
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, 2005

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

(State or other jurisdiction of
incorporation or organization)

31-0267900

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

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

(Address of principal executive offices)

75039

(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 July 24, 2006, there were 56,503,473 shares of the issuer's common stock outstanding.

FLOWSERVE CORPORATION
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EXPLANATORY NOTE

As a result of the significant delay in completing our Annual Report on Form 10-K for the year ended December 31, 2005 and the obligations regarding internal control certification under Section 404 of the Sarbanes-Oxley Act of 2002 ("Section 404"), we were unable to timely file with the Securities and Exchange Commission ("SEC"), this Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2005 ("Quarterly Report") and certain other period reports. We continue to work toward becoming current in our quarterly filings with the SEC as soon as practicable after the filing of this Quarterly Report.

PART I — FINANCIAL INFORMATION

Item 1. Financial Statements.

FLOWERVE CORPORATION (Unaudited)

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Amounts in thousands, except per share data)

	Three Months Ended September 30,	
	2005	2004
Sales	\$ 649,485	\$ 623,426
Cost of sales	438,269	433,975
Gross profit	211,216	189,451
Selling, general and administrative expense	156,405	146,271
Operating income	54,811	43,180
Interest expense	(18,972)	(21,025)
Interest income	1,335	667
Loss on early extinguishment of debt	(27,856)	(963)
Other income (expense), net	365	(4,016)
Earnings before income taxes	9,683	17,843
Provision for income taxes	4,500	10,573
Income from continuing operations	5,183	7,270
Discontinued operations, net of tax	(15,133)	(902)
Net (loss) earnings	\$ (9,950)	\$ 6,368
Earnings (loss) per share:		
Basic:		
Continuing operations	\$ 0.09	\$ 0.14
Discontinued operations	(0.27)	(0.02)
Net (loss) earnings	\$ (0.18)	\$ 0.12
Diluted:		
Continuing operations	\$ 0.08	\$ 0.13
Discontinued operations	(0.27)	(0.02)
Net (loss) earnings	\$ (0.19)	\$ 0.11

See accompanying notes to condensed consolidated financial statements.

FLOWERVE CORPORATION
(Unaudited)

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME

(Amounts in thousands)

	Three Months Ended September 30,	
	2005	2004
Net (loss) earnings	<u>\$ (9,950)</u>	<u>\$ 6,368</u>
Other comprehensive income (expense):		
Foreign currency translation adjustments, net of tax	<u>690</u>	<u>3,362</u>
Cash flow hedging activity, net of tax	<u>1,178</u>	<u>(4,840)</u>
Other comprehensive income (loss)	<u>1,868</u>	<u>(1,478)</u>
Comprehensive (loss) income	<u><u>\$ (8,082)</u></u>	<u><u>\$ 4,890</u></u>

See accompanying notes to condensed consolidated financial statements.

FLOWSERVE CORPORATION
(Unaudited)

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Amounts in thousands, except per share data)

	Nine Months Ended September 30,	
	2005	2004
Sales	\$ 1,956,767	\$ 1,818,762
Cost of sales	1,331,708	1,264,618
Gross profit	625,059	554,144
Selling, general and administrative expense	488,120	428,527
Operating income	136,939	125,617
Interest expense	(58,867)	(60,596)
Interest income	2,797	1,232
Loss on early extinguishment of debt	(27,744)	(1,048)
Other expense, net	(8,326)	(8,771)
Earnings before income taxes	44,799	56,434
Provision for income taxes	18,158	34,781
Income from continuing operations	26,641	21,653
Discontinued operations, net of tax	(22,655)	(1,870)
Net earnings	\$ 3,986	\$ 19,783
Earnings (loss) per share:		
Basic:		
Continuing operations	\$ 0.48	\$ 0.39
Discontinued operations	(0.41)	(0.03)
Net earnings	\$ 0.07	\$ 0.36
Diluted:		
Continuing operations	\$ 0.47	\$ 0.39
Discontinued operations	(0.40)	(0.03)
Net earnings	\$ 0.07	\$ 0.36

See accompanying notes to condensed consolidated financial statements.

FLOWERVE CORPORATION
(Unaudited)

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME

(Amounts in thousands)

	Nine Months Ended September 30,	
	2005	2004
Net earnings	<u>\$ 3,986</u>	<u>\$ 19,783</u>
Other comprehensive (expense) income:		
Foreign currency translation adjustments, net of tax	(24,457)	(10,951)
Cash flow hedging activity, net of tax	<u>1,996</u>	<u>(4,433)</u>
Other comprehensive loss	<u>(22,461)</u>	<u>(15,384)</u>
Comprehensive (loss) income	<u>\$ (18,475)</u>	<u>\$ 4,399</u>

See accompanying notes to condensed consolidated financial statements.

FLOWERVE CORPORATION
(Unaudited)

CONDENSED CONSOLIDATED BALANCE SHEETS

	September 30, 2005	December 31, 2004
(Amounts in thousands, except per share data)		
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 35,234	\$ 63,759
Restricted cash	2,159	—
Accounts receivable, net of allowance for doubtful accounts of \$7,782 and \$7,281, respectively	424,006	462,120
Inventories, net	405,298	388,402
Deferred taxes	113,044	81,225
Prepaid expenses and other	67,805	54,162
Total current assets	1,047,546	1,049,668
Property, plant and equipment, net of accumulated depreciation of \$451,656 and \$444,976, respectively	397,322	432,809
Goodwill	839,674	865,351
Deferred taxes	28,778	10,430
Other intangible assets, net	146,667	157,893
Other assets, net	110,041	117,884
Total assets	<u>\$ 2,570,028</u>	<u>\$ 2,634,035</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 297,259	\$ 316,545
Accrued liabilities	337,803	347,766
Debt due within one year	18,837	44,098
Deferred taxes	5,217	—
Total current liabilities	659,116	708,409
Long-term debt due after one year	680,347	657,746
Retirement obligations and other liabilities	367,832	397,655
Shareholders' equity:		
Serial preferred stock, \$1.00 par value, 1,000 shares authorized, no shares issued	—	—
Common shares, \$1.25 par value	72,018	72,018
Shares authorized – 120,000		
Shares issued – 57,614		
Capital in excess of par value	474,470	472,180
Retained earnings	438,314	434,328
	984,802	978,526
Treasury shares, at cost – 1,663 and 2,146 shares, respectively	(37,818)	(48,171)
Deferred compensation obligation	5,124	6,784
Accumulated other comprehensive loss	(89,375)	(66,914)
Total shareholders' equity	862,733	870,225
Total liabilities and shareholders' equity	<u>\$ 2,570,028</u>	<u>\$ 2,634,035</u>

See accompanying notes to condensed consolidated financial statements.

