are not intended to change the application of existing fair value measurement guidance. However, the amendments include certain instances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements has changed. On January 1, 2012, we adopted this guidance. The adoption of the guidance did not have a material impact on our financial condition, results of operations or cash flows.

In December 2010, the FASB issued additional guidance applicable to the testing of goodwill for potential impairment. Specifically, for reporting units with zero or negative carrying amounts, an entity is required to perform the second step of the goodwill impairment test (a comparison between the carrying amount of a reporting unit's goodwill to its implied fair value) if it is more likely than not that a goodwill impairment exists, considering any adverse qualitative factors. This guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. As of the date of our most recent goodwill impairment test, none of our reporting units would have been affected by the application of this guidance as each reporting unit had a carrying amount that exceeded zero.

In April 2010, the FASB issued authoritative guidance permitting use of the milestone method of revenue recognition for research or development arrangements that contain payment provisions or consideration contingent on the achievement of specified events. On January 1, 2011, we adopted the new guidance on a prospective basis. The adoption of this guidance did not have a material impact on our financial condition, results of operations or cash flows.

In October 2009, the FASB issued amended guidance on the accounting for revenue arrangements that contain multiple elements by eliminating the criteria that objective and reliable evidence of fair value for undelivered products or services needs to exist in order to be able to account separately for deliverables and eliminating the use of the residual method of allocating arrangement consideration. The amendments establish a hierarchy for determining the selling price of a deliverable and will allow for the separation of products and services in more instances than previously permitted.

We adopted the new multiple element guidance effective January 1, 2011 for new arrangements entered into or arrangements materially modified on or after that date on a prospective basis. In connection with the adoption of the revised multiple element arrangement guidance, we revised our revenue recognition accounting policies. For multiple deliverable arrangements entered into or materially modified on or after January 1, 2011, we recognize revenue for a delivered element based on the relative selling price if the deliverable has stand-alone value to the customer and, in arrangements that include a general right of return relative to the delivered element, performance of the undelivered element is considered probable and substantially in the Company's control. The selling price for a deliverable is based on vendor-specific objective evidence of selling price (“VSOE”), if available, third-party evidence of selling price (“TPE”), if VSOE is not available, or best estimated selling price (“BESP”), if neither VSOE nor TPE is available.

The deliverables in our arrangements with multiple elements include various products and may include related services, such as installation and start-up services. For multiple element arrangements entered into or materially modified after adoption of the revised multiple element arrangement guidance, we allocate arrangement consideration based on the relative selling prices of the separate units of accounting determined in accordance with the hierarchy described above. For deliverables that are sold separately, we establish VSOE based on the price when the deliverable is sold separately. We establish TPE, generally for services, based on prices similarly situated customers pay for similar services from third party vendors. For those deliverables for which we are unable to establish VSOE or TPE, we estimate the selling price considering various factors including market and pricing trends, geography, product customization, and profit objectives. Revenue allocated to products and services is generally recognized as the products are delivered and the services are performed, provided all other revenue recognition criteria have been satisfied. The adoption of the new multiple element guidance did not result in a material change in either the units of accounting or the pattern or timing of revenue recognition. Additionally, the adoption of the revised multiple element arrangement guidance did not have a material impact on our financial condition, results of operations or cash flows.

Note 3. Acquisitions

2012 Acquisitions

During 2012, we spent $41 million, net of cash acquired, on two acquisitions that were not material individually or in the aggregate to our results of operations or financial position. On October 26, 2012, we acquired Heartland Pump Rental & Sales, Inc. ("Heartland"), a dewatering pump sale and rental company, for approximately $29 million. Heartland generated revenue of approximately $33 million for the fiscal year ended December 31, 2011. On July 13, 2012, we acquired MJK Automation ("MJK") for a purchase price of approximately $12 million. MJK, which reported 2011 revenue of $11 million for the fiscal year ended June 30, 2012, is a leading manufacturer of flow and level sensors, and measurement and control technology for water and wastewater applications. Our financial statements include Heartland and MJK results of operations prospectively from October 26, 2012 and July 13, 2012, respectively, within the Water Infrastructure segment. As the acquisitions were not material to results of operations, pro forma results of operations reflecting results prior to the acquisitions and certain other disclosure items have not been presented.

2011 Acquisitions

YSI Corporation

On September 1, 2011, we acquired 100% of the outstanding shares of YSI Incorporated ("YSI") for a purchase price of $309 million, net of cash acquired. YSI, which reported 2010 revenue of $101 million, is a leading developer and manufacturer of sensors, instruments, software, and data collection platforms for environmental water monitoring. YSI employs 390 people at facilities in the United States, Europe and Asia. Our financial statements include YSI's results of operations prospectively from September 1, 2011 within the Water Infrastructure segment; however, the acquisition was not material to results of operations and accordingly, pro forma results of operations reflecting YSI's results prior to acquisition have not been presented.

