CADENCE DESIGN SYSTEMS INC
Form 10-Q
July 27, 2015

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended July 4, 2015

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 000-15867

CADENCE DESIGN SYSTEMS, INC.
(Exact Name of Registrant as Specified in Its Charter)

Delaware	00-0000000
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
2655 Seely Avenue, Building 5, San Jose, California	95134
(Address of Principal Executive Offices)	(Zip Code)

(408) 943-1234
Registrant's Telephone Number, including Area Code

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

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

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

Large accelerated filer	x	Accelerated filer	o
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	o

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

On July 4, 2015, approximately 291,380,000 shares of the registrant's common stock, $0.01 par value, were outstanding.

CADENCE DESIGN SYSTEMS, INC.
INDEX

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements
CADENCE DESIGN SYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)
(Unaudited)

	As of July 4, 2015	January 3, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$647,851	$932,161
Short-term investments	96,560	90,445
Receivables, net	131,325	122,492
Inventories	62,172	56,394
2015 notes hedges	—	523,930
Prepaid expenses and other	129,320	126,313
Total current assets	1,067,228	1,851,735
Property, plant and equipment, net of accumulated depreciation of $569,202 and $552,551, respectively	229,838	230,112
Goodwill	553,831	553,767
Acquired intangibles, net of accumulated amortization of $185,382 and $154,814, respectively	328,338	360,932
Long-term receivables	1,628	3,644
Other assets	199,790	209,366
Total assets	$2,380,653	$3,209,556
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Current liabilities:		
Convertible notes	$—	$342,499
2015 notes embedded conversion derivative	—	523,930
Accounts payable and accrued liabilities	202,794	225,375
Current portion of deferred revenue	324,569	301,287
Total current liabilities	527,363	1,393,091
Long-term liabilities:		
Long-term portion of deferred revenue	36,402	54,726
Long-term debt	348,733	348,676
Other long-term liabilities	70,940	79,489
Total long-term liabilities	456,075	482,891
Commitments and contingencies (Note 11)		
Stockholders’ equity:		
Common stock and capital in excess of par value	1,886,421	1,851,427
Treasury stock, at cost	(256,476)	(203,792)
Accumulated deficit	(231,989)	(326,408)
Accumulated other comprehensive income (loss)	(741)	12,347
Total stockholders’ equity	1,397,215	1,333,574
Total liabilities and stockholders’ equity	$2,380,653	$3,209,556

See notes to condensed consolidated financial statements.

CADENCE DESIGN SYSTEMS, INC.
CONDENSED CONSOLIDATED INCOME STATEMENTS
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended		Six Months Ended	
	July 4, 2015	June 28, 2014	July 4, 2015	June 28, 2014
Revenue:				
Product and maintenance	$384,951	$354,468	$768,588	$711,818
Services	30,932	24,320	58,661	45,520
Total revenue	415,883	378,788	827,249	757,338
Costs and expenses:				
Cost of product and maintenance	31,715	37,707	73,774	79,904
Cost of services	20,040	16,706	38,566	31,608
Marketing and sales	96,662	98,611	196,930	196,934
Research and development	157,974	152,672	320,970	299,138
General and administrative	27,467	32,042	55,109	60,786
Amortization of acquired intangibles	6,119	5,579	12,350	10,789
Restructuring and other charges (credits)	(498)	(26)	3,861	370
Total costs and expenses	339,479	343,291	701,560	679,529
Income from operations	76,404	35,497	125,689	77,809
Interest expense	(8,180)	(7,369)	(19,934)	(14,637)
Other income, net	1,347	1,635	6,128	5,017
Income before provision for income taxes	69,571	29,763	111,883	68,189
Provision for income taxes	11,411	6,500	17,464	11,856
Net income	$58,160	$23,263	$94,419	$56,333
Net income per share – basic	$0.20	$0.08	$0.33	$0.20
Net income per share – diluted	$0.19	$0.08	$0.30	$0.19
Weighted average common shares outstanding – basic	285,297	283,344	284,910	282,480
Weighted average common shares outstanding – diluted	313,665	305,755	312,756	303,395

See notes to condensed consolidated financial statements.

CADENCE DESIGN SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)
(Unaudited)

	Three Months Ended		Six Months Ended	
	July 4, 2015	June 28, 2014	July 4, 2015	June 28, 2014
Net income	$58,160	$23,263	$94,419	$56,333
Other comprehensive income (loss), net of tax effects:				
Foreign currency translation adjustments	(4,528)	2,377	(13,418)	6,828
Changes in unrealized holding gains or losses on available-for-sale securities, net of reclassification adjustment for realized gains and losses	(52)	775	13	595
Changes in defined benefit plan liabilities	26	(21)	317	387
Total other comprehensive income (loss), net of tax effects	(4,554)	3,131	(13,088)	7,810
Comprehensive income	$53,606	$26,394	$81,331	$64,143

See notes to condensed consolidated financial statements.

CADENCE DESIGN SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Six Months Ended	
	July 4, 2015	June 28, 2014
Cash and cash equivalents at beginning of period	$932,161	$536,260
Cash flows from operating activities:		
Net income	94,419	56,333
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	58,963	53,609
Amortization of debt discount and fees	8,971	9,814
Stock-based compensation	43,564	37,941
Gain on investments, net	(1,590)	(5,128)
Deferred income taxes	7,097	4,778
Other non-cash items	1,142	3,694
Changes in operating assets and liabilities, net of effect of acquired businesses:		
Receivables	(8,078)	5,336
Inventories	(6,243)	(12,266)
Prepaid expenses and other	(8,036)	(13,602)
Other assets	1,117	(1,273)
Accounts payable and accrued liabilities	(20,653)	(13,550)
Deferred revenue	5,827	(23,740)
Other long-term liabilities	(8,058)	(4,983)
Net cash provided by operating activities	168,442	96,963
Cash flows from investing activities:		
Purchases of available-for-sale securities	(59,516)	(77,490)
Proceeds from the sale of available-for-sale securities	37,586	54,601
Proceeds from the maturity of available-for-sale securities	15,600	23,799
Proceeds from the sale of long-term investments	2,293	—
Purchases of property, plant and equipment	(24,067)	(17,715)
Cash paid in business combinations and asset acquisitions, net of cash acquired	—	(163,685)
Net cash used for investing activities	(28,104)	(180,490)
Cash flows from financing activities:		
Proceeds from revolving credit facility	—	100,000
Payment of convertible notes	(349,999)	—
Payment of convertible notes embedded conversion derivative liability	(530,643)	—
Proceeds from convertible notes hedges	530,643	—
Payment of acquisition-related contingent consideration	—	(1,835)
Excess tax benefits from stock-based compensation	10,097	2,642
Proceeds from issuance of common stock	38,167	36,482
Stock received for payment of employee taxes on vesting of restricted stock	(15,814)	(12,292)
Payments for repurchases of common stock	(93,076)	(25,032)
Net cash provided by (used for) financing activities	(410,625)	99,965
Effect of exchange rate changes on cash and cash equivalents	(14,023)	4,718
Increase (decrease) in cash and cash equivalents	(284,310)	21,156
Cash and cash equivalents at end of period	$647,851	$557,416

Supplemental cash flow information:

Cash paid for interest	$12,006	$4,831
Cash paid for taxes, net	$16,373	$10,231
Non-cash investing and financing activities:		
Available-for-sale securities received from customer	$—	$1,695

See notes to condensed consolidated financial statements.