FLOWERVE CORPORATION
(Unaudited)

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Amounts in thousands)

	Nine Months Ended September 30,	
	2005	2004
Cash flows – Operating activities:		
Net earnings	\$ 3,986	\$ 19,783
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation	45,694	46,650
Amortization	7,651	8,031
Amortization of deferred loan costs and discount	3,006	3,787
Write-off of unamortized deferred loan costs and discount	11,307	1,048
Loss on early extinguishment of debt	16,437	—
Net loss on the disposition of assets	801	314
Equity compensation expense	11,405	735
Equity income, net of dividends received	(5,143)	4,694
Impairment of assets	23,602	—
Change in assets and liabilities, net of acquisitions:		
Accounts receivable, net	12,844	4,063
Inventories, net	(38,815)	(20,898)
Prepaid expenses and other	(13,578)	(5,625)
Other assets, net	2,582	(4,313)
Accounts payable	2,976	7,590
Accrued liabilities and income taxes payable	3,658	18,685
Retirement obligations and other liabilities	(34,711)	7,226
Net deferred taxes	(33,780)	(4,926)
Net cash flows provided by operating activities	<u>19,922</u>	<u>86,844</u>
Cash flows – Investing activities:		
Capital expenditures	(25,522)	(28,527)
Cash received for disposal of assets	—	4,093
Cash paid for acquisition	—	(9,429)
Change in restricted cash	(2,159)	—
Net cash flows used by investing activities	<u>(27,681)</u>	<u>(33,863)</u>
Cash flows – Financing activities:		
Net repayments under other financing arrangements	(3,989)	(355)
Payments on long-term debt	—	(152,480)
Proceeds from issuance of long-term debt	600,000	85,000
Payment of deferred loan costs	(9,322)	(665)
Proceeds from stock option activity	1,111	2,487
Repurchase of term loans and senior subordinated notes (includes premiums paid of \$16.5 million)	(607,043)	—
Net cash flows used by financing activities	<u>(19,243)</u>	<u>(66,013)</u>
Effect of exchange rate changes on cash	<u>(1,523)</u>	<u>(7)</u>
Net change in cash and cash equivalents	<u>(28,525)</u>	<u>(13,039)</u>
Cash and cash equivalents at beginning of year	<u>63,759</u>	<u>53,522</u>
Cash and cash equivalents at end of period	<u>\$ 35,234</u>	<u>\$ 40,483</u>

See accompanying notes to condensed consolidated financial statements.

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, 2005, and the related condensed consolidated statements of operations and comprehensive (loss) income for the three and nine months ended September 30, 2005 and 2004, and the condensed consolidated statements of cash flows for the nine months ended September 30, 2005 and 2004, 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 are presented as permitted by Regulation S-X and do not contain certain information included in our annual financial statements and notes to the financial statements. Accordingly, the accompanying condensed consolidated financial information should be read in conjunction with the consolidated financial statements for the year ended December 31, 2005 presented in our Annual Report on Form 10-K for the year ended December 31, 2005 ("2005 Annual Report"), which was filed with the SEC on June 30, 2006.

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

Stock-Based Compensation

We have several stock-based employee compensation plans, which we account for under the recognition and measurement principles of Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees," and related interpretations. It is our policy to set the exercise price of stock options at the closing price of our common stock on the New York Stock Exchange on the date such grants are authorized by our Board of Directors. For 2005 and prior years, no stock-based employee compensation cost is reflected in net earnings for stock option grants, as all options granted under those plans had an exercise price equal to or in excess of the market value of the underlying common stock on the date of grant. Should we elect to modify any of our existing stock option awards, APB No. 25, as interpreted by Financial Accounting Standards Board ("FASB") Financial Interpretation ("FIN") No. 44, "Accounting for Certain Transactions Involving Stock Compensation," requires us to recognize the intrinsic value of the underlying options at the date the modification becomes effective. Modifications could include accelerated vesting, a reduction in exercise prices or extension of the exercise period.

Awards of restricted stock are valued at the market price of our common stock on the grant date and recorded as unearned compensation within shareholders' equity. The unearned compensation is amortized to compensation expense over the vesting period of the restricted stock. We have unearned compensation of \$10.5 million and \$5.2 million at September 30, 2005 and December 31, 2004, respectively. These amounts will be recognized into net earnings in prospective periods.

The following table illustrates the effect on net earnings and earnings per share if we had applied the fair value recognition provisions of Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation," to all stock-based employee compensation, calculated using the Black-Scholes option-pricing model.

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(Amounts in thousands, except per share data)	Three Months Ended September 30,	
	2005	2004
Net (loss) earnings, as reported	\$ (9,950)	\$ 6,368
Restricted stock compensation expense included in net (loss) earnings, net of related tax effects	4,644	385
Less: Stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(5,297)	(297)
Pro forma net (loss) earnings	\$ (10,603)	\$ 6,456
Net (loss) earnings per share – basic:		
As reported	\$ (0.18)	\$ 0.12
Pro forma	(0.19)	0.12
Net (loss) earnings per share – diluted:		
As reported	\$ (0.19)	\$ 0.11
Pro forma	(0.19)	0.12

(Amounts in thousands, except per share data)	Nine Months Ended September 30,	
	2005	2004
Net earnings, as reported	\$ 3,986	\$ 19,783
Restricted stock compensation expense included in net earnings, net of related tax effects	7,069	482
Less: Stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects	(9,017)	(1,309)
Pro forma net earnings	\$ 2,038	\$ 18,956
Net earnings per share – basic:		
As reported	\$ 0.07	\$ 0.36
Pro forma	0.04	0.34
Net earnings per share – diluted:		
As reported	\$ 0.07	\$ 0.36
Pro forma	0.04	0.34

The above pro forma disclosures may not be representative of effects for future years, since the determination of the fair value of stock options granted includes an expected volatility factor and additional option grants are expected to be made each year.

