

FLOWSERVE CORP  
Form 10-Q  
November 01, 2007

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549**

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2007**  
**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 No. 1-13179  
FLOWSERVE CORPORATION**  
(Exact name of registrant as specified in its charter)

**New York**

**31-0267900**

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer Identification No.)

**5215 N. O Connor Blvd., Suite 2300, Irving, Texas**

**75039**

(Address of principal executive offices)

(Zip Code)

**(972) 443-6500**

(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  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

As of October 29, 2007, there were 57,139,380 shares of the issuer's common stock outstanding.

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**SIGNATURES**

Certification Pursuant to Section 302

Certification Pursuant to Section 302

Certification Pursuant to Section 906

Certification Pursuant to Section 906

**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements.****FLOWSERVE CORPORATION****(Unaudited)****CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

| (Amounts in thousands, except per share data) | <b>Three Months Ended September</b> |                           |
|---|-------------------------------------|---------------------------|
|   | <b>2007</b>                         | <b>30,</b><br><b>2006</b> |
| Sales   | \$ 919,247                          | \$ 770,757                |
| Cost of sales                                 | (605,664)                           | (520,954)                 |
| Gross profit                                  | 313,583                             | 249,803                   |
| Selling, general and administrative expense   | (210,135)                           | (191,252)                 |
| Net earnings from affiliates                  | 4,781                               | 3,326                     |
| Operating income                              | 108,229                             | 61,877                    |
| Interest expense                              | (15,332)                            | (16,385)                  |
| Interest income                               | 919                                 | 1,634                     |
| Other income (expense), net                   | 1,224                               | (1,835)                   |
| Earnings before income taxes                  | 95,040                              | 45,291                    |
| Provision for income taxes                    | (31,985)                            | (16,817)                  |
| Income from continuing operations             | 63,055                              | 28,474                    |
| Discontinued operations, net of tax           |                                     | 805                       |
| Net earnings                                  | \$ 63,055                           | \$ 29,279                 |
| Earnings per share:                           |                                     |                           |
| Basic:  |                                     |                           |
| Continuing operations                         | \$ 1.12                             | \$ 0.51                   |
| Discontinued operations                       |                                     | 0.02                      |
| Net earnings                                  | \$ 1.12                             | \$ 0.53                   |
| Diluted:                                      |                                     |                           |
| Continuing operations                         | \$ 1.10                             | \$ 0.49                   |
| Discontinued operations                       |                                     | 0.02                      |
| Net earnings                                  | \$ 1.10                             | \$ 0.51                   |
| Dividends per share                           | \$ 0.15                             | \$                        |

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****Three Months Ended September 30,**

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| (Amounts in thousands)                               | <b>2007</b> | <b>2006</b> |
|--|-------------|-------------|
| Net earnings   | \$ 63,055   | \$ 29,279   |
| Other comprehensive income (expense):                |             |             |
| Foreign currency translation adjustments, net of tax | 24,637      | (1,611)     |
| Pension and other postretirement effects, net of tax | (646)       |             |
| Cash flow hedging activity, net of tax               | (2,159)     | (1,814)     |
| Other comprehensive income (loss)                    | 21,832      | (3,425)     |
| Comprehensive income                                 | \$ 84,887   | \$ 25,854   |

See accompanying notes to condensed consolidated financial statements.

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**FLOWSERVE CORPORATION**  
**(Unaudited)**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

| (Amounts in thousands, except per share data) | <b>Nine Months Ended September 30,</b> |              |
|---|--|--------------|
|   | <b>2007</b>                            | <b>2006</b>  |
| Sales   | \$ 2,653,325                           | \$ 2,177,473 |
| Cost of sales                                 | (1,771,852)                            | (1,457,079)  |
| Gross profit                                  | 881,473                                | 720,394      |
| Selling, general and administrative expense   | (623,253)                              | (555,164)    |
| Net earnings from affiliates                  | 14,341                                 | 11,124       |
| Operating income                              | 272,561                                | 176,354      |
| Interest expense                              | (45,164)                               | (48,327)     |
| Interest income                               | 2,490                                  | 3,786        |
| Other income, net                             | 2,159                                  | 3,694        |
| Earnings before income taxes                  | 232,046                                | 135,507      |
| Provision for income taxes                    | (72,172)                               | (54,825)     |
| Income from continuing operations             | 159,874                                | 80,682       |
| Discontinued operations, net of tax           |  | 805          |
| Net earnings                                  | \$ 159,874                             | \$ 81,487    |
| Earnings per share:                           |  |              |
| Basic:  |  |              |
| Continuing operations                         | \$ 2.83                                | \$ 1.44      |
| Discontinued operations                       |  | 0.02         |
| Net earnings                                  | \$ 2.83                                | \$ 1.46      |
| Diluted:                                      |  |              |
| Continuing operations                         | \$ 2.79                                | \$ 1.41      |
| Discontinued operations                       |  | 0.02         |
| Net earnings                                  | \$ 2.79                                | \$ 1.43      |
| Dividends per share                           | \$ 0.45                                | \$           |

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

| (Amounts in thousands) | <b>Nine Months Ended September 30,</b> |             |
|------------------------|--|-------------|
|                        | <b>2007</b>                            | <b>2006</b> |
| Net earnings           | \$ 159,874                             | \$ 81,487   |

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|  |            |            |
|--|------------|------------|
| Other comprehensive income (expense):                |            |            |
| Foreign currency translation adjustments, net of tax | 44,769     | 21,351     |
| Pension and other postretirement effects, net of tax | (433)      |            |
| Cash flow hedging activity, net of tax               | (2,020)    | 546        |
| Other comprehensive income                           | 42,316     | 21,897     |
| Comprehensive income                                 | \$ 202,190 | \$ 103,384 |

See accompanying notes to condensed consolidated financial statements.



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**FLOWSERVE CORPORATION**  
**(Unaudited)**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

| (Amounts in thousands, except per share data)   | <b>September 30,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|---|-------------------------------|------------------------------|
| <b>ASSETS</b>   |                               |                              |
| Current assets:   |                               |                              |
| Cash and cash equivalents   | \$ 71,107                     | \$ 67,000                    |
| Restricted cash   | 3,730                         | 3,457                        |
| Accounts receivable, net of allowance for doubtful accounts of \$13,033 and \$13,135, respectively      | 704,734                       | 551,815                      |
| Inventories, net  | 729,871                       | 547,373                      |
| Deferred taxes  | 99,080                        | 95,027                       |
| Prepaid expenses and other  | 82,874                        | 38,209                       |
| Total current assets  | 1,691,396                     | 1,302,881                    |
| Property, plant and equipment, net of accumulated depreciation of \$560,495 and \$509,033, respectively | 472,704                       | 442,892                      |
| Goodwill  | 855,477                       | 851,123                      |
| Deferred taxes  | 1,139                         | 25,731                       |
| Other intangible assets, net  | 137,234                       | 143,358                      |
| Other assets, net   | 116,706                       | 103,250                      |
| Total assets  | \$ 3,274,656                  | \$ 2,869,235                 |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |                               |                              |
| Current liabilities:  |                               |                              |
| Accounts payable  | \$ 412,583                    | \$ 412,869                   |
| Accrued liabilities   | 639,815                       | 458,230                      |
| Debt due within one year  | 64,554                        | 8,050                        |
| Deferred taxes  | 4,507                         | 4,887                        |
| Total current liabilities   | 1,121,459                     | 884,036                      |
| Long-term debt due after one year   | 552,109                       | 556,519                      |
| Retirement obligations and other liabilities  | 434,415                       | 408,094                      |
| Shareholders' equity:   |                               |                              |
| Common shares, \$1.25 par value Shares authorized 120,000 Shares issued 58,712 and 58,631, respectively | 73,390                        | 73,289                       |
| Capital in excess of par value  | 555,127                       | 543,159                      |
| Retained earnings   | 687,079                       | 582,767                      |
|   | 1,315,596                     | 1,199,215                    |
| Treasury shares, at cost 2,576 and 2,609 shares, respectively   | (107,425)                     | (95,262)                     |
| Deferred compensation obligation  | 6,526                         | 6,973                        |
| Accumulated other comprehensive loss  | (48,024)                      | (90,340)                     |

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|  |              |              |
|--|--------------|--------------|
| Total shareholders' equity                 | 1,166,673    | 1,020,586    |
| Total liabilities and shareholders' equity | \$ 3,274,656 | \$ 2,869,235 |

See accompanying notes to condensed consolidated financial statements.

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**FLOWSERVE CORPORATION**  
**(Unaudited)**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

| (Amounts in thousands)  | <b>Nine Months Ended September 30,</b> |             |
|---|--|-------------|
|   | <b>2007</b>                            | <b>2006</b> |
| <b>Cash flows Operating activities:</b>   |  |             |
| Net earnings  | \$ 159,874                             | \$ 81,487   |
| Adjustments to reconcile net earnings to net cash provided by operating activities: |  |             |
| Depreciation  | 49,029                                 | 44,598      |
| Amortization of intangible and other assets   | 7,408                                  | 8,041       |
| Amortization of deferred loan costs   | 1,694                                  | 1,445       |
| Net gain on the disposition of assets   | (2,018)                                | (122)       |
| Excess tax benefits from stock-based payment arrangements                           | (8,177)                                | (1,177)     |
| Stock-based compensation  | 19,213                                 | 19,941      |
| Net earnings from affiliates, net of dividends received                             | (6,339)                                | (3,868)     |
| Change in assets and liabilities:   |  |             |
| Accounts receivable, net  | (119,022)                              | (28,489)    |
| Inventories, net  | (147,729)                              | (101,092)   |
| Prepaid expenses and other  | (34,831)                               | (7,268)     |
| Other assets, net   | (4,665)                                | (6,602)     |
| Accounts payable  | (24,111)                               | 6,399       |
| Accrued liabilities   | 152,866                                | 2,601       |
| Retirement obligations and other liabilities  | 12,531                                 | (2,489)     |
| Net deferred taxes  | (10,623)                               | 1,015       |
| Net cash flows provided by operating activities                                     | 45,100                                 | 14,420      |
| <b>Cash flows Investing activities:</b>   |  |             |
| Capital expenditures  | (60,941)                               | (43,520)    |
| Proceeds from disposal of assets  | 3,906                                  |             |
| Change in restricted cash   | (274)                                  | (52)        |
| Net cash flows used by investing activities   | (57,309)                               | (43,572)    |
| <b>Cash flows Financing activities:</b>   |  |             |
| Net borrowings under lines of credit  | 58,000                                 |             |
| Excess tax benefits from stock-based payment arrangements                           | 8,177                                  | 1,177       |
| Payments on long-term debt  | (1,420)                                | (16,897)    |
| Payments under other financing arrangements   | (4,486)                                |             |
| Repurchase of common shares   | (44,798)                               |             |
| Payments of dividends   | (17,176)                               |             |
| Proceeds from stock option activity   | 13,341                                 |             |
| Net cash flows provided (used) by financing activities                              | 11,638                                 | (15,720)    |

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|  |           |           |
|--|-----------|-----------|
| Effect of exchange rate changes on cash        | 4,678     | 745       |
| Net change in cash and cash equivalents        | 4,107     | (44,127)  |
| Cash and cash equivalents at beginning of year | 67,000    | 92,864    |
| Cash and cash equivalents at end of period     | \$ 71,107 | \$ 48,737 |

See accompanying notes to condensed consolidated financial statements.

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**FLOWSERVE CORPORATION**  
**(Unaudited)**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**1. Basis of Presentation and Accounting Policies**

**Basis of Presentation**

The accompanying condensed consolidated balance sheet as of September 30, 2007, and the related condensed consolidated statements of income and comprehensive income for the three and nine months ended September 30, 2007 and 2006, and the condensed consolidated statements of cash flows for the nine months ended September 30, 2007 and 2006, are unaudited. In management's opinion, all adjustments comprising normal recurring adjustments necessary for a fair presentation of such condensed consolidated financial statements have been made.

The accompanying condensed consolidated financial statements and notes in this Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2007 ( Quarterly Report ) are presented as permitted by Regulation S-X and do not contain certain information included in our annual financial statements and notes thereto. Accordingly, the accompanying condensed consolidated financial information should be read in conjunction with the consolidated financial statements presented in our Annual Report on Form 10-K for the year ended December 31, 2006 ( 2006 Annual Report ).

Certain reclassifications have been made to prior period amounts to conform to the current period presentation.

**Income Taxes, Deferred Taxes, Tax Valuation Allowances and Tax Reserves**

As of January 1, 2007, we adopted Financial Interpretation ( FIN ) No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109. FIN No. 48 addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under FIN No. 48, we may 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. The determination is based on the technical merits of the position and presumes that each uncertain tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information.

**Other Accounting Policies**

Other significant accounting policies, for which no significant changes have occurred in the three months ended September 30, 2007, are detailed in Note 1 of our 2006 Annual Report.

**Accounting Developments**

***Pronouncements Implemented***

In February 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 155, Accounting for Certain Hybrid Financial Instruments, which amends SFAS No. 133,

Accounting for Derivative Instruments and Hedging Activities, and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. SFAS No. 155 improves the financial reporting of certain hybrid financial instruments and simplifies the accounting for these instruments. In particular, SFAS No. 155: permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation;

clarifies which interest-only and principal-only strips are not subject to the requirements of SFAS No. 133;

establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation;

clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and

amends SFAS No. 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument.



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SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's fiscal year that begins after September 15, 2006. Our adoption of SFAS No. 155 effective January 1, 2007 had no impact on our consolidated financial condition or results of operations.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets*—an amendment of Statement No. 140. SFAS No. 156 clarifies when an obligation to service financial assets should be separately recognized as a servicing asset or a servicing liability, requires that a separately recognized servicing asset or servicing liability be initially measured at fair value and permits an entity with a separately recognized servicing asset or servicing liability to choose either the amortization method or fair value method for subsequent measurement. SFAS No. 156 is effective for all separately recognized servicing assets and liabilities acquired or issued after the beginning of an entity's fiscal year that begins after September 15, 2006. Our adoption of SFAS No. 156 effective January 1, 2007 had no impact on our consolidated financial condition or results of operations.