CADENCE DESIGN SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)
NOTE 1. BASIS OF PRESENTATION
The condensed consolidated financial statements included in this Quarterly Report on Form 10-Q have been prepared by Cadence Design Systems, Inc., or Cadence, without audit, pursuant to the rules and regulations of the United States Securities and Exchange Commission, or the SEC. Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. However, Cadence believes that the disclosures contained in this Quarterly Report on Form 10-Q comply with the requirements of Section 13(a) of the Securities Exchange Act of 1934, as amended, or the Exchange Act, for a Quarterly Report on Form 10-Q and are adequate to make the information presented not misleading. These condensed consolidated financial statements are meant to be, and should be, read in conjunction with the consolidated financial statements and the Notes thereto included in Cadence's Annual Report on Form 10-K for the fiscal year ended January 3, 2015. Certain prior period balances have been reclassified to conform to current period presentation.
The unaudited condensed consolidated financial statements included in this Quarterly Report on Form 10-Q reflect all adjustments (which include only normal, recurring adjustments and those items discussed in these Notes) that are, in the opinion of management, necessary to state fairly the results of operations, cash flows and financial position for the periods and dates presented. The results for such periods are not necessarily indicative of the results to be expected for the full fiscal year. Management has evaluated subsequent events through the issuance date of the unaudited condensed consolidated financial statements.
Preparation of the condensed consolidated financial statements in conformity with United States generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

NOTE 2. DEBT
Cadence's outstanding debt as of July 4, 2015 and January 3, 2015 was as follows:

	July 4, 2015			January 3, 2015		
	(In thousands)					
	Principal	Unamortized Discount	Carrying Value	Principal	Unamortized Discount	Carrying Value
2015 Notes	$—	$—	$—	$349,999	$(7,500)	$342,499
2024 Notes	350,000	(1,267)	348,733	350,000	(1,324)	348,676
Revolving credit facility	—	—	—	—	—	—
Total outstanding debt	$350,000	$(1,267)	$348,733	$699,999	$(8,824)	$691,175

2015 Notes
In June 2010, Cadence issued $350.0 million principal amount of 2.625% Cash Convertible Senior Notes due June 1, 2015, or the 2015 Notes. During the six months ended July 4, 2015, Cadence settled the outstanding principal amount of $350.0 million and paid note holders accrued interest of $3.8 million. The 2015 Notes contained a conversion feature, or the 2015 Notes Embedded Conversion Derivative, that entitled the holders of the notes to receive additional cash payments if the notes were converted prior to maturity. During the six months ended July 4, 2015, Cadence paid $530.6 million to holders of the 2015 notes that converted prior to maturity. Cadence received proceeds of $530.6 million from the 2015 Notes Hedges, which fully offset the additional cash payments associated with the 2015 Notes Embedded Conversion Derivative.
2015 Notes Hedges
Cadence entered into hedge transactions, or the 2015 Notes Hedges, in connection with the issuance of the 2015 Notes. The purpose of the 2015 Notes Hedges was to limit Cadence's exposure to the additional cash payments above the principal amount of the 2015 Notes that was due to the holders who elected to convert their notes prior to maturity.

As a result of the 2015 Notes Hedges, Cadence’s maximum cash exposure upon conversion or maturity of the 2015 Notes was the remaining principal balance of the notes and accrued interest. The 2015 Notes Hedges expired on June 1, 2015, and were settled in cash.

2015 Warrants

At the time of issuance of the 2015 Notes, Cadence entered into separate warrant transactions, or the 2015 Warrants, for the purchase of up to approximately 46.4 million shares of Cadence's common stock at a strike price of $10.78 per share, for total proceeds of $37.5 million, which was recorded as an increase in stockholders' equity. As a result of the 2015 Warrants, Cadence experiences dilution to its diluted earnings per share when its average closing stock price exceeds $10.78 for any fiscal quarter until the warrants expire. The 2015 Warrants expire daily over a 70-day period between September and December 2015. Cadence will be required to issue shares of common stock to the purchasers of the 2015 Warrants that represent the value by which the specified daily volume weighted average price of Cadence's common stock exceeds the strike price of $10.78 stipulated in the warrant agreements.

2015 Notes Interest Expense

The effective interest rate and components of interest expense of the 2015 Notes for the three and six months ended July 4, 2015 and June 28, 2014 were as follows:

	Three Months Ended		Six Months Ended	
	July 4, 2015	June 28, 2014	July 4, 2015	June 28, 2014
	(In thousands, except percentages)			
Effective interest rate	8.1 %	8.1 %	8.1 %	8.1 %
Contractual interest expense	$1,178	$2,289	$2,987	$4,578
Amortization of debt discount	$2,470	$4,275	$7,500	$8,507

2024 Notes

In October 2014, Cadence issued $350.0 million aggregate principal amount of 4.375% Senior Notes due October 15, 2024, or the 2024 Notes. Cadence received net proceeds of $342.4 million from issuance of the 2024 Notes, net of a discount of $1.4 million and issuance costs of $6.2 million. Both the discount and issuance costs will be amortized to interest expense over the term of the 2024 Notes using the effective interest method. Interest is payable in cash semi-annually in April and October. The 2024 Notes are unsecured and rank equal in right of payment to all of Cadence's existing and future senior indebtedness.

Cadence may redeem the 2024 Notes, in whole or in part, at a redemption price equal to the greater of (a) 100% of the principal amount of the notes to be redeemed and (b) the sum of the present values of the remaining scheduled payments of principal and interest, plus any accrued and unpaid interest, as more particularly described in the indenture governing the 2024 Notes.

The indenture governing the 2024 Notes includes customary representations, warranties and restrictive covenants, including, but not limited to, restrictions on our ability to grant liens on assets, enter into sale and lease-back transactions, or merge, consolidate or sell assets, and also includes customary events of default.

Revolving Credit Facility

Cadence maintains a senior unsecured revolving credit facility with a group of lenders led by Bank of America, N.A., as administrative agent. The credit facility provides for borrowings up to $250.0 million, with the right to request increased capacity up to an additional $150.0 million upon the receipt of lender commitments, for total maximum borrowings of $400.0 million. The credit facility, as amended, expires on September 19, 2019 and has no subsidiary guarantors. Any outstanding loans drawn under the credit facility are due at maturity on September 19, 2019. Outstanding borrowings may be paid at any time prior to maturity.

Interest accrues on borrowings under the credit facility at either LIBOR plus a margin between 1.25% and 2.0% per annum or at the base rate plus a margin between 0.25% and 1.0% per annum. The interest rate applied to borrowings is determined by Cadence's consolidated leverage ratio as specified by the credit facility agreement. Interest is payable quarterly. A commitment fee ranging from 0.20% to 0.35% is assessed on the daily average undrawn portion of revolving commitments.