Other Accounting Policies

Our significant accounting policies, for which no significant changes have occurred in the quarter ended September 30, 2005, are detailed in Note 1 of our 2005 Annual Report.

Accounting Developments

Pronouncements Implemented

In December 2004, the FASB issued SFAS No. 153, “Exchanges of Non-monetary Assets,” which addresses the measurement of exchanges of non-monetary assets. SFAS No. 153 eliminates the exception from fair value measurement for non-monetary exchanges of similar productive assets, which was previously provided by APB No. 29, “Accounting for Non-monetary Transactions,” and replaces it with an exception for exchanges that do not have commercial substance. SFAS No. 153 specifies that a non-monetary exchange has commercial substance if the future cash flows of the entity are

expected to change significantly as a result of the exchange. SFAS No. 153 is effective for non-monetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 during 2005 had no impact on our consolidated financial position or results of operations.

In April 2005, the FASB issued FIN No. 47, "Accounting for Conditional Asset Retirement Obligations". FIN No. 47 clarifies that the term conditional asset retirement obligation as used in SFAS No. 143, "Accounting for Asset Retirement Obligations," requiring companies to recognize a liability for the fair value of an asset retirement obligation that may be conditional on a future event if the fair value of the liability can be reasonably estimated. FIN No. 47 is effective as of the end of fiscal years ending after December 15, 2005. Our adoption of FIN No. 47, effective in the first quarter of 2005, did not have a material impact on our consolidated financial position or results of operation.

Pronouncements Not Yet Implemented

In December 2004, the FASB issued SFAS No. 123(R), "Share-Based Payment". SFAS No. 123(R) requires compensation costs related to share-based payment transactions to be recognized in the financial statements. With limited exceptions, the amount of the compensation cost is to be measured based on the grant-date fair value of the equity or liability instruments issued. In addition, liability awards are to be re-measured each reporting period. Compensation cost will be recognized over the period that an employee provides service in exchange for the award. SFAS No. 123(R) is a revision of SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation — Transition and Disclosure" and supersedes APB No. 25. SFAS No. 123(R) is effective for public companies as of the first interim or annual reporting period of the first fiscal year beginning after June 15, 2005. We adopted SFAS No. 123(R) effective January 1, 2006 using the modified prospective transition method. The specific magnitude of the impact of SFAS No. 123(R) on our results of operations for the year ended December 31, 2006 cannot be predicted at this time because it will depend on levels of share-based incentive awards granted in the future, as well as the effect of the pending modification discussed in Note 5. However, had we adopted SFAS No. 123(R) in prior periods, the impact would have approximated the impact of SFAS No. 123 as described in the disclosure of pro forma net income and earnings per share in "Stock-Based Compensation" above.

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs, an amendment of Accounting Research Bulletin No. 43, Chapter 4." SFAS No. 151 amends Accounting Research Bulletin ("ARB") No. 43, Chapter 4 and seeks to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted materials by requiring those items to be recognized as current period charges. Additionally, SFAS No. 151 requires that fixed production overheads be allocated to conversion costs based on the normal capacity of the production facilities. SFAS No. 151 is effective prospectively for inventory costs incurred in fiscal years beginning after June 15, 2005. We do not expect the adoption of SFAS No. 151 to have a material effect on our consolidated financial position or results of operations.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections." SFAS No. 154 establishes new standards on accounting for changes in accounting principles. All such changes must be accounted for by retrospective application to the financial statements of prior periods unless it is impracticable to do so. SFAS No. 154 replaces APB No. 20, "Accounting Changes," and SFAS No. 3, "Reporting Accounting Changes in Interim Periods." However, it carries forward the guidance in those pronouncements with respect to accounting for changes in estimates, changes in the reporting entity and the correction of errors. SFAS No. 154 is effective for accounting changes and error corrections made in fiscal years beginning after December 15, 2005, with early adoption permitted for changes and corrections made in years beginning after June 1, 2005. The application of SFAS No. 154 does not affect the transition provisions of any existing pronouncements, including those that are in the transition phase as of the effective date of SFAS No. 154. We do not expect the adoption of SFAS No. 154 to have a material effect on our consolidated financial position or 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 which 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.

2. Discontinued Operations

General Services Group — During the first quarter of 2005 we made a definitive decision to divest certain non-core service operations, collectively called the General Services Group ("GSG"), and accordingly, evaluated impairment pursuant

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to a held for sale concept as opposed to the previously held and used concept. As part of our decision to sell, we allocated \$12.3 million of goodwill to GSG based on its relative fair value to the total reporting unit's estimated fair value. We recognized impairment charges aggregating \$30.1 million during 2005, of which \$5.9 million and \$17.6 million were recorded during the first and third quarters, respectively, relating to GSG as the number of potential buyers diminished to one purchaser during the bidding process and the business underperformed during the year due to the pending sale. Effective December 31, 2005, we sold GSG to Furmanite, a unit of Dallas-based Xanser Corporation for approximately \$16 million in gross cash proceeds, including \$2 million held in escrow pending final settlement, subject to final working capital adjustments, excluding approximately \$12 million of net accounts receivable, generating a pre-tax loss of \$3.8 million, which was recognized in the fourth quarter of 2005. The pre-tax loss on the sale of GSG is subject to final working capital adjustments, which remain under negotiation. The outcome of such negotiations could result in a change in the ultimate loss on sale in the period of resolution. We used approximately \$11 million of the net cash proceeds to reduce our indebtedness in January 2006. We have allocated estimated interest expense related to this repayment to each period presented based upon then prevailing interest rates. As a result of this sale, we have presented the results of operations of GSG as discontinued operations for all periods presented.