The purchase price for YSI was allocated to the net tangible and intangible assets acquired and liabilities assumed based on their fair values as of September 1, 2011. The excess of the purchase price over the assets acquired and liabilities assumed was recorded as goodwill. A charge in the amount of $3 million is included in selling, general and administrative expense related to acquisition-related costs.

The following table presents the allocation of the purchase price to the assets acquired and liabilities assumed, based on their fair values (in millions):

Purchase Price		$309
Assets acquired and liabilities assumed:		
Accounts receivable	15	
Inventory	15	
Property, plant and equipment	9	
Goodwill	190	
Intangible assets	125	
Other current and non-current assets	17	
Other current and non-current liabilities	(62)	
Net assets acquired		$309

Goodwill of $190 million arising from the acquisition consists largely of the planned expansion of YSI to new geographic markets, synergies and economies of scale. The goodwill related to this acquisition has been assigned to our Water Infrastructure segment and is not expected to be deductible for income tax purposes. In addition, of the $125 million that was allocated to intangible assets, $41 million was assigned to customer relationships and will be amortized on a straight line basis over the estimated useful life of 16 years; $35 million was assigned to proprietary technology and will be amortized on a straight line basis over the weighted average useful life of 16 years; and the remaining $49 million of acquired intangible assets was assigned to trademarks, which is not subject to amortization as they were determined to have indefinite useful lives.

2010 Acquisitions

During 2010, we spent an aggregate of approximately $1 billion, net of cash acquired, primarily on the acquisitions of Godwin Pumps of America, Inc. and Godwin Holdings Limited (collectively referred to as "Godwin") and Nova Analytics Corporation ("Nova"). The results of operations from our 2010 acquisitions have been included in our consolidated and combined financial statements prospectively from their date of acquisition. With the exception of Godwin, pro forma results of operations for acquisitions completed in 2010 have not been presented because they are not significant, either individually or in the aggregate. Due to the significant nature of the Godwin acquisition, pro forma results of operations are presented below as if Godwin was acquired on January 1, 2010.

Godwin

On August 3, 2010, we acquired 100% of the privately held stock of Godwin for a purchase price of $580 million, net of cash acquired. Godwin is a supplier and servicer of automatic self-priming and on-demand pumping solutions serving the global industrial, construction, mining, municipal, oil and gas and dewatering markets.

The following table presents the allocation of the purchase price to the assets acquired and liabilities assumed, based on their fair values (in millions):

Purchase Price		$580
Assets acquired and liabilities assumed:		
Accounts receivable	44	
Inventory	56	
Property, plant and equipment	82	
Deferred income taxes	1	
Goodwill	252	
Intangible assets	167	
Other current and non-current assets	7	
Other current and non-current liabilities	(29)	
Net assets acquired		$580

Goodwill of $252 million arising from the acquisition consists largely of the value expected to be obtained from the ability to be more competitive through the offering of a more complete dewatering pumps portfolio and from leveraging our current sales, distribution and service network. The goodwill related to this acquisition is recorded in the Water Infrastructure segment, a significant portion of which is expected to be deductible for income tax purposes. In addition, of the $167 million that was allocated to intangible assets, $107 million was assigned to customer relationships and will be amortized on a straight line basis over the estimated useful life of 10 years; $14 million was assigned to proprietary technology and will be amortized on a straight line basis over the weighted average useful life of 20 years; and the remaining $46 million of acquired intangible assets was assigned to trademarks, which is not subject to amortization as they were determined to have indefinite useful lives.

Godwin generated approximately $145 million and $26 million in revenue and pre-tax operating income, respectively, from January 1 through August 2, 2010. Subsequent to our acquisition of Godwin in August 2010, the revenue and expenses of Godwin have been included in our Consolidated and Combined Income Statements. Our 2010 results of operations include revenue and pre-tax operating income from Godwin of $125 million and $16 million, respectively.

The following unaudited pro-forma information assumes that the acquisition of Godwin was completed as of January 1, 2010 (in millions):

2010	As Reported	Pre-Acquisition Godwin Operations (a)	Incremental Depreciation and Amortization Expense (b)	Transaction Costs (c)	Income Taxes (d)	Pro Forma
Revenue	$3,202	145				$3,347
Net income	329	25	(10)	3	(6)	341

(a) Godwin recognized pre-acquisition revenue of $145 million during 2010.

(b) Incremental depreciation and amortization expense associated with the purchase price allocation to plant, property and equipment and finite-lived intangible assets recognized as a result of the acquisition.

(c) Reflects the reversal of transaction costs directly related to the acquisition of Godwin.
(d) Reflects income tax impact of pro-forma adjustments and change in income tax status of Godwin Pumps of America, Inc.