The credit facility contains customary negative covenants that, among other things, restrict Cadence's ability to incur additional indebtedness, grant liens, make certain investments (including acquisitions), dispose of certain assets and make certain payments, including share repurchases and dividends. In addition, the credit facility contains financial covenants that require Cadence to maintain a leverage ratio not to exceed 2.75 to 1, and a minimum interest coverage ratio of 3 to 1.

As of July 4, 2015 and January 3, 2015, Cadence had no outstanding balance under the revolving credit facility and was in compliance with all financial covenants.

NOTE 3. CASH, CASH EQUIVALENTS AND INVESTMENTS

Cadence's cash, cash equivalents and short-term investments at fair value as of July 4, 2015 and January 3, 2015 were as follows:

	As of July 4, 2015	January 3, 2015
	(In thousands)	
Cash and cash equivalents	$647,851	$932,161
Short-term investments	96,560	90,445
Cash, cash equivalents and short-term investments	$744,411	$1,022,606

Cash and Cash Equivalents

Cadence considers all highly liquid investments with original maturities of three months or less on the date of purchase to be cash equivalents. The amortized cost of Cadence's cash equivalents approximates fair value. The following table summarizes Cadence's cash and cash equivalents at fair value as of July 4, 2015 and January 3, 2015:

	As of July 4, 2015	January 3, 2015
	(In thousands)	
Cash and interest bearing deposits	$232,408	$203,665
Money market funds	415,443	728,496
Total cash and cash equivalents	$647,851	$932,161

Short-Term Investments

The following tables summarize Cadence's short-term investments as of July 4, 2015 and January 3, 2015:

	As of July 4, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
Corporate debt securities	$36,272	$8	$(22)	$36,258
Bank certificates of deposit	13,100	7	—	13,107
United States Treasury securities	33,972	69	(1)	34,040
United States government agency securities	7,157	2	—	7,159
Commercial paper	4,188	7	—	4,195
Marketable debt securities	94,689	93	(23)	94,759
Marketable equity securities	1,817	—	(16)	1,801
Total short-term investments	$96,506	$93	$(39)	$96,560

	As of January 3, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
Corporate debt securities	$34,919	$6	$(31)	$34,894
Bank certificates of deposit	21,900	10	—	21,910
United States Treasury securities	19,375	12	(13)	19,374
United States government agency securities	9,209	3	(4)	9,208
Commercial paper	3,184	4	(2)	3,186
Marketable debt securities	88,587	35	(50)	88,572
Marketable equity securities	1,817	56	—	1,873
Total short-term investments	$90,404	$91	$(50)	$90,445

As of July 4, 2015, no securities held by Cadence had been in an unrealized loss position for more than 6 months.

The amortized cost and estimated fair value of marketable debt securities included in short-term investments as of July 4, 2015, by contractual maturity, are shown in the table below. Actual maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations without penalties.

	Amortized Cost	Fair Value
	(In thousands)	
Due in less than one year	$52,956	$52,990
Due in one to three years	41,733	41,769
Total marketable debt securities included in short-term investments	$94,689	$94,759

Realized gains and losses from the sale of marketable debt and equity securities are recorded in other income, net in the condensed consolidated income statements.

NOTE 4. FAIR VALUE

Inputs to valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect Cadence’s market assumptions. These two types of inputs have created the following fair value hierarchy:

- Level 1 – Quoted prices for identical instruments in active markets;
- Level 2 – Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets; and
- Level 3 – Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

This hierarchy requires Cadence to minimize the use of unobservable inputs and to use observable market data, if available, when determining fair value. Cadence recognizes transfers between levels of the hierarchy based on the fair values of the respective financial instruments at the end of the reporting period in which the transfer occurred. There were no transfers between levels of the fair value hierarchy during the six months ended July 4, 2015.

On a quarterly basis, Cadence measures at fair value certain financial assets and liabilities. The fair value of financial assets and liabilities was determined using the following levels of inputs as of July 4, 2015 and January 3, 2015:

	Fair Value Measurements as of July 4, 2015:			
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Assets				
Cash equivalents:				
Money market funds	$415,443	$415,443	$—	$—
Short-term investments:				
Corporate debt securities	36,258	—	36,258	—
Bank certificates of deposit	13,107	—	13,107	—
United States Treasury securities	34,040	34,040	—	—
United States government agency securities	7,159	7,159	—	—
Commercial paper	4,195	—	4,195	—
Marketable equity securities	1,801	1,801	—	—
Trading securities held in Non-Qualified Deferred Compensation, or NQDC, trust	24,226	24,226	—	—
Total Assets	$536,229	$482,669	$53,560	$—

	Total	Level 1	Level 2	Level 3
	(In thousands)			
Liabilities				
Foreign currency exchange contracts	536	—	536	—
Total Liabilities	$536	$—	$536	$—

	Fair Value Measurements as of January 3, 2015:			
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Assets				
Cash equivalents:				
Money market funds	$728,496	$728,496	$—	$—
Short-term investments:				
Corporate debt securities	34,894	—	34,894	—
Bank certificates of deposit	21,910	—	21,910	—
United States Treasury securities	19,374	19,374	—	—
United States government agency securities	9,208	9,208	—	—
Commercial paper	3,186	—	3,186	—
Marketable equity securities	1,873	1,873	—	—
Trading securities held in NQDC trust	27,034	27,034	—	—
2015 Notes Hedges	523,930	—	523,930	—
Total Assets	$1,369,905	$785,985	$583,920	$—

	Total	Level 1	Level 2	Level 3
	(In thousands)			
Liabilities				
2015 Notes Embedded Conversion Derivative	523,930	—	523,930	—
Foreign currency exchange contracts	3,163	—	3,163	—
Total Liabilities	$527,093	$—	$527,093	$—

NOTE 5. RECEIVABLES, NET

Cadence's current and long-term receivables balances as of July 4, 2015 and January 3, 2015 were as follows:

	As of	
	July 4, 2015	January 3, 2015
	(In thousands)	
Accounts receivable	$85,007	$79,410
Unbilled accounts receivable	46,318	43,082
Long-term receivables	1,628	3,644
Total receivables		
Other	**2.6**	2.5
	103.7	81.5
Financial Services	**116.1**	103.2
	$ 219.8	$ 184.7

Truck and Parts

The Truck segment includes the manufacture of trucks and the Parts segment includes the distribution of related aftermarket parts, both of which are sold through the same network of independent dealers. These segments derive a large proportion of their revenues and operating profits from operations in North America and Europe. The Truck segment incurs substantial costs to design, manufacture and sell trucks to its customers. The sale of new trucks provides the Parts segment with the basis for parts sales that may continue over the life of the truck, but are generally concentrated in the first five years after truck delivery. To reflect the benefit the Parts segment receives from costs incurred by the Truck segment, certain expenses are allocated from the Truck segment to the Parts segment. The expenses allocated are based on a percentage of the average annual expenses for factory overhead, engineering, research and development (R&D) and selling, general and administrative (SG&A) expenses for the preceding five years. The allocation is based on the ratio of the average parts direct margin dollars (net sales less material and labor costs) to the total truck and parts direct margin dollars

Table of Contents

Notes to Consolidated Financial Statements (Unaudited) (Millions, Except Share Amounts)

for the previous five years. The Company believes such expenses have been allocated on a reasonable basis. Truck segment assets related to the indirect expense allocation are not allocated to the Parts segment.