GSG generated the following results of operations:

(Amounts in millions)

	Three Months Ended September 30,	
	2005	2004
Sales	\$ 21.6	\$ 28.7
Cost of sales	20.0	24.3
Selling, general and administrative expense	22.3	6.1
Interest expense	0.2	0.2
Other expense, net	—	(0.1)
Earnings (loss) before income taxes	(20.9)	(2.0)
Income tax benefit	(5.8)	(0.6)
Results for discontinued operations, net of tax	\$ (15.1)	\$ (1.4)

(Amounts in millions)

	Nine Months Ended September 30,	
	2005	2004
Sales	\$ 76.3	\$ 87.0
Cost of sales	63.6	70.7
Selling, general and administrative expense	42.4	19.6
Interest expense	0.6	0.4
Other expense, net	(0.1)	(0.2)
Earnings before income taxes	(30.4)	(3.9)
Income tax benefit	(7.7)	(1.0)
Results for discontinued operations, net of tax	\$ (22.7)	\$ (2.9)

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GSG's assets and liabilities have been reclassified to prepaid expenses and other, other assets, net and accounts payable to reflect discontinued operations. As of September 30, 2005 and December 31, 2004, GSG's assets and liabilities consisted of the following:

(Amounts in millions)	September 30, 2005	December 31, 2004
Accounts receivable, net	\$ 19.7	\$ 23.0
Inventory, net	12.0	13.3
Prepaid expenses and other	0.4	0.4
Total current assets	32.1	36.7
Property, plant and equipment, net	6.2	17.5
Other intangible assets, net	0.1	0.1
Total assets (1)	\$ 38.4	\$ 54.3
Accounts payable	\$ 5.5	\$ 8.3
Accrued liabilities	4.3	1.7
Total current liabilities	9.8	10.0
Long-term liabilities	0.1	0.1
Total liabilities (2)	\$ 9.9	\$ 10.1

(1) Excludes \$12.3 million of goodwill allocated to GSG upon classification of GSG as assets held for sale.

(2) Excludes \$10.9 million of debt retired with net proceeds from the sale of GSG.

Government Marine Business Unit – In the first quarter of 2004, we made a definitive decision to sell our Government Marine Business Unit (“GMBU”), a business within our Flowserve Pump Division (“FPD”). As a result, we reclassified the operation to discontinued operations in the first quarter of 2004. In November 2004, we sold GMBU to Curtiss-Wright Electro-Mechanical Corporation for approximately \$28 million, generating a pre-tax gain of \$7.4 million after the allocation of approximately \$8 million of FPD goodwill and \$1 million of intangible assets. GMBU, which provided pump technology and service for U.S. Navy submarines and aircraft carriers, did not serve our core market and represented only a small part of our total pump business. We used net proceeds from the disposition of GMBU to reduce our outstanding indebtedness. As a result of this sale, we have presented the assets, liabilities and results of operations of the GMBU as discontinued operations for all periods included.

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GMBU generated the following results of operations:

(Amounts in millions)	Three Months Ended September 30, 2004
Sales	\$ 7.4
Cost of sales	6.0
Selling, general and administrative expense	0.7
Earnings (loss) before income taxes	0.7
Provision (benefit) for income taxes	0.2
Results for discontinued operations, net of tax	\$ 0.5

(Amounts in millions)	Nine Months Ended September 30, 2004
Sales	\$ 19.1
Cost of sales	15.3
Selling, general and administrative expense	2.3
Earnings before income taxes	1.5
Provision for income taxes	0.5
Results for discontinued operations, net of tax	\$ 1.0

3. Acquisition

We acquired the remaining 75% interest in Thompsons, Kelly and Lewis, Pty. Ltd ("TKL"), an Australian manufacturer and supplier of pumps, during March 2004. The incremental interests acquired were accounted for as a step acquisition and TKL's results of operations have been consolidated since the date of acquisition. The estimated fair value of the net assets acquired (including approximately \$2.2 million of cash acquired) exceeded the cash paid of \$12 million and, accordingly, no goodwill was recognized.

4. Goodwill

(Amounts in thousands)	Flowserve Pump	Flow Solutions	Flow Control	Total
Balance as of December 31, 2004	\$459,896	\$33,618	\$371,837	\$865,351
Impairment of GSG (1)	—	—	(12,327)	(12,327)
Currency translation	(3,014)	(2,069)	(8,267)	(13,350)
Balance as of September 30, 2005	\$456,882	\$31,549	\$351,243	\$839,674

(1) As discussed in Note 2 above, in the first quarter of 2005 we classified GSG as a discontinued operation, and we allocated goodwill of \$12.3 million to GSG. Based on the fair value of GSG at March 31, 2005, we recorded a goodwill impairment of \$5.9 million. We recorded an impairment of the remainder of the goodwill allocated to GSG during the three months ended September 30, 2005.

5. Stock Plans

During 2005, we made a number of modifications to our stock plans, including the acceleration of the vesting of certain restricted stock grants and outstanding options, as well as the extension of the exercise period associated with certain outstanding options. These modifications resulted from severance agreements with former executives and from our decision to temporarily suspend option exercises. As a result of the modifications primarily related to severance agreements with former

executives, we recorded additional compensation expenses in 2005 of approximately \$7.2 million, of which \$0 and \$6.2 million were recorded in the three and nine months ended September 30, 2005, respectively, based upon the intrinsic values of the awards on the dates the modifications were made.

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. Subsequently, we took action on November 4, 2005, to 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' 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 will expire 30 days after the options first become exercisable when our SEC filings have become current and an effective SEC Form S-8 Registration Statement has been filed with the SEC, and
- (ii) the regular term of options otherwise expiring in 2006 will expire on the later of:
 - (1) 75 days after the regular term of the option as originally granted expires, or
 - (2) December 31, 2006 (assuming the options become exercisable in 2006 for the reasons included in (i) above).

These extensions are subject to our shareholders approving certain applicable plan amendments at our next annual shareholders' meeting, scheduled for August 24, 2006. If shareholders do not approve the plan amendments as currently posed in our proxy statement, these extension actions will become void. If such plan amendments are approved at our next annual shareholders' meeting, the extensions will be considered as a stock modification for financial reporting purposes subject to the recognition of a non-cash compensation charge in accordance with SFAS No. 123(R). Our actual charge will be contingent upon many factors, including future share price volatility, risk free interest rate, option maturity, strike price, share price and dividend yield.