In March 2006, the Emerging Issues Task Force (EITF) issued EITF Issue No. 06-03, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)*. EITF No. 06-03 requires that the presentation of taxes assessed by a governmental authority that are directly imposed on a revenue-producing transaction between a seller and a customer on either a gross (included in revenues and costs) or a net (excluded from revenues) basis is an accounting policy decision that should be disclosed pursuant to Accounting Principles Board Opinion (APB) No. 22, *Disclosure of Accounting Policies*. In addition, if any of such taxes are reported on a gross basis, a company should disclose, on an aggregated basis, the amounts of those taxes in interim and annual financial statements for each period for which an income statement is presented if those amounts are significant. EITF Issue No. 06-03 is effective for interim and annual reporting periods beginning after December 31, 2006. As we have historically presented such taxes on a net basis within our results of operations, our adoption of EITF Issue No. 06-03 effective January 1, 2007 did not have a material impact on our consolidated financial position or results of operations.

In July 2006, the FASB issued FIN No. 48, *Accounting for Uncertainty in Income Taxes*—an Interpretation of FASB Statement No. 109. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. FIN No. 48 also prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, as well as guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The evaluation of a tax position in accordance with FIN No. 48 is a two-step process. The first step is a recognition process whereby the enterprise determines whether it is more-likely-than-not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. The second step is a measurement process whereby a tax position that meets the more-likely-than-not recognition threshold is calculated to determine the amount of benefit to recognize in the financial statements. The provisions of FIN No. 48 are effective for fiscal years beginning after December 15, 2006. The impact on our consolidated financial condition and results of operations of adopting FIN No. 48 effective January 1, 2007 is presented in Note 12.

***Pronouncements Not Yet Implemented***

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 establishes a single definition of fair value and a framework for measuring fair value under accounting principles generally accepted in the United States (GAAP), and expands disclosures about fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements; however, it does not require any new fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. We are still evaluating the impact of SFAS No. 157 on our consolidated financial condition and results of operations.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*—Including an amendment of FASB Statement No. 115. SFAS No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. It provides entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are still evaluating the impact of SFAS No. 159 on

our consolidated financial condition and results of operations.

Although there are no other final pronouncements recently issued that we have not adopted and that we expect to impact reported financial information or disclosures, accounting promulgating bodies have a number of pending projects that may directly impact us. We continue to evaluate the status of these projects and as these projects become final, we will provide disclosures regarding the likelihood and magnitude of their impact, if any.



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*General Services Group* During the first quarter of 2005 we committed to a plan to divest certain non-core service operations, collectively called the General Services Group ( GSG ). On December 31, 2005, we sold GSG to Furmanite, a unit of Dallas-based Xanser Corporation for a contingent sales price of \$15.5 million in gross cash proceeds, including \$2.0 million held in escrow pending final settlement and excluding approximately \$12 million of net accounts receivable. Utilizing the \$15.5 million contingent sales price, the sale resulted in a loss of \$2.5 million (\$3.8 million pre-tax), which we recognized in the fourth quarter of 2005. During the third quarter of 2006, we recognized \$0.8 million (\$1.1 million pre-tax) of reduction in the loss after an independent arbitrator issued a binding decision with respect to the valuation of inventory, which resolved one element of the contingent sales price. During the fourth quarter of 2006, we negotiated the final sales price of \$17.1 million, whereby we recognized an additional reduction in the loss on sale of \$0.2 million (\$0.5 million pre-tax), bringing the aggregate loss on sale recognized in 2006 and 2005 to \$1.5 million (\$2.2 million pre-tax). All remaining amounts due to us under the terms of the sale were collected in December 2006.

We used \$10.9 million of the initial net cash proceeds to reduce our indebtedness in January 2006, and an additional \$3.5 million in December 2006 using the final proceeds collected pursuant to this sale transaction. As a result of this sale, we have presented the results of operations of GSG and the impact of subsequent sales price adjustments as discontinued operations.

**3. Stock-Based Compensation Plans**

Our stock-based compensation includes stock options, restricted stock and other equity-based awards, and is accounted for under SFAS No. 123(R), Share-Based Payment. Under this method, we recorded stock-based compensation as follows:

|                                      | Three Months Ended September 30, |                     |        |                         |                     |        |
|--------------------------------------|----------------------------------|---------------------|--------|-------------------------|---------------------|--------|
|                                      | 2007                             |                     |        | 2006                    |                     |        |
|                                      | Stock<br>Options                 | Restricted<br>Stock | Total  | Stock<br>Options<br>(1) | Restricted<br>Stock | Total  |
| (Amounts in millions)                |                                  |                     |        |                         |                     |        |
| Stock-based compensation expense     | \$ 0.7                           | \$ 6.7              | \$ 7.4 | \$ 1.7                  | \$ 3.3              | \$ 5.0 |
| Related income tax benefit           | (0.1)                            | (2.1)               | (2.2)  | (0.2)                   | (0.9)               | (1.1)  |
| Net stock-based compensation expense | \$ 0.6                           | \$ 4.6              | \$ 5.2 | \$ 1.5                  | \$ 2.4              | \$ 3.9 |

|                                      | Nine Months Ended September 30, |                     |         |                         |                     |         |
|--------------------------------------|---------------------------------|---------------------|---------|-------------------------|---------------------|---------|
|                                      | 2007                            |                     |         | 2006                    |                     |         |
|                                      | Stock<br>Options                | Restricted<br>Stock | Total   | Stock<br>Options<br>(1) | Restricted<br>Stock | Total   |
| (Amounts in millions)                |                                 |                     |         |                         |                     |         |
| Stock-based compensation expense     | \$ 2.9                          | \$ 16.3             | \$ 19.2 | \$ 5.2                  | \$ 9.1              | \$ 14.3 |
| Related income tax benefit           | (0.8)                           | (5.1)               | (5.9)   | (1.0)                   | (2.7)               | (3.7)   |
| Net stock-based compensation expense | \$ 2.1                          | \$ 11.2             | \$ 13.3 | \$ 4.2                  | \$ 6.4              | \$ 10.6 |

(1) Excludes the \$5.6 million modification charge recorded in August 2006

as discussed  
below in  
Modifications  
since the charge  
we would have  
recognized in  
accordance with  
FIN No. 44,  
Accounting for  
Certain  
Transactions  
involving Stock  
Compensation an  
interpretation of  
APB Opinion  
No. 25, would  
have  
approximated the  
charge  
recognized in  
accordance with  
SFAS  
No. 123(R).

*Stock Options* Information related to stock options issued to officers, other employees and directors under all plans described in Note 7 to our consolidated financial statements included in our 2006 Annual Report is presented in the following table:

|                                |                    | <b>Nine Months Ended September 30, 2007</b> |                                  |                        | <b>Aggregate<br/>Intrinsic<br/>Value (in<br/>millions)</b> |
|--------------------------------|--------------------|---|----------------------------------|------------------------|--|
|                                |                    | <b>Weighted<br/>Average</b>                 | <b>Remaining<br/>Contractual</b> |                        |  |
|                                |                    | <b>Shares</b>                               | <b>Exercise Price</b>            | <b>Life (in years)</b> |  |
| Number of shares under option: |                    |   |                                  |                        |  |
| Outstanding                    | January 1, 2007    | 1,462,032                                   | \$ 30.27                         |                        |  |
| Exercised                      |                    | (582,683)                                   | 23.92                            |                        |  |
| Cancelled                      |                    | (39,460)                                    | 35.06                            |                        |  |
| Outstanding                    | September 30, 2007 | 839,889                                     | \$ 34.45                         | 7.2                    | \$ 35.0  |
| Exercisable                    | September 30, 2007 | 501,347                                     | \$ 29.59                         | 6.6                    | \$ 23.4  |

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No options were granted during the nine months ended September 30, 2007. The weighted average fair value per share of options granted was \$26.71 and \$24.90 for the three and nine months ended September 30, 2006, respectively. The total fair value of stock options vested during the three months ended September 30, 2007 and 2006 was \$2.6 million and \$2.3 million, respectively. The total fair value of stock options vested during the nine months ended September 30, 2007 and 2006 was \$5.4 million and \$3.0 million, respectively. The fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model.

As of September 30, 2007, we had \$2.5 million of unrecognized compensation cost related to outstanding unvested stock option awards, which is expected to be recognized over a weighted-average period of approximately 1 year. The total intrinsic value of stock options exercised during the three and nine months ended September 30, 2007 was \$5.6 million and \$21.5 million, respectively. No options were exercised during the nine months ended September 30, 2006 as we were in a black-out period due to our then non-current status of filings with the United States ( U.S. Securities and Exchange Commission ( SEC ).

*Restricted Stock* Awards of restricted stock are valued at the closing market price of our common stock on the date of grant. The unearned compensation is amortized to compensation expense over the vesting period of the restricted stock. We have unearned compensation of \$31.3 million and \$15.0 million at September 30, 2007 and December 31, 2006, respectively, which is expected to be recognized over a weighted-average period of approximately 2 years. These amounts will be recognized into net earnings in prospective periods as the awards vest. The total fair value of restricted shares and units vested during the three months ended September 30, 2007 and 2006 was \$3.4 million and \$1.3 million, respectively. The total fair value of restricted shares and units vested during the nine months ended September 30, 2007 and 2006 was \$10.9 million and \$3.6 million, respectively.

The following table summarizes information regarding restricted stock activity:

|  | <b>Nine Months Ended September 30, 2007</b> |   |
|--|---|---|
|  | <b>Shares</b>                               | <b>Weighted<br/>Average<br/>Grant-Date Fair<br/>Value</b> |
| Number of unvested shares:                   |   |   |
| Outstanding January 1, 2007                  | 800,523                                     | \$ 37.91  |
| Granted                                      | 648,191                                     | 53.26   |
| Vested                                       | (309,923)                                   | 35.18   |
| Cancelled                                    | (34,829)                                    | 40.56   |
| Unvested restricted stock September 30, 2007 | 1,103,962                                   | \$ 47.60  |

Unvested restricted stock outstanding as of September 30, 2007, includes 362,000 shares with performance-based vesting provisions that range from 0% to 200% based on pre-defined performance targets. Performance-based restricted stock is earned upon the achievement of performance targets, and is issuable in common shares. Compensation expense is recognized over a 36-month cliff vesting period based on the fair market value of our common stock on the date of grant, as adjusted for anticipated forfeitures. During the performance period, earned and unearned compensation expense is adjusted based on changes in the expected achievement of the performance targets.

*Modifications* On June 1, 2005, we took action to extend to December 31, 2006, the regular term of certain options granted to employees, including executive officers, qualified retirees and directors, which were scheduled to expire in 2005. On November 4, 2005, we took subsequent action to further extend the exercise date of these options, and options expiring in 2006, to January 1, 2009. We thereafter concluded, however, that recent regulatory guidance issued under Section 409A of the Internal Revenue Code might cause the recipients of these extended options to become subject to unintended adverse tax consequences under Section 409A. Accordingly, effective December 14, 2005, the Organization and Compensation Committee of the Board of Directors partially rescinded, in accordance with the regulations, the extensions of the regular term of these options, to provide as follows:

- (i) the regular term of options otherwise expiring in 2005 expired on October 29, 2006, and
- (ii) the regular term of options otherwise expiring in 2006 expired on the later of:
  - (1) 75 days after the regular term of the option as originally granted expires, or

- (2) December 31, 2006.

These extensions were subject to shareholder approval of applicable plan amendments, which was obtained at our annual shareholders meeting held on August 24, 2006. The approval of such plan amendments was considered a stock modification for financial reporting purposes subject to the recognition of a non-cash compensation charge in accordance with SFAS No. 123(R), and we recorded a charge of \$5.6 million in the third quarter of 2006.

**Table of Contents****4. Derivative Instruments and Hedges**

We enter into forward exchange contracts to manage our risks associated with transactions denominated in currencies other than the local currency of the operation engaging in the transaction. Our risk management and derivatives policy specifies the conditions under which we may enter into derivative contracts. At September 30, 2007 and December 31, 2006, we had \$380.9 million and \$433.7 million, respectively, of notional amount in outstanding forward exchange contracts with third parties. At September 30, 2007, the length of forward exchange contracts currently in place ranged from 1 day to 19 months.

The fair market value adjustments of our forward exchange contracts are recognized directly in our current period earnings. The fair value of these outstanding forward contracts at September 30, 2007 and December 31, 2006 was a net asset of \$7.7 million and \$3.4 million, respectively. Net gains (loss) from the changes in the fair value of these forward contracts of \$3.5 million and \$(3.5) million for the three months ended September 30, 2007 and 2006, respectively, and \$5.1 million and \$2.9 million, for the nine months ended September 30, 2007 and 2006, respectively, are included in other income (expense), net in our condensed consolidated statements of income.

Also as part of our risk management program, we enter into interest rate swap agreements to hedge exposure to floating interest rates on certain portions of our debt. At September 30, 2007 and December 31, 2006, we had \$415.0 million and \$435.0 million, respectively, of notional amount in outstanding interest rate swaps with third parties. At September 30, 2007, the maximum remaining length of any interest rate contract in place was approximately 36 months. The fair value of the interest rate swap agreements was a net liability of \$1.0 million and a net asset of \$1.9 million at September 30, 2007 and December 31, 2006, respectively. Unrealized net gains (loss) from the changes in fair value of our interest rate swap agreements, net of reclassifications, of \$2.0 million and \$(1.8) million, net of tax, for the three months ended September 30, 2007 and 2006, respectively, and \$1.9 million and \$0.4 million, net of tax, for the nine months ended September 30, 2007 and 2006, respectively, are included in other comprehensive income (loss).