Financial Services

The Financial Services segment includes finance and leasing of primarily PACCAR products and services provided to truck customers and dealers. Revenues are primarily generated from operations in North America and Europe.

Other

Included in Other is the Company s industrial winch manufacturing business. Also within this category are other sales, income and expense not attributable to a reportable segment, including a portion of corporate expenses.

The accounting policies of the reportable segments are the same as those applied in the consolidated financial statements as described in Note A of the Company s Annual Report on Form 10-K for the year ended December 31, 2013.

NOTE I - Derivative Financial Instruments

As part of its risk management strategy, the Company enters into derivative contracts to hedge against interest rates and foreign currency risk. Certain derivative instruments designated as either cash flow hedges or fair value hedges are subject to hedge accounting. Derivative instruments that are not subject to hedge accounting are held as economic hedges. The Company s policies prohibit the use of derivatives for speculation or trading. At the inception of each hedge relationship, the Company documents its risk management objectives, procedures and accounting treatment. All of the Company s interest-rate and certain foreign exchange contracts are transacted under International Swaps and Derivatives Association (ISDA) master agreements. Each agreement permits the net settlement of amounts owed in the event of default and certain other termination events. For derivative financial instruments, the Company has elected not to offset derivative positions in the balance sheet with the same counterparty under the same agreements and is not required to post or receive collateral. Exposure limits and minimum credit ratings are used to minimize the risks of counterparty default. The Company had no material exposures to default at March 31, 2014.

The Company uses regression analysis to assess effectiveness of interest-rate contracts on a quarterly basis. For foreign-exchange contracts, the Company performs quarterly assessments to ensure that critical terms continue to match. All components of the derivative instrument s gain or loss are included in the assessment of hedge effectiveness. Gains or losses on the ineffective portion of cash flow hedges are recognized currently in earnings. Hedge accounting is discontinued prospectively when the Company determines that a derivative financial instrument has ceased to be a highly effective hedge.

Interest-Rate Contracts: The Company enters into various interest-rate contracts, including interest-rate swaps and cross currency interest-rate swaps. Interest-rate swaps involve the exchange of fixed for floating rate or floating for fixed rate interest payments based on the contractual notional amounts in a single currency. Cross currency interest-rate swaps involve the exchange of notional amounts and interest payments in different currencies. The Company is exposed to interest-rate and exchange-rate risk caused by market volatility as a result of its borrowing activities. The objective of these contracts is to mitigate the fluctuations on earnings, cash flows and fair value of borrowings. Net amounts paid or received are reflected as adjustments to interest expense.

At March 31, 2014, the notional amount of the Company s interest-rate contracts was $3,923.7. Notional maturities for all interest-rate contracts are $986.8 for the remainder of 2014, $1,399.6 for 2015, $1,047.9 for 2016, $219.6 for 2017, $231.0 for 2018 and $38.8 thereafter. The majority of these contracts are floating to fixed swaps that effectively convert an equivalent amount of commercial paper and other variable rate debt to fixed rates.

PACCAR Inc Form 10-Q

Notes to Consolidated Financial Statements (Unaudited) (Millions, Except Share Amounts)

Foreign-Exchange Contracts: The Company enters into foreign-exchange contracts to hedge certain anticipated transactions and assets and liabilities denominated in foreign currencies, particularly the Canadian dollar, the euro, the British pound, the Australian dollar, the Brazilian real and the Mexican peso. The objective is to reduce fluctuations in earnings and cash flows associated with changes in foreign currency exchange rates. At March 31, 2014, the notional amount of the outstanding foreign-exchange contracts was $341.0. Foreign-exchange contracts mature within one year.

The following table presents the balance sheet classification and fair value of derivative financial instruments:

	March 31, 2014		December 31, 2013	
	Assets	**Liabilities**	Assets	Liabilities
Derivatives designated under hedge accounting:				
Interest-rate contracts:				
Financial Services:				
Other assets	**$ 47.5**		$ 46.3	
Deferred taxes and other liabilities		**$ 49.6**		$ 67.7
Foreign-exchange contracts:				
Truck, Parts and Other:				
Other current assets	**.1**			
Accounts payable, accrued expenses and other		**.6**		.6
Total	**$ 47.6**	**$ 50.2**	$ 46.3	$ 68.3
Economic hedges:				
Foreign-exchange contracts:				
Truck, Parts and Other:				
Other current assets	**$ .1**		$ .6	
Accounts payable, accrued expenses and other		**$ .6**		$ .2
Financial Services:				
Other assets	**.1**		1.1	
Deferred taxes and other liabilities		**2.1**		.1
Total	**$ .2**	**$ 2.7**	$ 1.7	$ .3

Table of Contents

PACCAR Inc Form 10-Q

Notes to Consolidated Financial Statements (Unaudited) (Millions, Except Share Amounts)

The following tables present the balance sheet classification of the gross and pro forma net amounts of derivative financial instruments:

As of March 31, 2014	**Gross Amount Recognized in Balance Sheet**	**Amount Not Offset in Financial Instruments**	**Pro Forma Net Amount**
Assets:			
Truck, Parts and Other			
Foreign-exchange contracts	**$ .2**	**$ (.2)**	
Financial Services			
Interest-rate contracts	**47.5**	**(11.5)**	**$ 36.0**
Foreign-exchange contracts	**.1**		**.1**
Total derivative assets	**$ 47.8**	**$ (11.7)**	**$ 36.1**
Liabilities:			
Truck, Parts and Other			
Foreign-exchange contracts	**$ 1.2**	**$ (.2)**	**$ 1.0**
Financial Services			
Interest-rate contracts	**49.6**	**(11.5)**	**38.1**
Foreign-exchange contracts	**2.1**		**2.1**
Total derivative liabilities	**$ 52.9**	**$ (11.7)**	**$ 41.2**

As of December 31, 2013	Gross Amount Recognized in Balance Sheet	Amount Not Offset in Financial Instruments	Pro Forma Net Amount
Assets:			
Truck, Parts and Other			
Foreign-exchange contracts	$ .6	$ (.2)	$ .4
Financial Services			
Interest-rate contracts	46.3	(16.1)	30.2
Foreign-exchange contracts	1.1		1.1
Total derivative assets	$ 48.0	$ (16.3)	$ 31.7
Liabilities:			
Truck, Parts and Other			
Foreign-exchange contracts	$ .8	$ (.2)	$ .6
Financial Services			
Interest-rate contracts	67.7	(16.1)	51.6
Foreign-exchange contracts	.1		.1
Total derivative liabilities	$ 68.6	$ (16.3)	$ 52.3

Table of Contents

PACCAR Inc Form 10-Q

Notes to Consolidated Financial Statements (Unaudited) (Millions, Except Share Amounts)

Fair Value Hedges

Changes in the fair value of derivatives designated as fair value hedges are recorded in earnings together with the changes in fair value of the hedged item attributable to the risk being hedged. The (income) or expense recognized in earnings related to fair value hedges was included in interest and other borrowing expenses in the Financial Services segment of the Consolidated Statements of Comprehensive Income as follows:

Three Months Ended March 31,	**2014**	2013
Interest-rate swaps	**$ .1**	$ .2
Term notes	**(1.1)**	(1.4)

Cash Flow Hedges

Substantially all of the Company s interest-rate contracts and some foreign-exchange contracts have been designated as cash flow hedges. Changes in the fair value of derivatives designated as cash flow hedges are recorded in AOCI to the extent such hedges are considered effective. The maximum length of time over which the Company is hedging its exposure to the variability in future cash flows is 6.9 years.