The earlier extension actions also extended the option exercise period available following separation from employment for reasons of death, disability and termination not for cause or certain voluntary separations. These separate extensions were partially rescinded at the December 14, 2005, meeting of the Organization and Compensation Committee of the Board of Directors, and as so revised are currently effective and not subject to shareholder approval. The exercise period available following such employment separations has been extended to the later of (i) 30 days after the options first became exercisable when our SEC filings have become current and an effective Registration Statement on Form S-8 has been filed with the SEC, or (ii) the period available for exercise following separation from employment under the terms of the option as originally granted. This extension is considered for financial reporting purposes as a stock modification subject to the recognition of a non-cash compensation change in accordance with APB No. 25 of \$1.0 million in 2005, none of which was recorded in the nine months ended September 30, 2005. The extension of the exercise period following separation from employment does not apply to option exercise periods governed by a separate separation contract or agreement.

6. Derivative Instruments and Hedges

We enter into forward contracts to hedge our risk associated with transactions denominated in currencies other than the local currency of the operation engaging in the transaction. Our risk management and derivatives policy specify the conditions in which we enter into derivative contracts. As of September 30, 2005, we had approximately \$210.5 million of notional amount in outstanding contracts with third parties. As of September 30, 2005, the maximum length of any forward contract in place was 23 months.

Certain of our forward contracts do not qualify for hedge accounting. The fair value of these outstanding forward contracts at September 30, 2005 was a liability of \$3.0 million and an asset of \$3.4 million at December 31, 2004. Unrealized gains (losses) from the changes in the fair value of these forward contracts of \$0.2 million and \$3,000 for the quarters ended September 30, 2005 and 2004, respectively, and \$(5.8) million and \$4.6 million for the nine months ended September 30, 2005 and 2004, respectively, are included in other income (expense), net in the consolidated statements of operations. The fair value

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of outstanding forward contracts qualifying for hedge accounting at September 30, 2005 was an asset of \$85,000 and a liability of \$2.3 million at December 31, 2004. Unrealized gains (losses) from the changes in the fair value of qualifying forward contracts and the associated underlying exposures of \$0.3 million and \$(49,000), net of tax, for the quarters ended September 30, 2005 and 2004, respectively, and \$0.2 million and \$86,000, net of tax, for the nine months ended September 30, 2005 and 2004, respectively, are included in other comprehensive (loss) 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. As of September 30, 2005, we have \$325 million of notional amount in outstanding interest rate swaps with third parties. As of September 30, 2005, the maximum remaining length of any interest rate contract in place was approximately 39 months. The fair value of the interest rate swap agreements was a liability of \$0.8 million and \$3.4 million at September 30, 2005 and December 31, 2004, respectively. Unrealized gains from the changes in fair value of our interest rate swap agreements, net of reclassifications, of \$1.3 million and \$2.1 million, net of tax, for the quarters ended September 30, 2005 and 2004, respectively, and \$2.2 million and \$1.8 million, net of tax, for the nine months ended September 30, 2005 and 2004, respectively, are included in other comprehensive (loss) income.

During the third quarter of 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 ("EIB") loan. The notional amount of the derivative was \$85 million, and it served to convert floating rate interest rate risk to a fixed rate, as well as U.S. dollar currency risk to Euros. The derivative matures in 2011. At September 30, 2005 and December 31, 2004, the fair value of this derivative was a liability of \$6.0 million and \$15.9 million respectively. This derivative did not qualify for hedge accounting. The unrealized gain (loss) on the derivative, offset with the foreign currency translation gain on the underlying loan aggregates to \$1.0 million and \$(3.1) million for the quarters ended September 30, 2005 and 2004, respectively, and \$(1.7) million and \$(3.1) million for the nine months ended September 30, 2005 and 2004, respectively, and is included in other income (expense), net in the consolidated statements of operations.

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 contracts and interest rate swap agreements and expect all counterparties to meet their obligations. We have not experienced credit losses from our counterparties.

7. Debt

Debt, including capital lease obligations, consisted of:

(Amounts in thousands)	September 30, 2005	December 31, 2004
Term Loan interest rate of 5.81%	\$ 600,000	\$ —
Term Loan Tranche A:		
U.S. Dollar Tranches, interest rate of 5.02%	—	76,240
Euro Tranche, interest rate of 4.69%	—	13,257
Term Loan Tranche C, interest rate of 5.20%	—	233,851
Senior Subordinated Notes, net of discount, coupon of 12.25%:		
U.S. Dollar denominated	—	187,004
Euro denominated	—	87,484
EIB loan, interest rate of 3.80% in 2005 and 2.39% in 2004	85,000	85,000
Receivable securitization and factoring obligations	12,369	17,635
Capital lease obligations and other	1,815	1,373
Debt and capital lease obligations	699,184	701,844
Less amounts due within one year	18,837	44,098
Total debt due after one year	\$ 680,347	\$ 657,746

New Credit Facilities

In March 2005, we obtained consents from our major lenders that enhanced our flexibility under our 2000 Credit Facilities (described below) to among other things permit the August 2005 refinancing of our 2000 Credit Facilities and the repurchase of our 12.25% Senior Subordinated Notes. On August 12, 2005, we entered into credit facilities comprised of a \$600 million term loan expiring on August 10, 2012 and a \$400 million revolving line of credit, which can be utilized to provide up to \$300 million in letters of credit, expiring on August 12, 2010. We refer to these credit facilities collectively as our New Credit Facilities. The proceeds of borrowings under our New Credit Facilities were used to call our 12.25% Senior Subordinated Notes and retire our indebtedness outstanding under our 2000 Credit Facilities. We also replaced the letter of credit agreement guaranteeing our obligations under the EIB credit facility (described below) with a letter of credit issued under the new revolving line of credit. We had outstanding letters of credit of \$142.6 million at September 30, 2005 under the revolving line of credit, which reduced borrowing capacity to \$257.4 million, compared with a borrowing capacity of \$248.7 million at December 31, 2004 under our 2000 Credit Facilities. During the nine months ended September 30, 2005, we made no payments under our New Credit Facilities. During the remainder of 2005, we made scheduled payments of \$1.5 million and optional payments of \$38.4 million.