Nova

On March 23, 2010, we acquired 100% of the outstanding stock of Nova, for a purchase price of $385 million, net of cash acquired. Nova provides us with analytical instrumentation brands and technologies, which when combined within our Water Infrastructure segment, provide our customers the ability to procure, from a single source, a full suite of transport, treatment and testing products and solutions.

The following table presents the allocation of the purchase price to the assets acquired and liabilities assumed, based on their fair values (in millions):

Purchase Price		$385
Assets acquired and liabilities assumed:		
Accounts receivable	16	
Inventory	29	
Property, plant and equipment	14	
Goodwill	232	
Intangible assets	164	
Other current and non-current assets	6	
Deferred income taxes	(53)	
Other current and non-current liabilities	(23)	
Net assets acquired		$385

Goodwill of $232 million arising from the acquisition consists largely of the planned expansion of the Nova footprint to new geographic markets, synergies and economies of scale. The goodwill related to this acquisition has been assigned to our Water Infrastructure segment and is not expected to be deductible for income tax purposes. In addition, of the $164 million that was allocated to intangible assets, $112 million was assigned to distributor relationships and will be amortized on a straight line basis over the estimated useful life of 20 years; $10 million was assigned to proprietary technology and will be amortized on a straight line basis over the weighted average useful life of 10 years; and the remaining $42 million of acquired intangible assets was assigned to trademarks, which is not subject to amortization as they were determined to have indefinite useful lives.

Note 4. Restructuring and Asset Impairment Charges

From time to time, the Company will incur costs related to restructuring actions in order to optimize our cost base and more strategically position ourselves based on the economic environment and customer demand. During 2012, the costs incurred primarily relate to restructuring related severance payments for reductions in force initiatives primarily within our Water Infrastructure segment. The components of restructuring and asset impairment charges incurred during each of the previous three years ended are presented below.

	Year Ended December 31,		
(in millions)	2012	2011	2010
By component:			
Severance and other charges	$17	$—	$17
Reversal of restructuring accruals	—	—	(2)
Total restructuring charges	17	—	15
Asset impairment	—	2	—
Total restructuring and asset impairment charges	$17	$2	$15
By segment:			
Water Infrastructure	$14	$—	$12
Applied Water	3	2	3

The following table displays a rollforward of the restructuring accruals, presented on our Consolidated Balance Sheet within accrued liabilities, for the years ended December 31, 2012 and 2011.

(in millions)	2012	2011
Restructuring accruals - January 1	$1	$9
Severance and other	17	—
Cash payments	(9)	(7)
Other	—	(1)
Restructuring accruals - December 31	$9	$1
By segment:		
Water Infrastructure	$6	$1
Applied Water	3	—

The following is a rollforward of employee position eliminations associated with restructuring activities for the years ended December 31, 2012 and 2011.

	2012	2011
Planned reductions - January 1	—	21
Additional planned reductions	189	2
Actual reductions	(135)	(23)
Planned reductions - December 31	54	—

Note 5. Separation Costs

We had non-recurring pre-tax separation costs of $22 million and $87 million, or $16 million and $72 million after tax during 2012 and 2011, respectively. The components of separation costs incurred during these periods are presented below.

	Year Ended December 31,	
(in millions)	2012	2011
Rebranding and marketing costs	$8	$13
Advisory and professional fees	7	18
Information and technology costs	3	19
Employee retention and hiring costs	1	14
Lease termination and other real estate costs	1	10
Non-cash asset impairments (a)	—	8
Other	2	5
Total separation costs in operating income	22	87
Tax-related separation cost	—	6
Income tax benefit	(6)	(21)
Total separation costs, net of tax	$16	$72

(a) During the third quarter of 2011, we recorded an impairment charge of $8 million on one of our facilities in China within our Applied Water segment. Prior to the separation this was a shared facility among certain Xylem and ITT businesses and in connection with the separation, the removal of certain ITT operations triggered an impairment evaluation. The fair value of the applicable assets was calculated using the cost approach.

Note 6. Other Non-Operating Income, Net

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

	Year Ended December 31,		
(in millions)	2012	2011	2010
Interest income	$4	$3	$—
Income from joint ventures	4	4	2
Other income (expense) – net	(8)	(2)	(2)
Total other non-operating income, net	$—	$5	$—

Note 7. Income Taxes

Prior to the Spin-off, Xylem was a member of ITT's consolidated federal and state tax returns, and therefore current and deferred tax expense has been computed for the Company on a separate return basis. Subsequent to the Spin-off, the Company files its own consolidated federal and state tax returns.