Amounts in AOCI are reclassified into net income in the same period in which the hedged transaction affects earnings. Net realized gains and losses from interest-rate contracts are recognized as an adjustment to interest expense. Net realized gains and losses from foreign-exchange contracts are recognized as an adjustment to cost of sales or to Financial Services interest expense, consistent with the hedged transaction. For the three months ended March 31, 2014 and 2013, the Company recognized gains on the ineffective portions of nil and $.1, respectively.

The following table presents the pre-tax effects of derivative instruments recognized in OCI:

Three Months Ended March 31,	**2014**		2013	
	Interest-Rate Contracts	**Foreign-Exchange Contracts**	Interest-Rate Contracts	Foreign-Exchange Contracts
Gain (loss) recognized in other comprehensive income:				
Truck, Parts and Other		**$ .2**		$ 1.6
Financial Services	**$ 8.4**		$ 19.7	
Total	**$ 8.4**	**$ .2**	$ 19.7	$ 1.6

Expense (income) reclassified out of AOCI into income:

Three Months Ended March 31,	**2014**		2013	
	Interest-Rate Contracts	**Foreign-Exchange Contracts**	Interest-Rate Contracts	Foreign-Exchange Contracts
Truck, Parts and Other:				

Cost of sales and revenues		**$ .1**		$ (2.3)
Interest and other expense, net		**(.1)**		(.2)
Financial Services:				
Interest and other borrowing expenses	**$ (6.9)**		$ (15.6)	
Total	**$ (6.9)**		$ (15.6)	$ (2.5)

Table of Contents

PACCAR Inc Form 10-Q

Notes to Consolidated Financial Statements (Unaudited) (Millions, Except Share Amounts)

The amount of loss recorded in AOCI at March 31, 2014 that is estimated to be reclassified to interest expense or cost of sales in the following 12 months if interest rates and exchange rates remain unchanged is approximately $21.8, net of taxes. The fixed interest earned on finance receivables will offset the amount recognized in interest expense, resulting in a stable interest margin consistent with the Company s risk management strategy.

Economic Hedges

For other risk management purposes, the Company enters into derivative instruments that do not qualify for hedge accounting. These derivative instruments are used to mitigate the risk of market volatility arising from borrowings and foreign currency denominated transactions. Changes in the fair value of economic hedges are recorded in earnings in the period in which the change occurs.

The expense (income) recognized in earnings related to economic hedges is as follows:

Three Months Ended March 31,	**2014**		2013	
	Interest-Rate Contracts	**Foreign-Exchange Contracts**	Interest-Rate Contracts	Foreign-Exchange Contracts
Truck, Parts and Other:				
Cost of sales and revenues		**$ .2**		$ (.1)
Interest and other expense, net		**(.9)**		1.7
Financial Services:				
Interest and other borrowing expenses		**.5**	$ (1.3)	.3
Total		**$ (.2)**	$ (1.3)	$ 1.9

NOTE J Fair Value Measurements

Fair value represents 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. Inputs to valuation techniques used to measure fair value are either observable or unobservable. These inputs have been categorized into the fair value hierarchy described below.

Level 1 Valuations are based on quoted prices that the Company has the ability to obtain in actively traded markets for identical assets or liabilities. Since valuations are based on quoted prices that are readily and regularly available in an active market or exchange traded market, valuation of these instruments does not require a significant degree of judgment.

Level 2 Valuations are based on quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 Valuations are based on model-based techniques for which some or all of the assumptions are obtained from indirect market information that is significant to the overall fair value measurement and which require a significant degree of management judgment.

There were no transfers of assets or liabilities between Level 1 and Level 2 of the fair value hierarchy during the three months ended March 31, 2014. The Company s policy is to recognize transfers between levels at the end of the reporting period.

The Company uses the following methods and assumptions to measure fair value for assets and liabilities subject to recurring fair value measurements.

Notes to Consolidated Financial Statements (Unaudited) (Millions, Except Share Amounts)

Marketable Securities: The Company s marketable debt securities consist of municipal bonds, government obligations, investment-grade corporate obligations, commercial paper, asset-backed securities and term deposits. The fair value of U.S. government obligations is determined using the market approach and is based on quoted prices in active markets and are categorized as Level 1.

The fair value of U.S. government agency obligations, non-U.S. government bonds, municipal bonds, corporate bonds, asset-backed securities, commercial paper and term deposits is determined using the market approach and is primarily based on matrix pricing as a practical expedient which does not rely exclusively on quoted prices for a specific security. Significant inputs used to determine fair value include interest rates, yield curves, credit rating of the security and other observable market information and are categorized as Level 2.

Derivative Financial Instruments: The Company s derivative contracts consist of interest-rate swaps, cross currency swaps and foreign currency exchange contracts. These derivative contracts are traded over the counter, and their fair value is determined using industry standard valuation models, which are based on the income approach (i.e., discounted cash flows). The significant observable inputs into the valuation models include interest rates, yield curves, currency exchange rates, credit default swap spreads and forward spot rates and are categorized as Level 2.

Assets and Liabilities Subject to Recurring Fair Value Measurement

The Company s assets and liabilities subject to recurring fair value measurements are either Level 1 or Level 2 as follows:

At March 31, 2014	Level 1	Level 2	Total
Assets:			
Marketable debt securities			
U.S. tax-exempt securities		**$ 219.1**	**$ 219.1**
U.S. corporate securities		**56.6**	**56.6**
U.S. government and agency securities	**$ 5.3**	**.2**	**5.5**
Non-U.S. corporate securities		**685.4**	**685.4**
Non-U.S. government securities		**184.1**	**184.1**
Other debt securities		**99.7**	**99.7**
Total marketable debt securities	**$ 5.3**	**$ 1,245.1**	**$ 1,250.4**
Derivatives			
Cross currency swaps		**$ 39.5**	**$ 39.5**
Interest-rate swaps		**8.0**	**8.0**
Foreign-exchange contracts		**.3**	**.3**
Total derivative assets		**$ 47.8**	**$ 47.8**
Liabilities:			
Derivatives			
Cross currency swaps		**$ 22.8**	**$ 22.8**
Interest-rate swaps		**26.8**	**26.8**
Foreign-exchange contracts		**3.3**	**3.3**
Total derivative liabilities		**$ 52.9**	**$ 52.9**