We incurred \$9.3 million in fees related to the New Credit Facilities, of which \$0.8 million were expensed in the third quarter of 2005. Prior to the refinancing, we had \$11.8 million of unamortized deferred loan costs related to the 2000 Credit Facilities and the Senior Subordinated Notes. Based upon the final syndicate of financial institutions for the New Credit Facilities, we expensed \$10.5 million of these unamortized deferred loan costs in the third quarter of 2005. In addition to the total loan costs of \$11.3 million that were expensed, we recorded a charge of \$16.4 million for premiums paid to call the Senior Subordinated Notes, for a total loss on extinguishment of \$27.7 million recorded in the third quarter of 2005. The remaining \$8.5 million of fees related to the New Credit Facilities were capitalized and combined with the remaining \$1.3 million of previously unamortized deferred loan costs for a total of \$9.8 million in deferred loan costs included in other assets, net. These costs are being amortized over the term of the New Credit Facilities.

Borrowings under our New 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 New 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 at September 30, 2005 was 1.75% for LIBOR borrowings. In addition, we pay lenders under the New Credit Facilities a commitment fee equal to a percentage, determined by reference to the ratio of our total debt to consolidated EBITDA, of the unutilized portion of the revolving line of credit, and letter of credit fees with respect to each financial standby letter of credit outstanding under our New Credit Facilities equal to a percentage based on the applicable margin in effect for LIBOR borrowings under the new revolving line of credit. The fee for performance standby letters of credit is 0.5% lower than the fee for financial standby letters of credit.

In connection with the New Credit Facilities entered into in August 2005, we entered into \$275 million of notional amount of interest rate swaps to hedge exposure of floating interest rates. Of this total notional amount of \$275 million, \$130 million carried a start date of September 30, 2005 and \$145 million carried a start date of December 30, 2005. These swaps, combined with the \$135 million of interest rate swaps held by us at the time of the refinancing, total \$410 million of notional amount of interest rate swaps outstanding at December 31, 2005.

Our obligations under the New 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 New Credit Facilities are collateralized by substantially all of our and the guarantors' assets.

The loans under our New Credit Facilities are subject to mandatory repayment with, in general:

- 100% of the net cash proceeds of asset sales; and
- Unless we attain and maintain investment grade credit ratings:
 - 75% of our excess cash flow, subject to a reduction based on the ratio of our total debt to consolidated EBITDA;
 - 50% of the proceeds of any equity offerings; and
 - 100% of the proceeds of any debt issuances (subject to certain exceptions).

We may prepay loans under our New Credit Facilities in whole or in part, without premium or penalty.

Our New Credit Facilities contain covenants requiring us to deliver to lenders leverage and interest coverage financial covenants and our audited annual and unaudited quarterly financial statements. Under the leverage covenant, the maximum permitted leverage ratio steps down beginning with the fourth quarter of 2006, with a further step-down beginning with the fourth quarter of 2007. Under the interest coverage covenant, the minimum required interest coverage ratio steps up beginning with the fourth quarter of 2006, with a further step-up beginning with the fourth quarter of 2007. Compliance with these financial covenants under our New Credit Facilities is tested quarterly, and we have complied with the financial covenants as of December 31, 2005. Further, we are required to furnish to our lenders within 50 days of the end of each of the first three quarters of each year our consolidated balance sheet, and related statements of operations, shareholders' equity and cash flows.

Our New Credit Facilities also contain covenants restricting our and our subsidiaries' ability to dispose of assets, merge, pay dividends, repurchase or redeem capital stock and indebtedness, incur indebtedness and guarantees, create liens, enter into agreements with negative pledge clauses, make certain investments or acquisitions, enter into sale and leaseback transactions, enter into transactions with affiliates, make capital expenditures, engage in any business activity other than our existing business or any business activities reasonably incidental thereto. We are currently in compliance with all debt covenants under the New Credit Facilities.

EIB Credit Facility

On April 14, 2004, we and one of our European subsidiaries, Flowserve B.V., entered into an agreement with EIB, pursuant to which EIB agreed to loan us up to €70 million, with the ability to draw funds in multiple currencies, to finance in part specified research and development projects undertaken by us in Europe. Borrowings under the EIB credit facility bear interest at a fixed or floating rate of interest agreed to by us and EIB with respect to each borrowing under the facility. Loans under the EIB credit facility are subject to mandatory repayment, at EIB's discretion, upon the occurrence of certain events, including a change of control or prepayment of certain other indebtedness. In addition, the EIB credit facility contains covenants that, among other things, limit our ability to dispose of assets related to the financed project and require us to deliver to EIB our audited annual financial statements within 30 days of publication. In August 2004, we borrowed \$85 million at a floating interest rate based on 3-month U.S. LIBOR that resets quarterly. As of September 30, 2005, the interest rate was 3.80%. The maturity of the amount drawn is June 15, 2011, but may be repaid at any time without penalty. Our obligations under the EIB credit facility are guaranteed by a letter of credit outstanding under our New Credit Facilities.

2000 Credit Facilities

As of December 31, 2004, our credit facilities were composed of Tranche A and Tranche C term loans and a revolving line of credit. Tranche A consisted of a United States ("U.S.") dollar denominated tranche and a Euro denominated tranche, the latter of which was a term note due in 2006. We refer to these credit facilities collectively as our 2000 Credit Facilities.

The Tranche A and Tranche C loans had ultimate maturities of June 2006 and June 2009, respectively. The term loans bore floating interest rates based on LIBOR plus a borrowing spread, or the prime rate plus a borrowing spread, at our option. The borrowing spread for the senior credit facilities can increase or decrease based on the leverage ratio as defined in the credit facility and on our public debt ratings.

As part of the 2000 Credit Facilities, we also had a \$300 million revolving line of credit that was set to expire in June 2006. The revolving line of credit allowed us to issue up to \$200 million in letters of credit. We had no amounts outstanding under the revolving line of credit at December 31, 2004.

We were required, under certain circumstances as defined in the 2000 Credit Facilities, to use a percentage of excess cash generated from operations to reduce the outstanding principal of the term loans in the following year. Based upon the annual calculations performed at December 31, 2004, no additional principal payments became due in 2005 under this provision. Amounts outstanding under the 2000 Credit Facilities were repaid in August 2005 using the proceeds from the New Credit Facilities.