During 2004, we entered into a compound derivative contract to hedge exposure to both currency translation and interest rate risks associated with our European Investment Bank credit facility. The notional amount of the derivative was \$85.0 million, and it served to convert floating rate interest rate risk to a fixed rate, as well as United States ( U.S. ) dollar currency risk to Euros. As described more fully in our 2006 Annual Report, we repaid all amounts outstanding under this facility on December 15, 2006 and settled the derivative. The unrealized gain (loss) on the derivative and the foreign transaction gain on the underlying loan aggregated to \$(0.8) million and \$2.8 million for the three and nine months, respectively, ended September 30, 2006, and is included in other income (expense), net in our condensed consolidated statements of income.

We are exposed to risk from credit-related losses resulting from nonperformance by counterparties to our financial instruments. We perform credit evaluations of our counterparties under forward exchange contracts and interest rate swap agreements and expect all counterparties to meet their obligations. We have not experienced credit losses from our counterparties.

**5. Debt**

Debt, including capital lease obligations, consisted of:

| (Amounts in thousands)                                      | September 30,<br>2007 | December 31,<br>2006 |
|---|-----------------------|----------------------|
| Term Loan, interest rate of 6.78% in 2007 and 6.88% in 2006 | \$ 556,799            | \$ 558,220           |
| Revolving Line of Credit, interest rate of 6.19%            | 58,000                |                      |
| Capital lease obligations and other                         | 1,864                 | 6,349                |
| Debt and capital lease obligations                          | 616,663               | 564,569              |
| Less amounts due within one year                            | 64,554                | 8,050                |

|                               |    |         |    |         |
|-------------------------------|----|---------|----|---------|
| Total debt due after one year | \$ | 552,109 | \$ | 556,519 |
|-------------------------------|----|---------|----|---------|

**Table of Contents****Credit Facilities**

On August 12, 2005, we entered into credit facilities comprised of a \$600.0 million term loan expiring on August 10, 2012 and a \$400.0 million revolving line of credit, which can be utilized to provide up to \$300.0 million in letters of credit, expiring on August 12, 2010. We hereinafter refer to these credit facilities collectively as our Credit Facilities. At September 30, 2007 and December 31, 2006, we had \$58.0 million and \$0, respectively, outstanding under the revolving line of credit. We had outstanding letters of credit of \$110.9 million and \$83.9 million at September 30, 2007 and December 31, 2006, respectively, which reduced borrowing capacity to \$231.1 million and \$316.1 million, respectively.

On August 7, 2007, we amended our Credit Facilities to, among other things, reduce the applicable margin applied to borrowings under the revolving line of credit, as well as extend the maturity date of the revolving line of credit by two years, to August 12, 2012. The amendment also eliminates all mandatory debt repayment requirements and the restriction on capital expenditures. The amendment further replaces the dollar limitation on acquisitions and certain restricted payments, with a limitation based on pro forma compliance with the required leverage ratio in both cases.

Borrowings under our Credit Facilities bear interest at a rate equal to, at our option, either (1) the base rate (which is based on the greater of the prime rate most recently announced by the administrative agent under our Credit Facilities or the Federal Funds rate plus 0.50%) or (2) London Interbank Offered Rate ( LIBOR ) plus an applicable margin determined by reference to the ratio of our total debt to consolidated Earnings Before Interest, Taxes, Depreciation and Amortization ( EBITDA ), which as of September 30, 2007 was 1.00% and 1.50% for borrowings under our revolving line of credit and term loan, respectively.

We may prepay loans under our Credit Facilities in whole or in part, without premium or penalty. During the three and nine months ended September 30, 2007, we made scheduled repayments of \$1.4 million under our Credit Facilities. We have a scheduled repayment of \$1.4 million due in the fourth quarter of 2007.

**European Letter of Credit Facility**

On September 14, 2007, we entered into an unsecured European Letter of Credit Facility ( European LOC ) to issue letters of credit in an aggregate face amount not to exceed 150.0 million at any time, with an initial commitment of 80.0 million. The aggregate commitment of the European LOC may be increased up to 150.0 million as may be agreed among the parties, and may be decreased by us at our option without any premium, fee or penalty. The European LOC will be used for contingent obligations solely in respect of surety and performance bonds, bank guarantees and similar obligations. We had outstanding letters of credit drawn on the European LOC of 25.3 million as of September 30, 2007. We will pay certain fees for the letters of credit written against the European LOC based upon the ratio of our total debt to consolidated EBITDA. As of September 30, 2007 the annual fees equaled 0.5% plus a fronting fee of 0.1%.

Our European LOC contains covenants restricting certain foreign subsidiaries' ability to issue debt, incur liens, sell assets, merge, consolidate, make certain investments, pay dividends, enter into agreements with negative pledge clauses or engage in any business activity other than our existing business. The European LOC also incorporates by reference the covenants contained in our Credit Facilities.

Our European LOC includes events of default usual for these types of letter of credit facilities, including nonpayment of any fee or obligation, violation of covenants, incorrectness of representations and warranties, cross defaults and cross acceleration, bankruptcy, material judgments, ERISA events, actual or asserted invalidity of the guarantees and certain changes of control of our company. The occurrence of any event of default could result in the termination of the commitments and an acceleration of our obligations under the European LOC. We complied with the covenants through September 30, 2007.

**6. Inventories**

Inventories are stated at lower of cost or market. Cost is determined by the first-in, first-out method. Inventories, net consisted of the following:

| (Amounts in thousands) | <b>September 30,<br/>2007</b> | <b>December 31,<br/>2006</b> |
|------------------------|-------------------------------|------------------------------|
| Raw materials          | \$ 229,108                    | \$ 167,224                   |

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|                                   |            |            |
|-----------------------------------|------------|------------|
| Work in process                   | 525,654    | 354,808    |
| Finished goods                    | 257,607    | 225,157    |
| Less: Progress billings           | (218,961)  | (140,056)  |
| Less: Excess and obsolete reserve | (63,537)   | (59,760)   |
| Inventories, net                  | \$ 729,871 | \$ 547,373 |



**Table of Contents****7. Equity Method Investments**

Summarized below is combined income statement information, based on the most recent financial information, for investments in entities we account for using the equity method:

| (Amounts in thousands)                   | <b>Three Months Ended September 30,</b> |             |
|--|---|-------------|
|  | <b>2007</b>                             | <b>2006</b> |
| Revenues                                 | \$ 102,805                              | \$ 77,754   |
| Gross profit                             | 23,695                                  | 18,969      |
| Income before provision for income taxes | 16,307                                  | 10,930      |
| Provision for income taxes               | (5,586)                                 | (3,515)     |
| Net income                               | \$ 10,721                               | \$ 7,415    |

| (Amounts in thousands)                   | <b>Nine Months Ended September 30,</b> |             |
|--|--|-------------|
|  | <b>2007</b>                            | <b>2006</b> |
| Revenues                                 | \$ 281,207                             | \$ 220,535  |
| Gross profit                             | 71,041                                 | 59,214      |
| Income before provision for income taxes | 46,874                                 | 35,300      |
| Provision for income taxes               | (14,820)                               | (10,875)    |
| Net income                               | \$ 32,054                              | \$ 24,425   |

The provision for income taxes is based on the tax laws and rates in the countries in which our investees operate. The tax jurisdictions vary not only by their nominal rates, but also by the allowability of deductions, credits and other benefits. Our share of net income is reflected in our condensed consolidated statements of income.

**8. Earnings Per Share**

Basic and diluted earnings per weighted average share outstanding were calculated as follows:

| (Amounts in thousands, except per share data)                      | <b>Three Months Ended September 30,</b> |             |
|--|---|-------------|
|  | <b>2007</b>                             | <b>2006</b> |
| Income from continuing operations                                  | \$ 63,055                               | \$ 28,474   |
| Net earnings   | 63,055                                  | 29,279      |
| Denominator for basic earnings per share weighted average shares   | 56,421                                  | 55,701      |
| Effect of potentially dilutive securities                          | 799                                     | 1,411       |
| Denominator for diluted earnings per share weighted average shares | 57,220                                  | 57,112      |
| Earnings per share:  |   |             |
| Basic:   |   |             |
| Continuing operations  | \$ 1.12                                 | \$ 0.51     |
| Discontinued operations  |   | 0.02        |
| Net earnings   | \$ 1.12                                 | \$ 0.53     |

Diluted:

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|                         |    |      |    |      |
|-------------------------|----|------|----|------|
| Continuing operations   | \$ | 1.10 | \$ | 0.49 |
| Discontinued operations |    |      |    | 0.02 |
| Net earnings            | \$ | 1.10 | \$ | 0.51 |

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| (Amounts in thousands, except per share data)                      | <b>Nine Months Ended September 30,</b> |             |
|--|--|-------------|
|  | <b>2007</b>                            | <b>2006</b> |
| Income from continuing operations                                  | \$ 159,874                             | \$ 80,682   |
| Net earnings   | 159,874                                | 81,487      |
| Denominator for basic earnings per share weighted average shares   | 56,401                                 | 55,623      |
| Effect of potentially dilutive securities                          | 849                                    | 1,377       |
| Denominator for diluted earnings per share weighted average shares | 57,250                                 | 57,000      |
| Earnings per share:  |  |             |
| Basic:   |  |             |
| Continuing operations  | \$ 2.83                                | \$ 1.44     |
| Discontinued operations  |  | 0.02        |
| Net earnings   | \$ 2.83                                | \$ 1.46     |
| Diluted:   |  |             |
| Continuing operations  | \$ 2.79                                | \$ 1.41     |
| Discontinued operations  |  | 0.02        |
| Net earnings   | \$ 2.79                                | \$ 1.43     |

Options outstanding with an exercise price greater than the average market price of the common stock were not included in the computation of diluted earnings per share. For the three and nine months ended both September 30, 2007 and 2006, we had no options to purchase common stock that were excluded from the computations of potentially dilutive securities.

**9. Legal Matters and Contingencies****Asbestos**

We are a defendant in a large number of pending lawsuits (which include, in many cases, multiple claimants) that seek to recover damages for personal injury allegedly caused by exposure to asbestos-containing products manufactured and/or distributed by us in the past. While the aggregate number of asbestos-related claims against us has declined in recent years, there can be no assurance that this trend will continue. Any such products were encapsulated and used only as components of process equipment, and we do not believe that any significant emission of respirable asbestos fibers occurred during the use of this equipment. We believe that a high percentage of the claims are covered by applicable insurance or indemnities from other companies.

**Shareholder Litigation**

In 2003, related lawsuits were filed in federal court in the Northern District of Texas (the Court), alleging that we violated federal securities laws. Since the filing of these cases, which have been consolidated, the lead plaintiff has amended its complaint several times. The lead plaintiff's current pleading is the fifth consolidated amended complaint (the Complaint). The Complaint alleges that federal securities violations occurred between February 6, 2001 and September 27, 2002 and names as defendants our company, C. Scott Greer, our former Chairman, President and Chief Executive Officer, Renee J. Hornbaker, our former Vice President and Chief Financial Officer, PricewaterhouseCoopers LLP, our independent registered public accounting firm, and Banc of America Securities LLC and Credit Suisse First Boston LLC, which served as underwriters for our two public stock offerings during the relevant period. The Complaint asserts claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, and Sections 11 and 15 of the Securities Act of 1933. The lead plaintiff seeks unspecified

compensatory damages, forfeiture by Mr. Greer and Ms. Hornbaker of unspecified incentive-based or equity-based compensation and profits from any stock sales, and recovery of costs. On November 22, 2005, the Court entered an order denying the defendants' motions to dismiss the Complaint. We have subsequently filed other contested motions for the purpose of dismissing this case which are currently pending before the Court. The case had been set for trial on October 1, 2007, but on August 22, 2007, the Court stayed the trial and all pretrial proceedings pending its ruling on whether the case may be certified as a class action. We continue to believe that the lawsuit is without merit and are vigorously defending the case.

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In 2005, a shareholder derivative lawsuit was filed purportedly on our behalf in the 193rd Judicial District of Dallas County, Texas. The lawsuit originally named as defendants Mr. Greer, Ms. Hornbaker, and former and current board members Hugh K. Coble, George T. Haymaker, Jr., William C. Rusnack, Michael F. Johnston, Charles M. Rampacek, Kevin E. Sheehan, Diane C. Harris, James O. Rollans and Christopher A. Bartlett. We have been named as a nominal defendant. Based primarily on the purported misstatements alleged in the above-described federal securities case, the original lawsuit asserted claims against the defendants for breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment. The plaintiff alleged that these purported violations of state law occurred between April 2000 and the date of suit. The plaintiff seeks on our behalf an unspecified amount of damages, injunctive relief and/or the imposition of a constructive trust on defendants' assets, disgorgement of compensation, profits or other benefits received by the defendants from us and recovery of attorneys' fees and costs. We strongly believe that the suit was improperly filed and filed a motion seeking dismissal of the case. The Court thereafter ordered the plaintiffs to replead. On October 11, 2007, the plaintiffs filed an amended petition adding new claims against the following additional defendants: Kathy Giddings, our former Vice-President and Corporate Controller; Bernard G. Rethore, our former Chairman and Chief Executive Officer; Banc of America Securities, LLC and Credit Suisse First Boston, LLC, which served as underwriters for our public stock offerings in November 2001 and April 2002, and PricewaterhouseCoopers, LLP, our independent registered public accounting firm. None of the defendants have yet responded to the amended petition.