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

	Year Ended December 31,		
(in millions)	2012	2011	2010
Income components:			
Domestic	$106	$46	$65
Foreign	282	337	323
Total pre-tax income	$388	$383	$388
Current:			
Domestic – federal	$27	$20	$29
Domestic – state and local	7	5	3
Foreign	56	71	58
Total Current	90	96	90
Deferred:			
Domestic – federal	$10	$21	$(41)
Domestic – state and local	(2)	3	—
Foreign	(7)	(16)	10
Total Deferred	1	8	(31)
Total income tax provision	$91	$104	$59
Effective income tax rate	23.4%	27.4%	15.2%

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

	Year Ended December 31,		
	2012	2011	2010
Tax provision at U.S. statutory rate	35.0%	35.0%	35.0%
Increase (decrease) in tax rate resulting from:			
Foreign restructurings	—	1.5	—
State income taxes	1.2	1.3	0.8
Settlements of tax examinations	0.2	(4.7)	(0.3)
Valuation allowance	8.9	4.7	(0.8)
Tax exempt interest	(18.2)	(14.6)	(5.7)
Foreign tax rate differential	(3.4)	(4.6)	(5.1)
Repatriation of foreign earnings, net of foreign tax credits	0.4	3.7	(8.8)
Non-deductible separation costs	—	2.6	—
Other – net	(0.7)	2.5	0.1
Provision for income taxes	23.4%	27.4%	15.2%

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

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

	December 31,	
(in millions)	2012	2011
Deferred tax assets:		
Employee benefits	$130	$132
Accrued expenses	17	6
Loss carryforward	237	199
Inventory	7	2
Foreign tax credit carryforwards	18	17
Other	3	4
	$412	$360
Valuation allowance	(229)	(195)
Net deferred tax asset	$183	$165
Deferred tax liabilities:		
Intangibles	$174	$172
Investment in foreign subsidiaries	15	15
Property, plant, and equipment	15	12
Other	34	21
Total deferred tax liabilities	$238	$220

Management assesses the available positive and negative evidence to estimate if sufficient future taxable income will be generated to realize existing deferred tax assets. On the basis of this evaluation, as of December 31, 2012, a valuation allowance of approximately $229 million has been established to reduce the deferred income tax asset related to certain U.S. and foreign net operating losses and U.S. and foreign capital loss carryforwards. During 2012, the valuation allowance increased by $44 million as a result of losses from certain foreign operations, decreased by $10 million as a result of the utilization of certain operating losses.

Deferred taxes are classified in the Consolidated Balance Sheets as follows:

	December 31,	
(in millions)	2012	2011
Current assets	$41	$45
Non-current assets	77	76
Current liabilities	—	(8)
Non-current liabilities	(173)	(168)
Total net deferred tax liabilities	$(55)	$(55)

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

(in millions)	December 31, 2012	First Year of Expiration
U.S. net operating loss	$14	December 31, 2023
State net operating loss	46	December 31, 2013
U.S. tax credits	18	December 31, 2020
Foreign net operating loss	794	December 31, 2014

As of December 31, 2012, we have provided a deferred tax liability of $15 million on the excess of $100 million of financial reporting over the tax basis of investments in certain foreign subsidiaries that has not been indefinitely reinvested. However, we have not provided for deferred taxes on the excess of financial reporting over the tax basis of investments in certain foreign subsidiaries in the amount of $1.6 billion because we plan to reinvest such amounts indefinitely outside the U.S. The determination of the amount of federal and state income taxes is not practicable because of complexities of the hypothetical calculation.

Unrecognized Tax Benefits

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

(in millions)	2012	2011	2010
Unrecognized tax benefits — January 1	$5	$43	$19
Additions for:			
Current year tax positions	1	—	20
Prior year tax positions	2	—	—
Business combinations	—	—	5
Reductions for:			
Assumption by ITT	—	(24)	—
Settlements	—	(14)	(1)
Unrecognized tax benefits — December 31	$8	$5	$43

During 2012, the amount of unrecognized tax benefits increased by $3 million. Of the $3 million increase, $2 million is related to positions established prior to 2012 and $1 million relates to new positions as of 2012.

The amount of unrecognized tax benefits at December 31, 2012, was $8 million which, if ultimately recognized, will reduce our annual effective tax rate. We do not believe that the unrecognized tax benefits will significantly change within the next twelve months.

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

Jurisdiction	Earliest Open Year
Canada	2008
Germany	2005
Italy	2007
Luxembourg	2008
Poland	2006
Sweden	2007
United Kingdom	2008
United States	2009

We classify interest relating to unrecognized tax benefits as a component of other non-operating income, net and tax penalties as a component of income tax expense in our Consolidated and Combined Income Statements. The amount of interest relating to unrecognized tax benefits as of December 31, 2012 was $1 million.

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

payment to ITT in the event audit settlement payments exceed amounts specified in the agreement. We also may be obligated to make payments in the event the Spin-off is determined to be taxable.

Tax Matters Ag