Notes to Consolidated Financial Statements (Unaudited) (Millions, Except Share Amounts)

At December 31, 2013	Level 1	Level 2	Total
Assets:			
Marketable debt securities			
U.S. tax-exempt securities		$ 216.1	$ 216.1
U.S. corporate securities		78.2	78.2
U.S. government and agency securities	$ 5.2	.3	5.5
Non-U.S. corporate securities		609.3	609.3
Non-U.S. government securities		217.5	217.5
Other debt securities		140.9	140.9
Total marketable debt securities	$ 5.2	$ 1,262.3	$ 1,267.5
Derivatives			
Cross currency swaps		$ 40.9	$ 40.9
Interest-rate swaps		5.4	5.4
Foreign-exchange contracts		1.7	1.7
Total derivative assets		$ 48.0	$ 48.0
Liabilities:			
Derivatives			
Cross currency swaps		$ 42.1	$ 42.1
Interest-rate swaps		25.6	25.6
Foreign-exchange contracts		.9	.9
Total derivative liabilities		$ 68.6	$ 68.6

Fair Value Disclosure of Other Financial Instruments

For financial instruments that are not recognized at fair value, the Company uses the following methods and assumptions to determine the fair value. These instruments are categorized as Level 2, except cash which is categorized as Level 1 and fixed rate loans which are categorized as Level 3.

Cash and Cash Equivalents: Carrying amounts approximate fair value.

Financial Services Net Receivables: For floating-rate loans, wholesale financings, and operating lease and other trade receivables, carrying values approximate fair values. For fixed rate loans, fair values are estimated using the income approach by discounting cash flows to their present value based on current rates for comparable loans. Finance lease receivables and related allowance for credit losses have been excluded from the accompanying table.

Debt: The carrying amounts of financial services commercial paper, variable rate bank loans and variable-rate term notes approximate fair value. For fixed rate debt, fair values are estimated using the income approach by discounting cash flows to their present value based on current rates for comparable debt.

Table of Contents

PACCAR Inc Form 10-Q

Notes to Consolidated Financial Statements (Unaudited) (Millions, Except Share Amounts)

The Company s estimate of fair value for fixed rate loans and debt that are not carried at fair value was as follows:

	March 31, 2014		December 31, 2013	
	Carrying Amount	**Fair Value**	Carrying Amount	Fair Value
Assets:				
Financial Services fixed rate loans	**$ 3,622.1**	**$ 3,666.1**	$ 3,592.7	$ 3,627.3
Liabilities:				
Truck, Parts and Other fixed rate debt			150.0	151.1
Financial Services fixed rate debt	**3,690.8**	**3,731.1**	4,039.1	4,087.0

NOTE K - Employee Benefit Plans

The Company has several defined benefit pension plans, which cover a majority of its employees. The following information details the components of net pension expense for the Company s defined benefit plans:

Three Months Ended March 31,	**2014**	2013
Service cost	**$ 17.0**	$ 18.9
Interest on projected benefit obligation	**23.0**	20.3
Expected return on assets	**(32.0)**	(29.9)
Amortization of prior service costs	**.3**	.3
Recognized actuarial loss	**5.2**	10.9
Net pension expense	**$ 13.5**	$ 20.5

During the three months ended March 31, 2014 and 2013, the Company contributed $4.2 and $3.4 to its pension plans, respectively.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS OVERVIEW:

PACCAR is a global technology company whose Truck segment includes the design and manufacture of high-quality, light-, medium- and heavy-duty commercial trucks. In North America, trucks are sold under the Kenworth and Peterbilt nameplates, in Europe, under the DAF nameplate and in Australia and South America, under the Kenworth and DAF nameplates. The Parts segment includes the distribution of aftermarket parts for trucks and related commercial vehicles. The Company s Financial Services segment derives its earnings primarily from financing or leasing PACCAR products in North America, Europe and Australia. The Company s Other business is the manufacturing and marketing of industrial winches.

Consolidated net sales and revenues in the first quarter of 2014 increased to $4.38 billion from $3.92 billion in the first quarter of 2013. Truck unit sales increased in the first quarter of 2014 to 31,800 units from 30,600 units in the same period of 2013 reflecting stronger industry truck sales in North America. The Company s worldwide parts net sales and revenues increased to $726.6 million in the first quarter of 2014 from $667.4 million for the same period last year, primarily due to higher aftermarket demand in the U.S. and Canada and Europe. Financial Services revenues of $293.7 million in the first quarter of 2014 were comparable to $293.1 million in the first quarter of 2013.

Net income in the first quarter of 2014 increased to $273.9 million ($.77 per diluted share) from $236.1 million ($.67 per diluted share) in the first quarter of 2013. The first quarter 2014 results reflect higher Truck and Parts segment sales and good Financial Services results.

In the first quarter of 2014, the Company repaid $150.0 million of manufacturing debt and, as a result, had no manufacturing debt as of March 31, 2014.

In the first quarter of 2014, the Company s research and development (R&D) expenses were $52.7 million compared to $72.1 million in the first quarter of 2013. R&D declined as new truck models and engines began production. R&D is focused on engine and new vehicle development.

Truck and Parts Outlook

Truck industry retail sales in the U.S. and Canada in 2014 are expected to be 220,000-240,000 units compared to 212,200 units in 2013 driven primarily by ongoing replacement of the aging truck population and improving construction and automotive sectors. The truck market in 2014 may also benefit from some expansion of industry fleet capacity, reflecting improved freight demand. In Europe, the 2014 truck industry registrations for over 16-tonne vehicles are expected to be 200,000-230,000 units, compared to 240,800 units in 2013.

In 2014, Parts industry aftermarket sales are expected to increase 3-7%, reflecting modest economic growth in the U.S. and Canada and Europe.

Capital investments in 2014 are expected to be $300 to $350 million, focused on enhanced powertrain development and increased operating efficiency for the assembly facilities. R&D in 2014 is expected to be $200 to $250 million.

Financial Services Outlook

Average earning assets in 2014 are expected to increase approximately 5% reflecting higher Financial Services asset level at the start of the year. Current levels of freight tonnage, freight rates and fleet utilization are contributing to customers profitability and cash flow. If current freight transportation conditions decline due to weaker economic conditions, past due accounts, truck repossessions and credit losses would likely increase from the current low levels.

See the Forward-Looking Statements section of Management s Discussion and Analysis for factors that may affect these outlooks.

Table of Contents

PACCAR Inc Form 10-Q

RESULTS OF OPERATIONS:

($ in millions, except per share amounts)

Three Months Ended March 31,	**2014**	2013
Net sales and revenues:		
Truck	**$ 3,329.2**	$ 2,933.3
Parts	**726.6**	667.4
Other	**30.4**	30.5
Truck, Parts and Other	**4,086.2**	3,631.2
Financial Services	**293.7**	293.1
	$ 4,379.9	$ 3,924.3
Income (loss) before income taxes:		
Truck	**$ 212.3**	$ 165.0
Parts	**112.1**	95.3
Other	**(9.2)**	(9.7)
Truck, Parts and Other	**315.2**	250.6
Financial Services	**85.5**	80.1
Investment income	**5.8**	6.5
Income taxes	**(132.6)**	(101.1)
Net income	**$ 273.9**	$ 236.1
Diluted earnings per share	**$ .77**	$ .67
Return on revenues	**6.3%**	6.0%

The following provides an analysis of the results of operations for the Company s three reportable segments, Truck, Parts and Financial Services. Where possible, the Company has quantified the factors identified in the following discussion and analysis. In cases where it is not possible to quantify the impact of factors, the Company lists them in estimated order of importance. Factors for which the Company is unable to specifically quantify the impact include market demand, fuel prices, freight tonnage and economic conditions affecting the Company s results of operations.