On March 14, 2006, a shareholder derivative lawsuit was filed purportedly on our behalf in federal court in the Northern District of Texas. The lawsuit named as defendants Mr. Greer, Ms. Hornbaker, and the following former and current board members Mr. Coble, Mr. Haymaker, Mr. Lewis M. Kling, Mr. Rusnack, Mr. Johnston, Mr. Rampacek, Mr. Sheehan, Ms. Harris, Mr. Rollans and Mr. Bartlett. We were named as a nominal defendant. Based primarily on certain of the purported misstatements alleged in the above-described federal securities case, the plaintiff asserted claims against the defendants for breaches of fiduciary duty. The plaintiff alleged that the purported breaches of fiduciary duty occurred between 2000 and 2004. The plaintiff sought on our behalf an unspecified amount of damages, disgorgement by Mr. Greer and Ms. Hornbaker of salaries, bonuses, restricted stock and stock options, and recovery of attorneys' fees and costs. Pursuant to a motion filed by us, the federal court dismissed that case on March 14, 2007, primarily on the basis that the case was not properly filed in federal court. On or about March 27, 2007, the same plaintiff re-filed essentially the same lawsuit naming the same defendants in the Supreme Court of the State of New York. We strongly believe that this new lawsuit was improperly filed in the Supreme Court of the State of New York as well and have filed a motion seeking dismissal of the case. A hearing was held on the motion to dismiss in May 2007 and the parties are awaiting a ruling from the Court.

**Oil-for-Food**

On February 7, 2006, we received a subpoena from the SEC seeking documents and information relating primarily to products that our Dutch and French subsidiaries delivered to Iraq from 1996 through 2003 under the United Nations Oil-for-Food Program. We believe that the SEC's investigation is focused primarily on whether any inappropriate payments were made to Iraqi officials in violation of the federal securities laws. We subsequently learned that the U.S. Department of Justice (DOJ) is investigating the same allegations. In addition, our Dutch and French subsidiaries have been contacted by governmental authorities in their respective countries concerning their involvement in the United Nations Oil-for-Food Program. These investigations include periods prior to, as well as subsequent to, our acquisition of these foreign operations involved in the investigations.

We believe that the U.S., Dutch and French governmental authorities are investigating other companies in connection with the United Nations Oil-for-Food Program.

We engaged outside counsel in February 2006 to conduct an investigation of our Dutch and French subsidiaries participation in the United Nations Oil-for-Food program. The Audit Committee of the Board of Directors has been regularly monitoring this situation since the receipt of the SEC subpoena and assumed direct oversight of the investigation in January 2007. This internal investigation is complete.

Our internal investigation has included, among other things, a detailed review of contracts with the Iraqi government under the United Nations Oil-for-Food Program during 1996 through 2003, a forensic review of the accounting records associated with these contracts, and interviews of persons with knowledge of the events in question. Our

investigation has found evidence that, during the years 2001 through 2003, certain non-U.S. personnel at the Dutch and French subsidiaries authorized payments in connection with certain of our product sales under the United Nations Oil-for-Food Program totaling approximately 600,000, which were subsequently deposited by third parties into Iraqi-controlled bank accounts. These payments were not authorized under the United Nations Oil-for-Food Program and were not properly documented in the subsidiaries' accounting records, but were expensed as paid.

We have taken certain disciplinary actions against persons who engaged in misconduct, violated our ethics policies or failed to cooperate fully in the investigation, including terminating the employment of certain non-U.S. senior management personnel at our French subsidiary. Other non-U.S. senior management personnel at our French and Dutch facilities involved in the above conduct had been previously separated from our company for other reasons.

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We have engaged in and made substantial progress in discussions with the SEC and DOJ in an effort to resolve their outstanding investigations on a negotiated basis. We also believe that the Dutch investigation has effectively concluded. We believe this investigation will be resolved with the Dutch subsidiary paying a penalty of approximately 265,000. We understand the remaining French investigation is ongoing. Accordingly we cannot predict the outcome of the French investigation at this time. If the French authorities take enforcement action with regard to its investigation, we may be subject to additional monetary and non-monetary penalties. We recorded expenses of approximately \$8 million and \$11 million in the three and nine months, respectively, ended September 30, 2007 for case resolution costs and related legal fees. We currently do not expect to incur further case resolution costs in this matter.

**Export Compliance**

In March 2006, we initiated a voluntary process to determine our compliance posture with respect to U.S. export control laws and regulations. Upon initial investigation, it appeared that some product transactions and technology transfers were not handled in full compliance with U.S. export control laws and regulations. As a result, in conjunction with outside counsel, we are currently involved in a voluntary systematic process to conduct further review, validation and voluntary disclosure of apparent export violations discovered as part of this review process. We have completed approximately two-thirds of the site visits scheduled as part of this voluntary disclosure process, but currently believe this process will not be substantially complete and the results of site visits will not be fully analyzed until the end of 2008, given the complexity of the export laws and the current scope of the investigation. Any apparent violations of U.S. export control laws and regulations that are identified, confirmed and disclosed to the U.S. government may result in civil or criminal penalties, including fines and/or other penalties. Although companies making voluntary export disclosures have historically received reduced penalties and certain mitigating credits, legislation enacted on October 16, 2007 increased the maximum penalty for certain export control violations (assessed on a per-shipment basis) to the greater of \$250,000 or twice the value of the transaction. Because our review into this issue is ongoing, we are currently unable to definitively determine the extent of any apparent violations or the nature or total amount of penalties to which we might be subject to in the future. Given that the resolution of this matter is uncertain at this time, we are not able to reasonably estimate the maximum amount of liability that could result from final resolution of this matter. We cannot currently predict whether the ultimate resolution of this matter will have a material adverse effect on our business, including our ability to do business outside the U.S., our financial condition or our results of operations.

**Other**

We are currently involved as a potentially responsible party at four former public waste disposal sites that may be subject to remediation under pending government procedures. The sites are in various stages of evaluation by federal and state environmental authorities. The projected cost of remediation at these sites, as well as our alleged fair share allocation, is uncertain and speculative until all studies have been completed and the parties have either negotiated an amicable resolution or the matter has been judicially resolved. At each site, there are many other parties who have similarly been identified, and the identification and location of additional parties is continuing under applicable federal or state law. Many of the other parties identified are financially strong and solvent companies that appear able to pay their share of the remediation costs. Based on our information about the waste disposal practices at these sites and the environmental regulatory process in general, we believe that it is likely that ultimate remediation liability costs for each site will be apportioned among all liable parties, including site owners and waste transporters, according to the volumes and/or toxicity of the wastes shown to have been disposed of at the sites. We believe that our exposure for existing disposal sites will be less than \$100,000.

In addition to the above public disposal sites, we received a Clean Up Notice on September 17, 2007 with respect to a site in Australia. The site was used for disposal of spent foundry sand. A risk assessment of the site is currently underway, but it will be several months before the assessment is completed. It is impossible to accurately quantify the potential liability associated with the site at this time, but it is not currently believed that it will be material.

We are also a defendant in several other lawsuits, including product liability claims that are insured, subject to the applicable deductibles, arising in the ordinary course of business. Based on currently available information, we believe that we have adequately accrued estimated probable losses for such lawsuits.

Although none of the aforementioned potential liabilities can be quantified with absolute certainty except as otherwise indicated above, we have established reserves covering exposures relating to contingencies, to the extent believed to be reasonably estimable and probable based on past experience and available facts. While additional exposures beyond these reserves could exist, they currently cannot be estimated. We will continue to evaluate these potential contingent loss exposures and, if they develop, recognize expense as soon as such losses become probable and can be reasonably estimated.



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We are also involved in ordinary routine litigation incidental to our business, none of which we believe to be material to our business, operations or overall financial condition. However, resolutions or dispositions of claims or lawsuits by settlement or otherwise could have a significant impact on our operating results for the reporting period in which any such resolution or disposition occurs.

**10. Retirement and Postretirement Benefits**

Components of the net periodic cost for retirement and postretirement benefits for the three months ended September 30, 2007 and 2006 were as follows:

| (Amounts in millions)                 | U.S.<br>Defined Benefit<br>Plans |        | Non-U.S.<br>Defined Benefit<br>Plans |        | Postretirement<br>Medical Benefits |        |
|---------------------------------------|----------------------------------|--------|--------------------------------------|--------|------------------------------------|--------|
|                                       | 2007                             | 2006   | 2007                                 | 2006   | 2007                               | 2006   |
|                                       | Service cost                     | \$ 4.9 | \$ 3.7                               | \$ 1.0 | \$ 0.9                             | \$     |
| Interest cost                         | 4.1                              | 3.8    | 2.9                                  | 2.5    | 1.0                                | 1.0    |
| Expected return on plan assets        | (4.2)                            | (3.9)  | (1.8)                                | (1.4)  |                                    |        |
| Amortization of unrecognized net loss | 1.7                              | 1.6    | 0.4                                  | 0.6    | 0.3                                | 0.3    |
| Amortization of prior service benefit | (0.3)                            | (0.3)  |                                      |        | (1.1)                              | (1.1)  |
| Net periodic cost recognized          | \$ 6.2                           | \$ 4.9 | \$ 2.5                               | \$ 2.6 | \$ 0.2                             | \$ 0.2 |

Components of the net periodic cost for retirement and postretirement benefits for the nine months ended September 30, 2007 and 2006 were as follows:

| (Amounts in millions)                 | U.S.<br>Defined Benefit<br>Plans |         | Non-U.S.<br>Defined Benefit<br>Plans |        | Postretirement<br>Medical Benefits |        |
|---------------------------------------|----------------------------------|---------|--------------------------------------|--------|------------------------------------|--------|
|                                       | 2007                             | 2006    | 2007                                 | 2006   | 2007                               | 2006   |
|                                       | Service cost                     | \$ 12.3 | \$ 11.1                              | \$ 3.1 | \$ 3.0                             | \$ 0.1 |
| Interest cost                         | 12.3                             | 11.6    | 8.7                                  | 7.4    | 2.9                                | 2.9    |
| Expected return on plan assets        | (12.8)                           | (11.8)  | (5.5)                                | (4.3)  |                                    |        |
| Amortization of unrecognized net loss | 4.6                              | 4.8     | 1.3                                  | 1.9    | 0.8                                | 0.8    |
| Amortization of prior service benefit | (1.0)                            | (1.0)   |                                      |        | (3.2)                              | (3.2)  |
| Net periodic cost recognized          | \$ 15.4                          | \$ 14.7 | \$ 7.6                               | \$ 8.0 | \$ 0.6                             | \$ 0.5 |

See additional discussion of our retirement and postretirement benefits in Note 12 to our consolidated financial statements included in our 2006 Annual Report.

**11. Shareholders Equity**

On September 29, 2006, the Board of Directors authorized a program to repurchase up to 2.0 million shares of our outstanding common stock by the end of the second quarter of 2007. Shares were repurchased to offset potentially dilutive effects of stock options issued under our equity-based compensation programs. To date, we have repurchased a total of 2.0 million shares and have concluded the program.

On both April 11, 2007 and July 11, 2007, we paid quarterly cash dividends of \$0.15 per share to shareholders of record as of March 28, 2007 and June 27, 2007, respectively. On August 16, 2007, our Board of Directors authorized the payment of a quarterly cash dividend of \$0.15 per share, which was paid on October 10, 2007 to shareholders of record as of September 26, 2007.

**12. Income Taxes**

For the three months ended September 30, 2007, we earned \$95.0 million before taxes and provided for income taxes of \$32.0 million, resulting in an effective tax rate of 33.7%. For the nine months ended September 30, 2007, we

earned \$232.0 million before taxes and provided for income taxes of \$72.2 million, resulting in an effective tax rate of 31.1%. The effective tax rate varied from the U.S. federal statutory rate for the three and nine months ended September 30, 2007 primarily due to the net impact of foreign operations, changes in tax law, changes in valuation allowances and net favorable results from various tax audits.

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For the three months ended September 30, 2006, we earned \$45.3 million before taxes and provided for income taxes of \$16.8 million, resulting in an effective tax rate of 37.1%. For the nine months ended September 30, 2006, we earned \$135.5 million before taxes and provided for income taxes of \$54.8 million, resulting in an effective tax rate of 40.5%. The effective tax rate varied from the U.S. federal statutory rate for the three months ended September 30, 2006 primarily due to the tax impact of operating activities in certain non-U.S. jurisdictions for which a tax benefit was not recognized.

In July 2006, the FASB issued FIN No. 48, which addresses the determination of whether tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under FIN No. 48, we may 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. The determination is based on the technical merits of the position and presumes that each uncertain tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information.

The tax benefits recognized in the financial statements from such a position should be measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties on income taxes, accounting in interim periods and requires increased disclosures. We adopted the provisions of FIN No. 48 on January 1, 2007.

The cumulative effect of adopting FIN No. 48 was an increase in tax reserves and a decrease of \$29.8 million to opening retained earnings at January 1, 2007. Upon adoption, the amount of gross unrecognized tax benefits at January 1, 2007 was approximately \$129 million. There are offsetting tax benefits of approximately \$43 million associated with the correlative effects of transfer pricing adjustments, net operating losses and timing adjustments. The net liability for uncertain tax positions is \$86.0 million. Of this amount \$84.9 million, if recognized, would favorably impact our effective tax rate.

Interest and penalties related to income tax liabilities are included in income tax expense. The balance of accrued interest and penalties recorded on the balance sheet at January 1, 2007 was approximately \$14 million.

As of September 30, 2007, the amount of unrecognized tax benefits has increased by \$14.5 million from January 1, 2007 due primarily to interest accrual on existing uncertain tax benefits, currency translation adjustments, and anticipated results of various tax audits. With limited exception, we are no longer subject to U.S. federal, state and local income tax audits for years through 2001 or non-U.S. income tax audits for years through 2000. Our U.S. income tax returns for 2002 through 2004 are currently under examination by the Internal Revenue Service ( IRS ). Additionally, we are currently under examination for various years in Germany, Italy, Canada, Venezuela and Argentina.