Senior Subordinated Notes

At September 30, 2005, we had no Senior Subordinated Notes outstanding. The Senior Subordinated Notes were originally issued in 2000 at a discount to yield 12.5%, but had a coupon interest rate of 12.25%. Interest on these notes was payable semi-annually in February and August. In August 2005, all remaining Senior Subordinated Notes outstanding were called by us at 106.125% of face value as specified in the loan agreement and repaid, along with accrued interest.

Accounts Receivable Securitization

In October 2004, Flowserve US Inc., one of our wholly owned subsidiaries, and Flowserve Receivables Corporation (“FRC”), a wholly owned subsidiary of Flowserve US Inc., entered into a receivables purchase agreement (“RPA”) with Jupiter Securitization Corporation (“Jupiter”) and JPMorgan Chase Bank, N.A. (successor by merger to Bank One, NA) whereby FRC could obtain up to \$75 million in financing on a revolving basis by securitizing certain U.S.-based trade receivables.

To obtain financing, Flowserve US Inc. transferred certain receivables to FRC, which was formed solely for this accounts receivable securitization program. Pursuant to the RPA, FRC then sold undivided purchaser interests in these receivables to Jupiter, which then pooled these interests with other unrelated interests and issued short-term commercial paper, which was repaid from cash flows generated by collections on the receivables. Flowserve US Inc. continued to service the receivables for a servicing fee of 0.5% of the average net receivable balance. No servicing liability was recognized at December 31, 2004 because the amount was immaterial due to the short-term average collection period of the securitized receivables. FRC has no recourse against Flowserve US Inc. for failure of the debtors to pay when due. As of December 31, 2004, FRC had secured \$60 million in financing under the program. The proceeds were used to repay \$16 million and \$44 million of Tranche A and Tranche C bank term loans, respectively, outstanding under our 2000 Credit Facilities. As of September 30, 2005, FRC had repaid \$11.6 million and had outstanding financing under the program of \$48.4 million.

We account for this transaction in accordance with SFAS No. 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities—a Replacement of FASB Statement No. 125.” Under this guidance borrowings under the facility in excess of \$11.3 million are excluded from our debt balance in the consolidated balance sheets but included for purposes of covenant calculations under the 2000 Credit Facilities.

FRC retains a subordinate interest in the receivables, which represents the amount in excess of purchaser interests transferred to Jupiter. As of September 30, 2005 the short-term portion of \$87.9 million of this subordinate interest is included in accounts receivable, net on the consolidated balance sheet. The long-term portion of \$2.9 million of this subordinate interest is included in the other assets, net on the consolidated balance sheet. Our retained interest in the receivables is recorded at the present value of its estimated net realizable value based on an assumed days sales outstanding (“DSO”) of 60 days and a discount rate of 5.4%.

During the third quarter of 2005 Flowserve US Inc. transferred \$215.5 million of receivables to FRC which then sold undivided purchaser interests in the receivables to Jupiter. In the third quarter of 2005, FRC collected \$217.9 million in cash that was used to purchase additional receivables from Flowserve US Inc. and return invested capital to Flowserve US Inc. Losses on the sales of purchaser interests totaled \$0.5 million and \$1.5 million for the three and nine months ended September 30, 2005, respectively. FRC also recorded interest expense of \$0.1 million and \$0.3 million for the three and nine months ended September 30, 2005, respectively.

On October 31, 2005, we terminated the RPA. In connection with this, we borrowed approximately \$48 million under our New Credit Facilities and repurchased outstanding receivable interests from Jupiter.

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. Under our 2000 Credit Facilities, such factoring was generally limited to \$50 million, based on due date of the factored receivables. The limit on factoring was raised to \$75 million under the New Credit Facilities entered into in August 2005.

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8. Inventories

Inventories are stated at lower of cost or market. Cost is determined for principally all U.S. inventories by the LIFO method and for other inventories by the first-in, first-out ("FIFO") method.

Inventories and the method of determining costs were:

(Amounts in thousands)	September 30, 2005	December 31, 2004
Raw materials	\$ 122,106	\$ 123,149
Work in process	224,395	197,850
Finished goods	222,053	214,929
Less: Progress billings	(69,297)	(59,048)
Less: Excess and obsolete reserve	(59,214)	(58,181)
	440,043	418,699
LIFO reserve	(34,745)	(30,297)
Net inventory	\$ 405,298	\$ 388,402
Percent of inventory accounted for by:		
LIFO	44%	42%
FIFO	56%	58%

9. Earnings Per Share

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

(Amounts in thousands, except per share amounts)	Three Months Ended September 30,	
	2005	2004
Income from continuing operations	\$ 5,183	\$ 7,270
Net (loss) earnings	\$ (9,950)	\$ 6,368
Denominator for basic earnings per share — weighted average shares	55,139	55,174
Effect of potentially dilutive securities	1,346	553
Denominator for diluted earnings per share — weighted average shares	56,485	55,727
Net earnings per share:		
Basic:		
Continuing operations	\$ 0.09	\$ 0.14
Net (loss) earnings	(0.18)	0.12
Diluted:		
Continuing operations	\$ 0.08	\$ 0.13
Net (loss) earnings	(0.19)	0.11

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(Amounts in thousands, except per share amounts)	Nine Months Ended September 30,	
	2005	2004
Income from continuing operations	\$ 26,641	\$ 21,653
Net earnings	\$ 3,986	\$ 19,783
Denominator for basic earnings per share — weighted average shares	55,439	54,976
Effect of potentially dilutive securities	1,131	552
Denominator for diluted earnings per share — weighted average shares	56,570	55,528
Net earnings per share:		
Basic:		
Continuing operations	\$ 0.48	\$ 0.39
Net earnings	0.07	0.36
Diluted:		
Continuing operations	\$ 0.47	\$ 0.39
Net earnings	0.07	0.36

10. Legal Matters and Contingencies

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. Any such products were encapsulated and used only as components of process equipment, and we do not believe that any emission of respirable asbestos-containing fibers occurred during the use of this equipment. We believe that a high percentage of the applicable claims are covered by applicable insurance or indemnities from other companies.

On February 4, 2004, we received an informal inquiry from the SEC requesting the voluntary production of documents and information related to our February 3, 2004 announcement that we would restate our financial results for the nine months ended September 30, 2003 and the full years 2002, 2001 and 2000. On June 2, 2004, we were advised that the SEC had issued a formal order of private investigation into issues regarding this restatement and any other issues that arise from the investigation. On May 31, 2006, we were informed by the staff of the SEC that it had concluded this investigation without recommending any enforcement action against us.