2014 Compared to 2013:

Truck

The Company s Truck segment accounted for 76.0% of revenues in the first quarter of 2014 compared to 74.7% in the first quarter of 2013.

($ in millions)

Three Months Ended March 31,	**2014**	2013	% Change

Truck net sales and revenues:			
U.S. and Canada	**$ 1,959.1**	$ 1,610.2	22
Europe	**962.6**	851.4	13
Mexico, South America, Australia and other	**407.5**	471.7	(14)
	$ 3,329.2	$ 2,933.3	13
Truck income before income taxes	**$ 212.3**	$ 165.0	29
Pre-tax return on revenues	**6.4%**	5.6%	

The Company s worldwide truck net sales and revenues in the first quarter of 2014 of $3.33 billion increased from the first quarter of 2013 primarily due to higher truck deliveries in the U.S., higher price realization in Europe related to higher content Euro 6 emission vehicles, partially offset by lower truck deliveries in Mexico, Australia and Europe.

PACCAR Inc Form 10-Q

For the first quarter of 2014, Truck segment income before income taxes and pre-tax return on revenues reflects higher truck unit deliveries in the U.S. and lower R&D spending, partially offset by lower deliveries in all foreign markets.

The Company s new truck deliveries are summarized below:

Three Months Ended March 31,	**2014**	2013	% Change
U.S.	**16,100**	12,700	27
Canada	**2,500**	2,700	(7)
U.S. and Canada	**18,600**	15,400	21
Europe	**9,300**	10,600	(12)
Mexico, South America, Australia and other	**3,900**	4,600	(15)
Total units	**31,800**	30,600	4

In the first quarter of 2014, industry retail sales in the heavy-duty market in the U.S. and Canada increased to 50,300 units from 44,900 units in the same period of 2013. The Company s heavy-duty truck retail market share was 27.2% in the first quarter of 2014 compared to 26.6% in the first quarter of 2013. The medium-duty market was 18,000 units in the first quarter of 2014 compared to 16,200 units in the same period of 2013. The Company s medium-duty market share was 13.4% in the first quarter of 2014 compared to 12.1% in the first quarter of 2013.

The over 16-tonne truck market in Western and Central Europe in the first quarter of 2014 was 54,000 units, an 11% increase from 48,700 units in the first quarter of 2013. The largest increases were in Germany, France and Spain, partially offset by reduction in the U.K. and the Netherlands. The Company s market share was 12.2% in the first quarter of 2014, a decrease from 15.8% in the same period of 2013. The decrease in market share was primarily due to lower DAF registrations in the U.K. and the Netherlands which were impacted by the Euro 5/Euro 6 transition rules. The 6- to 16-tonne market in the first quarter of 2014 was 11,000 units compared to 11,900 units in the first quarter of 2013. DAF market share in the 6- to 16-tonne market in the first quarter of 2014 was 6.3% compared to 11.0% in the same period of 2013. The decline in market share is a result of reduced registrations in the U.K. which were also affected by the Euro 5/Euro 6 transition rules.

The major factors for the change in net sales and revenues, cost of sales and revenues and gross margin for the three months ended March 31, 2014 for the Truck segment are as follows:

($ in millions)	**Net Sales**	**Cost of Sales**	**Gross Margin**
Three Months Ended March 31, 2013	**$ 2,933.3**	**$ 2,666.3**	**$ 267.0**
Increase (decrease)			
Truck delivery volume	**239.5**	**210.8**	**28.7**
Average truck sales prices	**148.4**		**148.4**
Average per truck material, labor and other direct costs		**118.7**	**(118.7)**
Factory overhead and other indirect costs		**30.3**	**(30.3)**
Operating lease revenues and depreciation expense	**18.4**	**16.3**	**2.1**
Currency translation	**(10.4)**	**(9.7)**	**(.7)**
Total increase	**395.9**	**366.4**	**29.5**
Three Months Ended March 31, 2014	**$ 3,329.2**	**$ 3,032.7**	**$ 296.5**

PACCAR Inc Form 10-Q

Truck delivery volume reflects higher deliveries in the U.S. ($346.7 million), partially offset by lower truck deliveries in Mexico ($48.8 million), Europe ($36.0 million) and Australia ($30.0 million).

Average truck sales prices increased sales by $148.4 million, primarily due to higher content Euro 6 emission vehicles in Europe ($92.6 million) and improved price realization in the U.S. and Canada ($39.0 million).

Costs of sales increased $118.7 million due to higher average cost per truck, primarily from the effect of higher content Euro 6 emission vehicles in Europe ($91.5 million).

Factory overhead and other indirect costs increased $30.3 million primarily due to higher salaries and related costs ($24.8 million) and depreciation expense ($7.6 million).

Operating lease revenues and depreciation expense increased due to a higher operating lease portfolio in Europe.

Truck gross margin in the first quarter of 2014 of 8.9% decreased slightly from 9.1% in the same period in 2013 due to the factors noted above.

Truck selling, general and administrative (SG&A) expenses increased to $54.0 million in the first quarter of 2014 compared to $53.1 million in the first quarter of 2013, primarily due to higher salaries and related costs. As a percentage of sales, SG&A decreased to 1.6% in the first quarter of 2014 compared to 1.8% in the first quarter of 2013 reflecting higher sales volume.

Parts

The Company s Parts segment accounted for 16.6% of revenues in the first quarter of 2014 compared to 17.0% in the first quarter of 2013.

($ in millions)

Three Months Ended March 31,	**2014**	2013	% Change
Parts net sales and revenues:			
U.S. and Canada	**$ 424.0**	$ 382.7	11
Europe	**218.2**	200.0	9
Mexico, South America, Australia and other	**84.4**	84.7	
	$ 726.6	$ 667.4	9
Parts income before income taxes	**$ 112.1**	$ 95.3	18
Pre-tax return on revenues	**15.4%**	14.3%	

The Company s worldwide parts net sales and revenues increased in the first quarter of 2014 due to higher aftermarket demand, primarily in the U.S., Canada and Europe. The increase in Parts segment income before taxes and pre-tax return on revenues in the first quarter of 2014 was primarily due to higher sales and gross margins.