It is reasonably possible that within the next 12 months we and various taxing authorities will resolve some or all of the matters presently under audit, including a favorable resolution associated with the one-time repatriation of foreign profits in 2004, which was not previously recorded as a benefit. It is also reasonably possible that we will have the statute of limitations close in various taxing jurisdictions within the next 12 months. As such, we estimate we could record a reduction in our tax expense from \$8 million to \$16 million within the next 12 months.

**13. Segment Information**

We are principally engaged in the worldwide design, manufacture, distribution and service of industrial flow management equipment. We provide pumps, valves and mechanical seals primarily for the petroleum industry, chemical-processing industry, power-generation industry, water industry, general industry and other industries requiring flow management products.

We have the following three divisions, each of which constitutes a business segment:

Flowsolve Pump Division ( FPD );

Flow Control Division ( FCD ); and

Flow Solutions Division ( FSD ).

Each division manufactures different products and is defined by the type of products and services provided. Each division has a President, who reports directly to our Chief Executive Officer, and a Division Vice President Finance,

who reports directly to our Chief Accounting Officer. For decision-making purposes, our Chief Executive Officer and other members of senior executive management use financial information generated and reported at the division level. Our corporate headquarters does not constitute a separate division or business segment.

We evaluate segment performance and allocate resources based on each segment's operating income. Amounts classified as "All Other" include corporate headquarters costs and other minor entities that do not constitute separate segments. Intersegment sales and transfers are recorded at cost plus a profit margin, with the margin on such sales eliminated in consolidation.

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The following is a summary of the financial information of the reportable segments reconciled to the amounts reported in the condensed consolidated financial statements.

**Three Months Ended September 30, 2007**

|                             | <b>Flowserve</b> | <b>Flow</b>    | <b>Flow</b>      | <b>Subtotal<br/>Reportable</b> | <b>Consolidated</b>  |              |
|-----------------------------|------------------|----------------|------------------|--------------------------------|----------------------|--------------|
| (Amounts in thousands)      | <b>Pump</b>      | <b>Control</b> | <b>Solutions</b> | <b>Segments</b>                | <b>All<br/>Other</b> | <b>Total</b> |
| Sales to external customers | \$ 496,171       | \$ 293,352     | \$ 127,671       | \$ 917,194                     | \$ 2,053             | \$ 919,247   |
| Intersegment sales          | 278              | 1,689          | 13,035           | 15,002                         | (15,002)             |              |
| Segment operating income    | 68,895           | 41,101         | 30,413           | 140,409                        | (32,180)             | 108,229      |

**Three Months Ended September 30, 2006**

|                             | <b>Flowserve</b> | <b>Flow</b>    | <b>Flow</b>      | <b>Subtotal<br/>Reportable</b> | <b>Consolidated</b>  |              |
|-----------------------------|------------------|----------------|------------------|--------------------------------|----------------------|--------------|
| (Amounts in thousands)      | <b>Pump</b>      | <b>Control</b> | <b>Solutions</b> | <b>Segments</b>                | <b>All<br/>Other</b> | <b>Total</b> |
| Sales to external customers | \$ 400,226       | \$ 257,317     | \$ 111,877       | \$ 769,420                     | \$ 1,337             | \$ 770,757   |
| Intersegment sales          | 1,037            | 554            | 11,014           | 12,605                         | (12,605)             |              |
| Segment operating income    | 39,705           | 34,695         | 25,567           | 99,967                         | (38,090)             | 61,877       |

**Nine Months Ended September 30, 2007**

|                             | <b>Flowserve</b> | <b>Flow</b>    | <b>Flow</b>      | <b>Subtotal<br/>Reportable</b> | <b>Consolidated</b> |              |
|-----------------------------|------------------|----------------|------------------|--------------------------------|---------------------|--------------|
| (Amounts in thousands)      | <b>Pump</b>      | <b>Control</b> | <b>Solutions</b> | <b>Segments</b>                | <b>All Other</b>    | <b>Total</b> |
| Sales to external customers | \$ 1,439,006     | \$ 844,071     | \$ 365,915       | \$ 2,648,992                   | \$ 4,333            | \$ 2,653,325 |
| Intersegment sales          | 1,294            | 4,652          | 38,458           | 44,404                         | (44,404)            |              |
| Segment operating income    | 175,871          | 118,583        | 81,417           | 375,871                        | (103,310)           | 272,561      |

**Nine Months Ended September 30, 2006**

|                             | <b>Flowserve</b> | <b>Flow</b>    | <b>Flow</b>      | <b>Subtotal<br/>Reportable</b> | <b>Consolidated</b> |              |
|-----------------------------|------------------|----------------|------------------|--------------------------------|---------------------|--------------|
| (Amounts in thousands)      | <b>Pump</b>      | <b>Control</b> | <b>Solutions</b> | <b>Segments</b>                | <b>All Other</b>    | <b>Total</b> |
| Sales to external customers | \$ 1,113,178     | \$ 726,075     | \$ 334,250       | \$ 2,173,503                   | \$ 3,970            | \$ 2,177,473 |
| Intersegment sales          | 3,102            | 1,944          | 31,828           | 36,874                         | (36,874)            |              |
| Segment operating income    | 114,174          | 89,647         | 76,336           | 280,157                        | (103,803)           | 176,354      |

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

The following discussion and analysis of our consolidated financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements, and notes thereto, and the other financial data included elsewhere in this Quarterly Report. The following discussion should also be read in conjunction with our audited consolidated financial statements, and notes thereto, and Management's Discussion and Analysis of Financial Condition and Results of Operations included in our 2006 Annual Report.

**EXECUTIVE OVERVIEW**

We are an established leader in the fluid motion and control business, with a strong portfolio of pumping systems, valves, sealing solutions, automation and services in support of the oil and gas, chemical, power generation, water treatment and general industrial markets. These products are integral to the movement, control and protection of fluids in customers' critical processes, whether it is a refinery, a power generation facility or a transportation pipeline. Our business model is heavily influenced by the capital spending of these industries for the placement of new products into service and for maintenance on existing facilities. The worldwide installed base of our products is another important source of revenue, where products are expected to ensure the maximum operating time of many key industrial processes. The aftermarket business includes parts, service solutions, product life cycle solutions and other value added services, and is generally a higher margin business and a key component to our profitable growth.

We experienced favorable conditions in 2006 in several of our core markets, specifically oil and gas, which has continued through the first nine months of 2007. The sustained increase in the price of crude oil and natural gas, in particular, has spurred capital investment by oil and gas companies, resulting in many new projects and expansion opportunities for us. Favorable market conditions have resulted in corresponding growth, much of which is in non-traditional areas of the world where new oil and gas reserves have been discovered. We believe the outlook for our business remains favorable; however, we believe that oil and gas prices will fluctuate in the future and such volatility could have a negative impact on our business in some or all of the geographical areas in which we conduct business. We and our customers are seeing rapid growth in the Middle East and Asia, with China providing a significant source of project growth as that country continues to develop. We continue to execute on our strategy to increase our presence in these regions to capture aftermarket business through our current installed base, as well as new projects and process plant expansions. The opportunity to increase our installed base of new products and drive recurring aftermarket business in future years is a critical by-product of these favorable market conditions. Although we have experienced strong demand for our products and services in recent periods, we face challenges affecting many companies in our industry and/or with significant international operations.

We currently employ approximately 14,000 employees in more than 55 countries who are focused on six key strategies that reach across the business. See Our Strategies section of Management's Discussion and Analysis of Financial Condition and Results of Operations in our 2006 Annual Report for a discussion of our six key strategies.

We continue to build on our geographic breadth with the implementation of additional Quick Response Centers ( QRCs ) with the goal to be positioned as near to our customers as practicable for service and support in order to capture this important aftermarket business. Along with ensuring that we have the local capability to sell, install and service our equipment in remote regions, it becomes equally imperative to continuously improve our global operations. Our global supply chain capability is being expanded to meet global customer demands and ensure the quality and timely delivery of our products. Significant efforts are underway to reduce the supply base and drive processes across the divisions to find areas of synergy and cost reduction. In addition, we are improving our supply chain management capability to ensure it can meet global customer demands. We continue to focus on improving on-time delivery and quality, while reducing warranty costs across our global operations through a focused Continuous Improvement Process ( CIP ) initiative. The goal of the CIP initiative is to maximize service fulfillment to customers such as on-time delivery, reduced cycle time and quality at the highest internal productivity. This program is a key factor in our margin expansion plans.

**RESULTS OF OPERATIONS Three and Nine months ended September 30, 2007 and 2006****Consolidated Results****Bookings, Sales and Backlog**

| (Amounts in millions) | Three Months Ended September 30, |          |
|-----------------------|----------------------------------|----------|
|                       | 2007                             | 2006     |
| Bookings              | \$ 1,061.0                       | \$ 892.0 |
| Sales                 | 919.2                            | 770.8    |

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| (Amounts in millions) | <b>Nine Months Ended September 30,</b> |             |
|-----------------------|--|-------------|
|                       | <b>2007</b>                            | <b>2006</b> |
| Bookings              | \$ 3,203.1                             | \$ 2,682.6  |
| Sales                 | 2,653.3                                | 2,177.5     |

We define a booking as the receipt of a customer order that contractually engages us to perform activities on behalf of our customer with regard to manufacture, service or support. Bookings for the three months ended September 30, 2007 increased by \$169.0 million, or 18.9%, as compared with the same period in 2006. The increase includes currency benefits of approximately \$47 million. The increase is led by strength in chemical and water markets in Europe, the Middle East and Africa ( EMA ) for FPD and strength across all key valve markets for FCD. Strength in oil and gas and general industries markets continues to drive improved bookings in FSD. Original equipment bookings accounted for approximately three-quarters of the increase, and is attributable to both FPD and FCD.

Bookings for the nine months ended September 30, 2007 increased by \$520.5 million, or 19.4%, as compared with the same period in 2006. The increase includes currency benefits of approximately \$136 million. The increase is primarily attributable to continued strength in oil and gas, water, chemical and power markets in EMA, North America and Latin America for FPD and strength in the control valve markets for FCD. FSD is experiencing strong growth in both aftermarket and project bookings across all regions, which is attributable to chemical, general industries and oil and gas markets. Original equipment bookings accounted for approximately three-quarters of the increase, and is attributable to both FPD and FCD.

Sales for the three months ended September 30, 2007 increased by \$148.4 million, or 19.3%, as compared with the same period in 2006. The increase includes currency benefits of approximately \$40 million. The increase is primarily attributable to continued strength in the oil and gas markets, which has positively impacted both original equipment and aftermarket sales in North America and EMA for FPD, as well as original equipment sales in North America for FCD.

Sales for the nine months ended September 30, 2007 increased by \$475.8 million, or 21.9%, as compared with the same period in 2006. The increase includes currency benefits of approximately \$108 million. The increase is primarily attributable to continued strength in the oil and gas markets, which has positively impacted both original equipment and aftermarket sales in North America and EMA for FPD. Additionally, FCD is experiencing strong project sales across all markets.

Net sales to international customers, including export sales from the U.S., were approximately 66% and 65% of consolidated sales for the three and nine months ended September 30, 2007, respectively, which is comparable with the same periods in 2006.

Backlog represents the value of aggregate uncompleted customer orders. Backlog of \$2.3 billion at September 30, 2007 increased by \$639.0 million, or 39.2%, as compared with December 31, 2006. Currency effects provided an increase of approximately \$113 million. The increase resulted primarily from increased bookings during the nine months ended September 30, 2007, as discussed above. The increase in total backlog also reflects an increase in orders for large engineered products, which naturally have longer lead times, as well as expanded lead times at the request of certain customers.

**Gross Profit and Gross Profit Margin**

| (Amounts in millions) | <b>Three Months Ended September 30,</b> |             |
|-----------------------|---|-------------|
|                       | <b>2007</b>                             | <b>2006</b> |
| Gross profit          | \$ 313.6                                | \$ 249.8    |
| Gross profit margin   | 34.1%                                   | 32.4%       |

| (Amounts in millions) | <b>Nine Months Ended September 30,</b> |             |
|-----------------------|--|-------------|
|                       | <b>2007</b>                            | <b>2006</b> |
| Gross profit          | \$ 881.5                               | \$ 720.4    |



|                     |       |       |
|---------------------|-------|-------|
| Gross profit margin | 33.2% | 33.1% |
|---------------------|-------|-------|

Gross profit for the three months ended September 30, 2007 increased by \$63.8 million, or 25.5%, as compared with the same period in 2006. Gross profit margin for the three months ended September 30, 2007 of 34.1% increased from 32.4% for the same period in 2006. The increase in gross profit margin is primarily attributable to the rate of growth in aftermarket sales exceeding the rate of growth in original equipment sales, especially in FPD. As a result, aftermarket sales increased to 37% of total sales as compared with 36% of total sales for the same period in 2006. The aftermarket business consistently provides more favorable gross margins than original equipment sales. Gross profit margin was also positively impacted by higher sales, which favorably impacts absorption of fixed manufacturing costs, the successful implementation of various CIP and supply chain management initiatives by FCD. Our CIP initiative is driving increased throughput on existing capacity, reduced cycle time, lean manufacturing and reduced warranty costs. Our supply chain initiative is focused on materials cost savings through low cost supply sources, long-term supply agreements and product outsourcing.

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Gross profit for the nine months ended September 30, 2007 increased by \$161.1 million, or 22.4%, as compared with the same period in 2006. Gross profit margin for the nine months ended September 30, 2007 of 33.2% was comparable to the same period in 2006. Gross profit margin was positively impacted by higher sales, which favorably impacts our absorption of fixed manufacturing costs, and the successful implementation of various CIP and supply chain management initiatives by FCD. These improvements are offset by the rate of growth in original equipment sales exceeding the rate of growth in aftermarket sales, especially in FPD. As a result, original equipment sales increased to 63% of total sales as compared with 61% of total sales for the same period in 2006. Additionally, the growth in FPD, which has a lower gross profit margin on a higher base of sales than our other divisions, impacted overall gross profit margin.

**Selling, General and Administrative Expense ( SG&A )**

| (Amounts in millions)                 | <b>Three Months Ended September 30,</b> |             |
|---------------------------------------|---|-------------|
|                                       | <b>2007</b>                             | <b>2006</b> |
| SG&A expense                          | \$ 210.1                                | \$ 191.3    |
| SG&A expense as a percentage of sales | 22.9%                                   | 24.8%       |

| (Amounts in millions)                 | <b>Nine Months Ended September 30,</b> |             |
|---------------------------------------|--|-------------|
|                                       | <b>2007</b>                            | <b>2006</b> |
| SG&A expense                          | \$ 623.3                               | \$ 555.2    |
| SG&A expense as a percentage of sales | 23.5%                                  | 25.5%       |

SG&A for the three months ended September 30, 2007 increased by \$18.8 million, or 9.8%, as compared with the same period in 2006. Currency effects resulted in an increase of approximately \$6 million. The increase in SG&A is primarily attributable to an increase in employee-related costs of \$9.2 million due to continued investment in sales and engineering personnel and other in-house capabilities to drive long-term growth, as well as annual merit increases and equity compensation arising from improved performance and a higher stock price. A decrease of \$3.0 million in audit fees was more than offset by an increase in other professional fees, including approximately \$8 million in legal fees and accrued resolution costs to governmental authorities related to our foreign subsidiaries involvement with the United Nations Oil-for-Food Program, and fees related to research and development ( R&D ) and information technology infrastructure. SG&A as a percentage of sales for the three months ended September 30, 2007 improved 190 basis points as compared with the same period in 2006. The decrease is attributable to leverage from higher sales, as well as ongoing efforts to contain costs.

SG&A for the nine months ended September 30, 2007 increased by \$68.1 million, or 12.3%, as compared with the same period in 2006. Currency effects resulted in an increase of approximately \$18 million. The increase in SG&A is primarily attributable to an increase in employee-related costs of \$35.8 million due to continued investment in sales and engineering personnel and other in-house capabilities to drive long-term growth, as well as annual merit increases and equity compensation arising from improved performance and a higher stock price. Third party commissions increased \$4.7 million, in support of increased bookings and sales. A decrease of \$11.5 million in audit fees was more than offset by an increase in other professional fees, including approximately \$11 million in legal fees and accrued resolution costs to governmental authorities related to our foreign subsidiaries involvement with the United Nations Oil-for-Food Program, and fees related to R&D and information technology infrastructure. SG&A as a percentage of sales for the nine months ended September 30, 2007 improved 200 basis points as compared with the same period in 2006. The decrease is attributable to leverage from higher sales, as well as ongoing efforts to contain costs.

**Net Earnings from Affiliates**

| (Amounts in millions)        | <b>Three Months Ended September 30,</b> |             |
|------------------------------|---|-------------|
|                              | <b>2007</b>                             | <b>2006</b> |
| Net earnings from affiliates | \$ 4.8                                  | \$ 3.3      |

| (Amounts in millions)        | Nine Months Ended September 30, |         |
|------------------------------|---------------------------------|---------|
|                              | 2007                            | 2006    |
| Net earnings from affiliates | \$ 14.3                         | \$ 11.1 |

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Net earnings from affiliates represents our joint venture interests in Asia and the Middle East. Net earnings from affiliates for the three months ended September 30, 2007 increased by \$1.5 million as compared with the same period in 2006. The improvement in earnings is primarily attributable to an FCD joint venture in India and an FPD joint venture in Japan.

Net earnings from affiliates for the nine months ended September 30, 2007 increased by \$3.2 million as compared with the same period in 2006. The improvement in earnings is primarily attributable to an FCD joint venture in India and FPD joint ventures in Japan and the United Arab Emirates.

**Operating Income and Operating Margin**

|                       | <b>Three Months Ended September<br/>30,</b> |             |
|-----------------------|---|-------------|
|                       | <b>2007</b>                                 | <b>2006</b> |
| (Amounts in millions) |   |             |
| Operating income      | \$ 108.2                                    | \$ 61.9     |
| Operating margin      | 11.8%                                       | 8.0%        |

|                       | <b>Nine Months Ended September 30,</b> |             |
|-----------------------|--|-------------|
|                       | <b>2007</b>                            | <b>2006</b> |
| (Amounts in millions) |  |             |
| Operating income      | \$ 272.6                               | \$ 176.4    |
| Operating margin      | 10.3%                                  | 8.1%        |

Operating income for the three months ended September 30, 2007 increased by \$46.3 million, or 74.8%, as compared with the same period in 2006. The increase includes currency benefits of approximately \$8 million. The increase is primarily a result of the \$63.8 million increase in gross profit, partially offset by the \$18.8 million increase in SG&A, as discussed above. Operating margin increased 380 basis points, due primarily to the increase in gross profit margin and the decrease in SG&A as a percentage of sales, as discussed above.

Operating income for the nine months ended September 30, 2007 increased by \$96.2 million, or 54.5%, as compared with the same period in 2006. The increase includes currency benefits of approximately \$18 million. The increase is primarily a result of the \$161.1 million increase in gross profit, partially offset by the \$68.1 million increase in SG&A, as discussed above. Operating margin increased 220 basis points, due primarily to the decrease in SG&A as a percentage of sales, as discussed above.

**Interest Expense and Interest Income**

|                       | <b>Three Months Ended September<br/>30,</b> |             |
|-----------------------|---|-------------|
|                       | <b>2007</b>                                 | <b>2006</b> |
| (Amounts in millions) |   |             |
| Interest expense      | \$ (15.3)                                   | \$ (16.4)   |
| Interest income       | 0.9   | 1.6         |

|                       | <b>Nine Months Ended September 30,</b> |             |
|-----------------------|--|-------------|
|                       | <b>2007</b>                            | <b>2006</b> |
| (Amounts in millions) |  |             |
| Interest expense      | \$ (45.2)                              | \$ (48.3)   |
| Interest income       | 2.5                                    | 3.8         |

Interest expense for the three months ended September 30, 2007 decreased by \$1.1 million, as compared with the same period in 2006. The decrease is primarily attributable to lower average outstanding debt, as well as a lower average interest rate in 2007.

Interest expense for the nine months ended September 30, 2007 decreased by \$3.1 million, as compared with the same period in 2006. The decrease is attributable to lower average outstanding debt. Approximately 67% of our debt was at fixed rates at September 30, 2007, including the effects of \$415.0 million of notional interest rate swaps.

Interest income for the three and nine months ended September 30, 2007 decreased \$0.7 million and \$1.3 million, respectively, as compared with the same periods in 2006. The decrease is due primarily to a lower average cash

balance.

**Table of Contents****Tax Expense and Tax Rate**

| (Amounts in millions)    | <b>Three Months Ended September 30,</b> |             |
|--------------------------|---|-------------|
|                          | <b>2007</b>                             | <b>2006</b> |
| Provision for income tax | \$ 32.0                                 | \$ 16.8     |
| Effective tax rate       | 33.7%                                   | 37.1%       |

| (Amounts in millions)    | <b>Nine Months Ended September 30,</b> |             |
|--------------------------|--|-------------|
|                          | <b>2007</b>                            | <b>2006</b> |
| Provision for income tax | \$ 72.2                                | \$ 54.8     |
| Effective tax rate       | 31.1%                                  | 40.5%       |

Our effective tax rate of 33.7% for the three months ended September 30, 2007 decreased from 37.1% for the same period in 2006. Our effective tax rate of 31.1% for the nine months ended September 30, 2007 decreased from 40.5% for the same period in 2006. The decreases are primarily due to the net impact of foreign operations, changes in tax law, changes in valuation allowances and net favorable results from various tax audits.

**Other Comprehensive Income (Loss)**

| (Amounts in millions)             | <b>Three Months Ended September 30,</b> |             |
|-----------------------------------|---|-------------|
|                                   | <b>2007</b>                             | <b>2006</b> |
| Other comprehensive income (loss) | \$ 21.8                                 | \$ (3.4)    |

| (Amounts in millions)      | <b>Nine Months Ended September 30,</b> |             |
|----------------------------|--|-------------|
|                            | <b>2007</b>                            | <b>2006</b> |
| Other comprehensive income | \$ 42.3                                | \$ 21.9     |

Other comprehensive income for the three and nine months ended September 30, 2007 increased by \$25.2 million and \$20.4 million, respectively, as compared with the same periods in 2006. The weakening of the U.S. dollar exchange rate, primarily as compared to the Euro, during the three and nine months ended September 30, 2007 has been more significant as compared with the same periods in 2006, resulting in an increased impact of currency translation adjustments. The nine months ended September 30, 2007 also reflects a decline in interest rate hedging results as compared with the same period in 2006.

**Business Segments**

We conduct our business through three business segments that represent our major product types:

FPD for engineered pumps, industrial pumps and related services;

FCD for industrial valves, manual valves, control valves, nuclear valves, valve actuators and related services; and

FSD for precision mechanical seals and related services.

We evaluate segment performance and allocate resources based on each segment's operating income. See Note 13 to our condensed consolidated financial statements included in this Quarterly Report for further discussion of our segments. The key operating results for our three business segments, FPD, FCD and FSD are discussed below.

**Flowserve Pump Division**

Through FPD, we design, manufacture and distribute highly engineered pumps, industrial pumps and pump systems (collectively referred to as "original equipment"). FPD also manufactures replacement parts and related equipment, and provides a full array of support services (collectively referred to as "aftermarket"). FPD has 27 manufacturing facilities worldwide, of which nine are located in North America, 11 in Europe, five in South America and two in Asia. FPD also has more than 60 service centers, including those located in a manufacturing facility. We believe that we are the

largest pump manufacturer serving the oil and gas, chemical and power generation industries, and the third largest pump manufacturer overall.

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| (Amounts in millions) | <b>Three Months Ended September 30,</b> |             |
|-----------------------|---|-------------|
|                       | <b>2007</b>                             | <b>2006</b> |
| Bookings              | \$ 594.9                                | \$ 521.0    |
| Sales                 | 496.4                                   | 401.3       |
| Gross profit          | 147.9                                   | 108.5       |
| Gross profit margin   | 29.8%                                   | 27.0%       |
| Operating income      | 68.9                                    | 39.7        |
| Operating margin      | 13.9%                                   | 9.9%        |

| (Amounts in millions) | <b>Nine Months Ended September 30,</b> |             |
|-----------------------|--|-------------|
|                       | <b>2007</b>                            | <b>2006</b> |
| Bookings              | \$ 1,869.3                             | \$ 1,546.2  |
| Sales                 | 1,440.3                                | 1,116.3     |
| Gross profit          | 408.9                                  | 312.8       |
| Gross profit margin   | 28.4%                                  | 28.0%       |
| Operating income      | 175.9                                  | 114.2       |
| Operating margin      | 12.2%                                  | 10.2%       |

Bookings for the three months ended September 30, 2007 increased by \$73.9 million, or 14.2%, as compared with the same period in 2006. The increase includes currency benefits of approximately \$29 million. The increase is attributable to EMA, which increased \$72.0 million (including currency benefits of approximately \$22 million). Both original equipment and aftermarket bookings continue to be strong, increasing 20% and 8%, respectively, as compared with the same period in 2006. Increased bookings were led by strength in chemical, water and general industry markets.

Bookings for the nine months ended September 30, 2007 increased by \$323.1 million, or 20.9%, as compared with the same period in 2006. The increase includes currency benefits of approximately \$86 million. The increase is attributable to EMA and North America, which increased \$193.0 million (including currency benefits of approximately \$74 million), and \$101.7 million, respectively. Both original equipment and aftermarket bookings continue to be strong, increasing 25% and 16%, respectively, as compared with the same period in 2006. Increased bookings were led by continued strength in oil and gas, power and water markets.

Sales for the three months ended September 30, 2007 increased by \$95.1 million, or 23.7%, as compared with the same period in 2006. The increase includes currency benefits of approximately \$24 million. The increase is primarily attributable to EMA and North America, which increased \$49.0 million (including currency benefits of approximately \$18 million) and \$32.6 million, respectively. Both original equipment and aftermarket sales show continued strength, increasing 21% and 30%, respectively, as compared with the same period in 2006. The primary driver of this improvement has been the continued strength in the oil and gas industry.

Sales for the nine months ended September 30, 2007 increased by \$324.0 million, or 29.0%, as compared to the same period in 2006. The increase includes currency benefits of approximately \$64 million. The increase is primarily attributable to EMA and North America, which increased \$185.4 million (including currency benefits of approximately \$53 million) and \$108.1 million, respectively. Both original equipment and aftermarket sales show continued strength, increasing 38% and 19%, respectively, as compared with the same period in 2006. The increases in EMA and North America are due to strength in the oil and gas industry.

Gross profit for the three months ended September 30, 2007 increased by \$39.4 million, or 36.3%, as compared with the same period in 2006. Gross profit margin for the three months ended September 30, 2007 of 29.8% increased from 27.0% for the same period in 2006. While both original equipment and aftermarket sales increased, aftermarket sales growth exceeded the growth in original equipment for the period. As a result, aftermarket sales increased to 42% of total sales as compared with 40% of total sales for the same period in 2006. The sales mix was also favorably impacted by the timing of certain large original equipment projects, which shipped in early October. The aftermarket



business consistently provides more favorable gross margins than original equipment sales.