Table of Contents

PACCAR Inc Form 10-Q

The major factors for the change in net sales and revenues, cost of sales and revenues and gross margin for the three months ended March 31, 2014 for the Parts segment are as follows:

($ in millions)	Net Sales	Cost of Sales	Gross Margin
Three Months Ended March 31, 2013	**$ 667.4**	**$ 497.6**	**$ 169.8**
Increase (decrease)			
Aftermarket parts volume	**29.1**	**19.9**	**9.2**
Average aftermarket parts sales prices	**28.6**		**28.6**
Average aftermarket parts direct costs		**19.4**	**(19.4)**
Warehouse and other indirect costs		**1.8**	**(1.8)**
Currency translation	**1.5**	**.4**	**1.1**
Total increase	**59.2**	**41.5**	**17.7**
Three Months Ended March 31, 2014	**$ 726.6**	**$ 539.1**	**$ 187.5**

Higher market demand, primarily in the U.S., Canada and Europe, resulted in increased aftermarket parts sales volume of $29.1 million and related cost of sales by $19.9 million.

Average aftermarket parts sales prices increased sales by $28.6 million reflecting improved price realization.

Average aftermarket parts direct costs increased $19.4 million due to higher material costs.

Warehouse and other indirect costs increased $1.8 million primarily due to additional costs to support higher sales volume.

Parts gross margins in the first quarter of 2014 of 25.8% increased from 25.4% in the first quarter of 2013 due to the factors noted above. Parts SG&A increased to $51.8 million in the first quarter of 2014 compared to $50.8 million in the first quarter of 2013, primarily due to higher salaries and related expenses. As a percentage of sales, Parts SG&A decreased to 7.1% in the first quarter of 2014 from 7.6% in the first quarter of 2013 due to higher sales volume.

PACCAR Inc Form 10-Q

Financial Services

The Company s Financial Services segment accounted for 6.7% of revenues in the first quarter of 2014 compared to 7.5% in the first quarter of 2013.

($ in millions)

Three Months Ended March 31,	**2014**	2013	% Change
New loan and lease volume:			
U.S. and Canada	**$ 480.0**	$ 476.8	1
Europe	**225.0**	191.3	18
Mexico and Australia	**158.3**	193.9	(18)
	$ 863.3	$ 862.0	
New loan and lease volume by product:			
Loans and finance leases	**$ 707.4**	$ 680.6	4
Equipment on operating lease	**155.9**	181.4	(14)
	$ 863.3	$ 862.0	
New loan and lease unit volume:			
Loans and finance leases	**6,800**	6,700	1
Equipment on operating lease	**1,500**	1,800	(17)
	8,300	8,500	(2)
Average earning assets:			
U.S. and Canada	**$ 6,525.7**	$ 6,188.0	5
Europe	**2,738.8**	2,372.1	15
Mexico and Australia	**1,719.3**	1,733.7	(1)
	$ 10,983.8	$ 10,293.8	7
Average earning assets by product:			
Loans and finance leases	**$ 7,166.0**	$ 6,781.9	6
Dealer wholesale financing	**1,434.3**	1,385.3	4
Equipment on lease and other	**2,383.5**	2,126.6	12
	$ 10,983.8	$ 10,293.8	7
Revenue:			
U.S. and Canada	**$ 153.4**	$ 160.8	(5)
Europe	**80.1**	72.3	11
Mexico and Australia	**60.2**	60.0	
	$ 293.7	$ 293.1	
Revenue by product:			
Loans and finance leases	**$ 100.5**	$ 101.2	(1)
Dealer wholesale financing	**12.4**	12.6	(2)
Equipment on lease and other	**180.8**	179.3	1
	$ 293.7	$ 293.1	

Income before income taxes	**$**	**85.5**	$	80.1	7

New loan and lease volume of $863.3 million in the first quarter of 2014 was comparable to $862.0 million in the first quarter of 2013. In the first quarter of 2014, finance market share on new PACCAR trucks sales was 27.5% compared to 27.9% in the first quarter of 2013 reflecting lower market share in the U.S. and Canada.

Financial Services revenues of $293.7 million in the first quarter of 2014 increased slightly from $293.1 million in the first quarter of 2013 primarily due to higher average earning asset balances, offset by lower yields. Income before income taxes increased to $85.5 million in the first quarter of 2014 from $80.1 million in the first quarter of 2013 primarily due to higher finance and lease margins and a lower provision for losses on receivables.

Table of Contents

PACCAR Inc Form 10-Q

The major factors for the change in interest and fees, interest and other borrowing expenses and finance margin for the three months ended March 31, 2014 are outlined in the table below:

($ in millions)	Interest and Fees	Interest and Other Borrowing Expenses	Finance Margin
Three Months Ended March 31, 2013	**$ 113.8**	**$ 38.9**	**$ 74.9**
Increase (decrease)			
Average finance receivables	**7.0**		**7.0**
Average debt balances		**2.0**	**(2.0)**
Yields	**(6.1)**		**(6.1)**
Borrowing rates		**(3.7)**	**3.7**
Currency translation	**(1.8)**	**(.6)**	**(1.2)**
Total (decrease) increase	**(.9)**	**(2.3)**	**1.4**
Three Months Ended March 31, 2014	**$ 112.9**	**$ 36.6**	**$ 76.3**

Average finance receivables increased $529.6 million (excluding foreign exchange effects) in the first quarter of 2014 as a result of retail portfolio new business volume exceeding repayments and an increase in dealer wholesale financing.

Average debt balances increased $448.6 million in the first quarter of 2014. The higher average debt balances reflect funding for a higher average earning asset portfolio, including loans, finance leases and equipment on operating leases.

Lower market rates resulted in lower portfolio yields (5.4% in 2014 compared to 5.7% in 2013) and lower borrowing rates (1.9% in 2014 compared to 2.0% in 2013).

The following table summarizes operating lease, rental and other revenues and depreciation and other expense:

(in millions)

Three Months Ended March 31,	**2014**	2013
Operating lease revenues	**$ 173.5**	$ 157.4
Used truck sales and other	**7.3**	21.9
Operating lease, rental and other revenues	**$ 180.8**	$ 179.3
Depreciation of operating lease equipment	**$ 114.8**	$ 101.3
Vehicle operating expenses	**25.4**	23.3
Cost of used truck sales and other	**4.1**	19.5

Depreciation and other expense	**$**	**144.3**	$	144.1

Table of Contents

PACCAR Inc Form 10-Q

The major factors for the change in operating lease, rental and other revenues, depreciation and other expense and lease margin for the three months ended March 31, 2014 are outlined below:

($ in millions)	Operating Lease, Rental And Other Revenues	Depreciation and Other Expense	Lease Margin
Three Months Ended March 31, 2013	$ 179.3	$ 144.1	$ 35.2
Increase (decrease)			
Operating lease impairments		(.3)	.3
Used truck sales and other	(14.6)	(15.4)	.8
Results on returned lease assets		.4	(.4)
Average operating lease assets	12.7	10.1	2.6
Revenue and cost per asset	2.2	4.3	(2.1)
Currency translation	1.2	1.1	.1
Total increase	1.5	.2	1.3
Three Months Ended March 31, 2014	$ 180.8	$ 144.3	$ 36.5

A lower volume of used truck sales decreased operating lease, rental and other revenues by $14.6 million and decreased depreciation and other expense by $15.4 million.

Average operating lease assets increased $256.9&nb