Gross profit for the nine months ended September 30, 2007 increased by \$96.1 million, or 30.7%, as compared with the same period in 2006. Gross profit margin for the nine months ended September 30, 2007 of 28.4% increased from 28.0% for the same period in 2006. While both original equipment and aftermarket sales increased, year-to-date original equipment sales growth continues to exceed the growth in aftermarket for the period. As a result, original equipment sales increased to 59% of total sales as compared with 56% of total sales for the same period in 2006. The aftermarket business consistently provides more favorable gross margins than original equipment sales. This impact is partially offset by increased sales, which favorably increases our absorption of fixed manufacturing costs, and implantation of various CIP and supply chain initiatives.

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Operating income for the three months ended September 30, 2007 increased by \$29.2 million, or 73.6%, as compared with the same period in 2006. The increase includes currency benefits of approximately \$4 million. The increase was due primarily to increased gross profit of \$39.4 million, partially offset by a \$10.8 million increase in SG&A. The increase in SG&A is primarily attributable to \$4.9 million in higher selling costs, driven by an increase in sales and engineering personnel to support the global growth of our business and increased commissions resulting from increased sales levels, \$0.8 million in additional R&D spending and improvements to our enterprise resource planning systems. SG&A as a percentage of sales for the three months ended September 30, 2007 improved 120 basis points as compared with the same period in 2006. The improvement in SG&A is attributable to leverage from higher sales, as well as ongoing efforts to contain costs.

Operating income for the nine months ended September 30, 2007 increased by \$61.7 million, or 54.0%, as compared with the same period in 2006. The increase includes currency benefits of approximately \$9 million. The increase was due primarily to increased gross profit of \$96.1 million, partially offset by a \$36.5 million increase in SG&A. The increase in SG&A is primarily attributable to \$17.0 million in higher selling costs, driven by an increase in sales and engineering personnel to support the global growth of our business and increased commissions resulting from increased sales levels, \$2.5 million in additional R&D spending and improvements to our enterprise resource planning systems. SG&A as a percentage of sales for the nine months ended September 30, 2007 improved 150 basis points as compared with the same period in 2006. The improvement in SG&A is attributable to leverage from higher sales, as well as ongoing efforts to contain costs.

Backlog of \$1.8 billion at September 30, 2007 increased by \$493.9 million, or 39.1%, as compared with December 31, 2006. Currency effects provided an increase of approximately \$92 million. Backlog growth is primarily a result of the growth in bookings. The increase in backlog reflects an increase in orders of engineered products, which naturally have longer lead times, as well as expanded lead times at the request of certain customers.

**Flow Control Division**

Our second largest business segment is FCD, which designs, manufactures and distributes a broad portfolio of valve products, actuators and controls serving the oil and gas, power, chemical, mining and general industries. FCD leverages its experience and application know-how by offering a complete menu of engineered services to complement its expansive product portfolio. FCD has manufacturing and service facilities in 19 countries around the world, with only five of its 20 manufacturing operations located in the U.S. Based on independent industry sources, we believe that we are the third largest industrial valve supplier on a global basis.

| (Amounts in millions) | <b>Three Months Ended September<br/>30,</b> |             |
|-----------------------|---|-------------|
|                       | <b>2007</b>                                 | <b>2006</b> |
| Bookings              | \$ 324.0                                    | \$ 264.3    |
| Sales                 | 295.0                                       | 257.9       |
| Gross profit          | 101.1                                       | 88.2        |
| Gross profit margin   | 34.3%                                       | 34.2%       |
| Operating income      | 41.1  | 34.7        |
| Operating margin      | 13.9%                                       | 13.5%       |

| (Amounts in millions) | <b>Nine Months Ended September 30,</b> |             |
|-----------------------|--|-------------|
|                       | <b>2007</b>                            | <b>2006</b> |
| Bookings              | \$ 948.1                               | \$ 805.9    |
| Sales                 | 848.7                                  | 728.0       |
| Gross profit          | 295.6                                  | 249.9       |
| Gross profit margin   | 34.8%                                  | 34.3%       |
| Operating income      | 118.6                                  | 89.6        |
| Operating margin      | 14.0%                                  | 12.3%       |

Bookings for the three months ended September 30, 2007 increased by \$59.7 million, or 22.6%, as compared with the same period in 2006. This increase includes currency benefits of approximately \$13 million. The growth in bookings is primarily attributable to the sustained strength across our key end markets. Increased project activity in the global oil and gas market, coupled with continued strength in the chemical industry, particularly in North America and Asia, contributed to growth in control valve bookings. Bookings improvement in the process valve market resulted from strength in the Chinese coal gasification and gas purification industries. Increased parts and services business for the North American nuclear and fossil fuel maintenance repair operations ( MRO ) business contributed to improved power valve bookings.

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Bookings for the nine months ended September 30, 2007 increased by \$142.2 million, or 17.6%, as compared with the same period in 2006. The increase includes currency benefits of approximately \$39 million. The increase in bookings is primarily attributable to the control valve market, which realized continued growth in project business activity, most notably in the oil and gas markets across North America and the Middle East. Strength in the North American and Asian chemical markets contributed to growth in both control and process valve bookings. Strength in the aftermarket parts and services business drove improved bookings in the nuclear and fossil fuel power generation markets. Growth in China has contributed to bookings improvement across all aspects of our valve portfolio, most notably in the chemical and coal gasification industries.

Sales for the three months ended September 30, 2007 increased by \$37.1 million, or 14.4%, as compared with the same period in 2006. The increase includes currency benefits of approximately \$12 million. The growth in sales is principally the result of strong North American project sales, specifically in the oil and gas markets. Notable improvements were realized in the Chinese chemical industry, as well as increased strength in the steam systems market across Europe. Sales of process valves increased due to the shipment of several large chemical orders in China. Sales for the nine months ended September 30, 2007 increased by \$120.7 million, or 16.6%, as compared with the same period in 2006. The increase includes currency benefits of approximately \$34 million. The increase is primarily attributable to the continued strength in both project and MRO business across all of our key end markets. Sales of control valves increased due to notable improvements in the Australian mining and Asian pulp and paper markets, and as a result of continued strength in the North American and Middle Eastern oil and gas markets. Fulfillment of significant Russian district heating orders placed in the later half of 2006 continues to contribute to the growth in power valve sales. As a result of an increase in MRO orders, which typically have a shorter lead time, we experienced an improved book-to-ship ratio, particularly in the North American power generation market. Our ability to implement modest price increases in the first quarter of 2007 has enabled us to mitigate the impact of increased metals and other supply chain costs.

Gross profit for the three months ended September 30, 2007 increased by \$12.9 million, or 14.6%, as compared with the same period in 2006, due primarily to higher sales levels. Gross profit margin for the three months ended September 30, 2007 of 34.3% was comparable to the same period in 2006. The improvement in gross profit margin resulting from the improvement in sales, which favorably impacts our leverage of fixed manufacturing costs, was mostly offset by a stronger concentration of project mix in our sales for the quarter.

Gross profit for the nine months ended September 30, 2007 increased by \$45.7 million, or 18.3%, as compared with the same period in 2006. Gross profit margin for the nine months ended September 30, 2007 of 34.8% increased from 34.3% for the same period in 2006. This increase reflects the aforementioned higher sales levels and implementation of various CIP and supply chain initiatives, as well as an increase in higher margin aftermarket MRO business.

Operating income for the three months ended September 30, 2007 increased by \$6.4 million, or 18.4%, as compared with the same period in 2006. The increase includes currency benefits of approximately \$2 million. The increase is principally attributable to the \$12.9 million improvement in gross profit and an increase of \$0.6 million in equity income generated by our joint venture in India. These increases were offset in part by higher SG&A costs, which increased \$7.1 million as compared with the same period in 2006. Currency effects yielded an increase in SG&A of approximately \$2 million. Increased SG&A costs were principally attributable to \$3.8 million in higher selling costs, driven primarily by increased third party commissions resulting from increased sales and bookings levels, and \$1.3 million in additional research and development ( R&D ) spending as compared with the same period in 2006.

Operating income for the nine months ended September 30, 2007 increased by \$29.0 million, or 32.4%, as compared with the same period in 2006. The increase includes currency benefits of approximately \$6 million. The increase is principally attributable to the aforementioned \$45.7 million improvement in gross profit and an increase of \$1.2 million in equity income generated by our joint venture in India. These increases were partially offset by \$17.9 million of higher SG&A costs. Currency effects yielded an increase in SG&A of approximately \$7 million. The increase in SG&A is primarily attributable to \$10.7 million of increased selling costs, primarily related to increased salary cost and higher external commission expense resulting from increased sales and bookings levels and \$3.5 million of increased R&D spending. Partially offsetting these increases was \$1.3 million of realignment costs recorded in the second quarter of 2006 that did not recur.

Backlog of \$430.6 million at September 30, 2007 increased by \$116.3 million, or 37.0%, as compared with December 31, 2006. Currency effects provided an increase of approximately \$17 million. The increase in backlog is primarily attributable to increased volume, an increase in the number of project orders and longer lead times in some of the more significant oil and gas projects.

**Table of Contents****Flow Solutions Division**

Through FSD, we engineer, manufacture and sell mechanical seals, auxiliary systems and parts, and provide related services, principally to process industries and general industrial markets, with similar products sold internally in support of FPD. FSD has added to its global operations and now has nine manufacturing locations, four of which are located in the U.S. FSD operates 66 QRCs worldwide, including 25 sites in North America, 16 in Europe, and the remainder in South America and Asia. Our ability to rapidly deliver mechanical sealing technology through our global engineering systems, our on-site engineers and our extensive network of QRCs represents a significant competitive advantage. This business model has enabled FSD to establish a large number of alliances with multi-national customers. Based on independent industry sources, we believe that we are the second largest mechanical seal supplier in the world.

| (Amounts in millions) | <b>Three Months Ended September 30,</b> |             |
|-----------------------|---|-------------|
|                       | <b>2007</b>                             | <b>2006</b> |
| Bookings              | \$ 159.4                                | \$ 125.6    |
| Sales                 | 140.7                                   | 122.9       |
| Gross profit          | 64.5                                    | 55.8        |
| Gross profit margin   | 45.8%                                   | 45.4%       |
| Operating income      | 30.4                                    | 25.6        |
| Operating margin      | 21.6%                                   | 20.8%       |

| (Amounts in millions) | <b>Nine Months Ended September 30,</b> |             |
|-----------------------|--|-------------|
|                       | <b>2007</b>                            | <b>2006</b> |
| Bookings              | \$ 438.4                               | \$ 376.2    |
| Sales                 | 404.4                                  | 366.1       |
| Gross profit          | 182.9                                  | 164.1       |
| Gross profit margin   | 45.2%                                  | 44.8%       |
| Operating income      | 81.4                                   | 76.3        |
| Operating margin      | 20.1%                                  | 20.9%       |

Bookings for the three months ended September 30, 2007 increased by \$33.8 million, or 26.9%, as compared with the same period in 2006. This increase includes currency benefits of approximately \$5 million. The increase is due primarily to a \$32.7 million increase in customer bookings, including increases of \$14.7 million and \$18.0 million in project and aftermarket bookings, respectively. Growth in project bookings occurred primarily in North America, with smaller increases in Latin America and Asia. Our strongest rates of growth occurred in Latin America and Asia. Growth in aftermarket bookings occurred primarily in EMA and Asia. Success in the end user markets continues to be a strength.

Bookings for the nine months ended September 30, 2007 increased by \$62.2 million, or 16.5%, as compared with the same period in 2006. This increase includes currency benefits of approximately \$12 million. The increase is due primarily to a \$55.4 million increase in customer bookings, including increases of \$31.0 million and \$24.4 million in project and aftermarket bookings, respectively. All regions have exhibited growth in project type customer bookings, with the strongest rates of growth occurring in Latin America's oil and gas market and Asia's oil and gas and mining markets. Increases in aftermarket customer bookings have occurred primarily in EMA and Asia.

Sales for the three months ended September 30, 2007 increased by \$17.8 million, or 14.5%, as compared with the same period in 2006. This increase includes currency benefits of approximately \$4 million. The increase is primarily attributable to increased customer project sales in North America. Our strongest rates of growth occurred in Latin America and Asia. In addition, expanded QRC capacity in EMA has enabled us to provide rapid turnarounds to our customers, significantly increasing our aftermarket sales in EMA.

Sales for the nine months ended September 30, 2007 increased by \$38.3 million, or 10.5%, as compared with the same period in 2006. This increase includes currency benefits of approximately \$11 million. The increase is primarily

attributable to increased aftermarket customer sales in EMA. Increased customer project sales in North America and increases in both project and aftermarket customer sales in Latin America and Asia also contributed.

Gross profit for the three months ended September 30, 2007 increased by \$8.7 million, or 15.6%, as compared with the same period in 2006. Gross profit margin for the three months ended September 30, 2007 of 45.8% increased from 45.4% for the same period in 2006. Gross profit for the nine months ended September 30, 2007 increased by \$18.8 million, or 11.5%, as compared with the same period in 2006. Gross profit margin for the nine months ended September 30, 2007 of 45.2% increased from 44.8% for the same period in 2006. The improvements are due to a product shift towards the higher margin aftermarket business in EMA, which combined with a price increase earlier in 2007 and improved absorption of fixed manufacturing costs resulting from higher sales, has offset downward margin pressures related to materials costs and a shift in North American sales towards lower margin project business.

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Operating income for the three months ended September 30, 2007 increased by \$4.8 million, or 18.8%, as compared with the same period in 2006. This increase includes currency benefits of approximately \$1 million. Operating income for the nine months ended September 30, 2007 increased by \$5.1 million, or 6.7%, as compared with the same period in 2006. This increase includes currency benefits of approximately \$3 million. The increase in gross profit discussed above was partially offset by increases in SG&A expenses as compared with the same periods in 2006. The increase in SG&A is attributable to an increase in sales and engineering personnel and related expenses to support the global growth of our business; improvements to our infrastructure, including increased capacity and enterprise resource planning system upgrades; and an increase in legal fees and expenses.

Backlog of \$111.1 million at September 30, 2007 increased by \$36.7 million, or 49.3%, as compared with December 31, 2006. Currency effects provided an increase of approximately \$5 million. Backlog at September 30, 2007 and December 31, 2006 includes \$22.6 million and \$14.7 million, respectively, of interdivision backlog (which is eliminated and not included in consolidated backlog). Backlog growth is primarily a result of growth in project bookings with significantly longer lead times.

**LIQUIDITY AND CAPITAL RESOURCES*****Cash Flow Analysis***

| (Amounts in millions)                                  | Nine Months Ended September 30, |         |
|--|---------------------------------|---------|
|  | 2007                            | 2006    |
| Net cash flows provided by operating activities        | \$ 45.1                         | \$ 14.4 |
| Net cash flows used by investing activities            | (57.3)                          | (43.6)  |
| Net cash flows provided (used) by financing activities | 11.6                            | (15.7)  |

Cash generated by operations and borrowings available under our existing revolving credit facility are our primary sources of short-term liquidity. Our cash balance at September 30, 2007 was \$71.1 million, as compared with \$67.0 million at December 31, 2006.

The cash flows provided by operating activities for the first nine months of 2007 primarily reflect a \$78.4 million increase in net income, offset by a \$45.0 million decrease in cash flows from working capital, particularly due to higher inventory of \$147.7 million, especially project-related inventory required to support future shipments of products in backlog, and higher accounts receivable of \$119.0 million resulting primarily from increased sales. Partially offsetting this growth is an increase in accrued liabilities of \$152.9 million due primarily to advanced cash received from our customers to support our increased investment in inventory. We also contributed \$15.6 million to our U.S. pension plans during September 2007, as compared with \$35.7 million in September 2006.

Our goal for days sales receivables outstanding ( DSO ) is 60 days. As of September 30, 2007, we achieved a DSO of 69 days as compared with 60 days as of September 30, 2006. For reference purposes based on 2007 sales, an improvement of one day could provide approximately \$10 million in cash flow. Increases in inventory used \$147.7 million of cash flow for the nine months ended September 30, 2007 compared with \$101.1 million for the same period in 2006. Inventory turns were 3.3 times as of September 30, 2007, compared with 3.9 times as of September 30, 2006, reflecting the increase in inventory, partially offset by the increase in sales. Our calculation of inventory turns does not reflect the impact of advanced cash received from our customers. For reference purposes based on 2007 data, an improvement of one turn could yield approximately \$169 million in cash flow.

Cash flows used by investing activities during the nine months ended September 30, 2007 were \$57.3 million, as compared with \$43.6 million for the same period in 2006. Capital expenditures during the nine months ended September 30, 2007 were \$60.9 million, an increase of \$17.4 million as compared with the same period in 2006, which reflects increased spending to support capacity expansion, enterprise resource planning application upgrades and information technology infrastructure.

Cash flows provided by financing activities during the nine months ended September 30, 2007 were \$11.6 million, as compared with a use of \$15.7 million for the same period in 2006. Cash inflows in 2007 were due primarily to \$58.0 million in borrowings under our revolving line of credit. The borrowings were used primarily to fund increased working capital needs, share repurchases and increased capital spending. Cash outflows in 2007 include repurchase of common shares for \$44.8 million and the payment of dividends of \$17.2 million. Cash outflows in 2006 were due to



net payments on long-term debt, including \$10.9 million of mandatory repayments using the proceeds from the sale of GSG, as discussed in Note 2 to our condensed consolidated financial statements included in this Quarterly Report.

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We believe cash flows from operating activities combined with availability under our existing revolving credit agreement and our existing cash balance will be sufficient to enable us to meet our cash flow needs for the next 12 months. Cash flows from operations could be adversely affected by economic, political and other risks associated with sales of our products, operational factors, competition, fluctuations in foreign exchange rates and fluctuations in interest rates, among other factors. See *Cautionary Note Regarding Forward-Looking Statements* below.

On September 29, 2006, the Board of Directors authorized a program to repurchase up to 2.0 million shares of our outstanding common stock by the end of second quarter of 2007. Shares were repurchased to offset potentially dilutive effects of stock options issued under our equity-based compensation programs. To date, we have repurchased a total of 2.0 million shares and have concluded the program.

On both April 11, 2007 and July 11, 2007, we paid quarterly cash dividends of \$0.15 per share to shareholders of record as of March 28, 2007 and June 27, 2007, respectively. On August 16, 2007, our Board of Directors authorized the payment of a quarterly cash dividend of \$0.15 per share, which was paid on October 10, 2007 to shareholders of record as of September 26, 2007. While we currently intend to pay regular quarterly dividends in the foreseeable future, any future dividends will be reviewed individually and declared by our Board of Directors at its discretion, dependent on its assessment of our financial condition and business outlook at the applicable time.

**Acquisitions and Dispositions**

We regularly evaluate acquisition opportunities of various sizes. The cost and terms of any financing to be raised in conjunction with any acquisition, including our ability to raise economical capital, is a critical consideration in any such evaluation.

As disclosed on July 5, 2007, we sold a small production facility in La Chaux-de-Fonds, Switzerland and two small non-core product lines. As disclosed on September 14, 2007, we sold certain product distribution assets of our small non-core instrumentation and positioner facility in Karlstad, Sweden. The divested operations are insignificant to our continuing operations. The completion of these sales transactions did not have a material impact on our results of operations for the third quarter of 2007.

**Capital Expenditures**

Capital expenditures were \$60.9 million for the nine months ended September 30, 2007 compared with \$43.5 million for the same period in 2006. Capital expenditures in 2007 and 2006 have focused on capacity expansion, enterprise resource planning application upgrades, information technology infrastructure and cost reduction opportunities. For the full year 2007, our capital expenditures are expected to be between approximately \$90 million and \$100 million. Certain of our facilities may face capacity constraints in the foreseeable future, which may lead to higher capital expenditure levels.

**Financing*****Credit Facilities***

On August 12, 2005, we entered into Credit Facilities comprised of a \$600.0 million term loan maturing on August 10, 2012 and a \$400.0 million revolving line of credit, which can be utilized to provide up to \$300.0 million in letters of credit, expiring on August 12, 2010. At September 30, 2007 and December 31, 2006, we had \$58.0 million and \$0, respectively, outstanding under the revolving line of credit. We had outstanding letters of credit of \$110.9 million and \$83.9 million at September 30, 2007 and December 31, 2006, respectively, which reduced borrowing capacity to \$231.1 million and \$316.1 million, respectively.

On August 6, 2007, we amended our Credit Facilities to, among other things, reduce the applicable margin applied to borrowings under the revolving line of credit, as well as extend the maturity date of the revolving line of credit, by two years to August 12, 2012. The amendment also eliminates all mandatory debt repayment requirements and the restriction on capital expenditures. The amendment further replaces the dollar limitation on acquisitions and certain restricted payments, with a limitation based on pro forma compliance with the required leverage ratio in both cases.

Borrowings under our Credit Facilities bear interest at a rate equal to, at our option, either (1) the base rate (which is based on the greater of the prime rate most recently announced by the administrative agent under our Credit Facilities or the Federal Funds rate plus 0.50%) or (2) LIBOR plus an applicable margin determined by reference to the ratio of our total debt to consolidated EBITDA, which as of September 30, 2007 was 1.00% and 1.50% for borrowings under our revolving line of credit and term loan, respectively.



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We may prepay loans under our Credit Facilities in whole or in part, without premium or penalty. During the three and nine months ended September 30, 2007, we made scheduled repayments of \$1.4 million under our Credit Facilities. We have a scheduled repayment of \$1.4 million due in the fourth quarter of 2007.

Our obligations under the Credit Facilities are unconditionally guaranteed, jointly and severally, by substantially all of our existing and subsequently acquired or organized domestic subsidiaries and 65% of the capital stock of certain foreign subsidiaries. In addition, prior to our obtaining and maintaining investment grade credit ratings, our and the guarantors' obligations under the Credit Facilities are collateralized by substantially all of our and the guarantors' assets.

Additional discussion of our Credit Facilities, including amounts outstanding and applicable interest rates, is included in Note 5 to our condensed consolidated financial statements, included in this Quarterly Report.

We have entered into interest rate and currency swap agreements to hedge our exposure to cash flows related to our Credit Facilities. These agreements are more fully described in Note 4 to our condensed consolidated financial statements, included in this Quarterly Report, and in Item 3. Quantitative and Qualitative Disclosures about Market Risk below.

***European Letter of Credit Facility***

On September 14, 2007, we entered into an unsecured European LOC to issue letters of credit in an aggregate face amount not to exceed 150.0 million at any time, with an initial commitment of 80.0 million. The aggregate commitment of the European LOC may be increased up to 150.0 million as may be agreed among the parties, and may be decreased by us at our option without any premium, fee or penalty. The European LOC will be used for contingent obligations solely in respect of surety and performance bonds, bank guarantees and similar obligations. We had outstanding letters of credit drawn on the European LOC of 25.3 million as of September 30, 2007. We will pay certain fees for the letters of credit written against the European LOC based upon the ratio of our total debt to consolidated EBITDA. As of September 30, 2007 the annual fees equaled 0.5% plus a fronting fee of 0.1%.

***Accounts Receivable Factoring***

Through our European subsidiaries, we engage in non-recourse factoring of certain accounts receivable. The various agreements have different terms, including options for renewal and mutual termination clauses. Our Credit Facilities, which are fully described in Note 11 to our consolidated financial statements, included in our 2006 Annual Report, limit factoring volume to \$75.0 million at any given point in time as defined by our Credit Facilities.

***Debt Covenants and Other Matters***

Our Credit Facilities contain leverage and interest coverage financial covenants. Under the leverage covenant, the maximum permitted leverage ratio stepped down in the fourth quarter of 2006. On August 7, 2007 our Credit Facilities were amended to, among other things, permit a maximum leverage ratio of 3.25 times debt to EBITDA with no further reductions. Under the interest coverage covenant, the minimum required interest coverage ratio stepped up in the fourth quarter of 2006, with a further step-up beginning in the fourth quarter of 2007. Compliance with these financial covenants under our Credit Facilities is tested quarterly.

Our Credit Facilities include events of default usual for these types of credit facilities, including nonpayment of principal or interest, violation of covenants, incorrectness of representations and warranties, cross defaults and cross acceleration, bankruptcy, material judgments, Employee Retirement Income Security Act of 1974, as amended ( ERISA ), events, actual or asserted invalidity of the guarantees or the security documents, and certain changes of control of our company. The occurrence of any event of default could result in the acceleration of our and the guarantors' obligations under the Credit Facilities. We complied with the covenants through September 30, 2007.

Our European LOC contains covenants restricting certain foreign subsidiaries ability to issue debt, incur liens, sell assets, merge, consolidate, make certain investments, pay dividends, enter into agreements with negative pledge clauses or engage in any business activity other than our existing business. The European LOC also incorporates by reference the covenants contained in our Credit Facilities.

Our European LOC includes events of default usual for these types of letter of credit facilities, including nonpayment of any fee or obligation, violation of covenants, incorrectness of representations and warranties, cross defaults and cross acceleration, bankruptcy, material judgments, ERISA events, actual or asserted invalidity of the guarantees and certain changes of control of our company. The occurrence of any event of default could result in the termination of

the commitments and an acceleration of our obligations under the European LOC. We complied with the covenants through September 30, 2007.

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**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Management's discussion and analysis of financial condition and results of operations are based on our condensed consolidated financial statements and related footnotes contained within this Quarterly Report. Our more critical accounting policies used in the preparation of the consolidated financial statements were discussed in our 2006 Annual Report. These critical policies, for which no significant changes have occurred in the three months ended September 30, 2007, include:

Revenue Recognition;

Deferred Taxes, Tax Valuation Allowances and Tax Reserves;

Reserves for Contingent Loss;

Retirement and Postretirement Benefits; and

Valuation of Goodwill, Indefinite-Lived Intangible Assets and Other Long-Lived Assets.

The process of preparing financial statements in conformity with GAAP requires the use of estimates and assumptions to determine certain of the assets, liabilities, revenues and expenses. These estimates and assumptions are based upon what we believe is the best information available at the time of the estimates or assumptions. The estimates and assumptions could change materially as conditions within and beyond our control change. Accordingly, actual results could differ materially from those estimates. The significant estimates are reviewed quarterly with the Audit Committee of our Board of Directors.

Based on an assessment of our accounting policies and the underlying judgments and uncertainties affecting the application of those policies, we believe that our condensed consolidated financial statements provide a meaningful and fair perspective of our consolidated financial condition and results of operations. This is not to suggest that other general risk factors, such as changes in worldwide demand, changes in material costs, performance of acquired businesses and others, could not adversely impact our consolidated financial condition, results of operations and cash flows in future periods. See "Cautionary Note Regarding Forward-Looking Statements" below.

**ACCOUNTING DEVELOPMENTS**

We have presented the information about accounting pronouncements not yet implemented in Note 1 to our condensed consolidated financial statements included in this Quarterly Report.

**Cautionary Note Regarding Forward-Looking Statements**

This Quarterly Report includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such statements include statements concerning future financial performance, future debt and financing levels, investment objectives, implications of litigation and regulatory investigations, and other plans and objectives of management for future operations or economic performance, or assumptions or forecasts related thereto. These statements are only predictions. We caution that forward-looking statements are not guarantees. Actual events or our results of operations could differ materially from those expressed or implied, but not limited to, in forward-looking statements. Forward-looking statements are typically identified by the use of terms such as, may, should, expect, could, in plan, anticipate, estimate, believe, continue, predict, potential or the negative of such terms and other terminology.

The forward-looking statements included in this Quarterly Report are based on our current expectations, plans, estimates, assumptions and beliefs that involve numerous risks and uncertainties. Assumptions relating to the foregoing involve judgments with respect to, among other things, future economi