During the quarter ended September 30, 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, Renée J. Hombaker, 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. Hombaker 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. The case is currently set for trial on March 27, 2007. We continue to believe that the lawsuit is without merit and are vigorously defending the case.

As of May 1, 2005, due to the non-current status of our filings with the SEC in accordance with the Securities Exchange Act of 1934, our Registration Statements on Form S-8 were no longer available to cover offers and sales of securities to our employees and other persons. Since that date, the acquisition of interests in our common stock fund under our 401(k) plan by plan participants may have been subject to the registration requirements of the Securities Act of 1933 or applicable state securities laws and may not have qualified for an available exemption from such requirements. Federal securities laws generally provide for a one-year rescission right for an investor who acquires unregistered securities in a transaction that is subject to registration and for which no exemption was available. As such, an investor successfully asserting a rescission right

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during the one-year time period has the right to require an issuer to repurchase the securities acquired by the investor at the price paid by the investor for the securities (or if such security has been disposed of, to receive damages with respect to any loss on such disposition), plus interest from the date of acquisition. These rights may apply to affected participants in our 401(k) plan. Based on our current stock price, we believe that our current potential liability for rescission claims is not material to our financial condition or results of operations; however, our potential liability could become material in the future if our stock price were to fall below participants' acquisition prices for their interest in our stock fund during the one-year period following the unregistered acquisitions.

We have been involved as a potentially responsible party ("PRP") at 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.

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. We are also involved in a substantial number of labor claims, including one case where we had a confidential settlement reflected in our results of operations for the second quarter of 2004.

Although none of the aforementioned potential liabilities can be quantified with absolute certainty, we have established reserves covering these exposures, which we believe to be reasonable 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.

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.

11. Retirement and Postretirement Benefits

Components of the net periodic cost (benefit) for the three months ended September 30, 2005 and 2004 were as follows:

(Amounts in millions)	U.S. Defined Benefit Plans		Non-U.S. Defined Benefit Plans		Postretirement Medical Benefits	
	2005	2004	2005	2004	2005	2004
Net periodic cost (benefit)						
Service cost	\$ 3.7	\$ 3.5	\$ 0.8	\$ 0.9	\$ —	\$ 0.1
Interest cost	3.9	3.8	2.6	2.2	1.0	1.3
Expected return on plan assets	(4.1)	(4.3)	(1.4)	(1.1)	—	—
Curtailments/settlements	(0.1)	0.6	—	—	—	—
Amortization of unrecognized net loss	1.3	0.6	0.3	0.3	0.2	0.4
Amortization of prior service costs/ (benefit)	(0.4)	(0.3)	—	—	(1.0)	(0.8)
Net cost recognized	<u>\$ 4.3</u>	<u>\$ 3.9</u>	<u>\$ 2.3</u>	<u>\$ 2.3</u>	<u>\$ 0.2</u>	<u>\$ 1.0</u>

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Components of the net periodic cost (benefit) for the nine months ended September 30, 2005 and 2004 were as follows:

(Amounts in millions)	U.S.		Non-U.S.		Postretirement	
	Defined Benefit Plans		Defined Benefit Plans		Medical Benefits	
	2005	2004	2005	2004	2005	2004
Net periodic cost (benefit)						
Service cost	\$ 11.1	\$ 10.4	\$ 2.5	\$ 2.5	\$ 0.1	\$ 0.1
Interest cost	11.6	11.6	7.7	6.6	3.1	4.0
Expected return on plan assets	(12.3)	(13.0)	(4.3)	(3.3)	—	—
Curtailments/settlements	(0.2)	0.6	—	—	—	—
Amortization of unrecognized net loss	3.8	1.9	1.1	1.0	0.5	1.1
Amortization of prior service costs	(1.1)	(1.0)	—	—	(3.1)	(2.3)
Net cost recognized	<u>\$ 12.9</u>	<u>\$ 10.5</u>	<u>\$ 7.0</u>	<u>\$ 6.8</u>	<u>\$ 0.6</u>	<u>\$ 2.9</u>

12. Income Taxes

For the three months ended September 30, 2005, we earned \$9.7 million before taxes and provided for income taxes of \$4.5 million, resulting in an effective tax rate of 46.5%. For the nine months ended September 30, 2005, we earned \$44.8 million before taxes and provided for income taxes of \$18.2 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 and nine months ended September 30, 2004 primarily due to the net impact of foreign operations.

For the three months ended September 30, 2004, we earned \$17.8 million before taxes and provided for income taxes of \$10.6 million, resulting in an effective tax rate of 59.3%. For the nine months ended September 30, 2004, we earned \$56.4 million before taxes and provided for income taxes of \$34.8 million, resulting in an effective tax rate of 61.6%. The effective tax rate varied from the U.S. federal statutory rate for the three and nine months ended September 30, 2004 primarily due to the impact of increased foreign earnings repatriation used to pay down U.S. debt.

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:

- Flowserve Pump Division;
- Flow Solutions Division; and
- Flow Control Division.

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 Controller, 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 the 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 with 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, 2005

(Amounts in thousands)	Flowserve Pump	Flow Solutions	Flow Control	Subtotal – Reportable Segments	All Other	Consolidated Total
Sales to external customers	\$321,156	\$103,338	\$223,613	\$648,107	\$ 1,378	\$ 649,485
Intersegment sales	810	9,852	1,076	11,738	(11,738)	-
Segment operating income	28,971	23,006	25,280	77,257	(22,446)	54,811

Three Months Ended September 30, 2004

(Amounts in thousands)	Flowserve Pump	Flow Solutions	Flow Control	Subtotal – Reportable Segments	All Other	Consolidated Total
Sales to external customers	\$322,468	\$88,749	\$210,772	\$621,989	\$ 1,437	\$ 623,426
Intersegment sales	1,362	7,143	1,052	9,557	(9,557)	—
Segment operating income	23,482	18,761	18,765	61,008	(17,828)	43,180

Nine Months Ended September 30, 2005

(Amounts in thousands)	Flowserve Pump	Flow Solutions	Flow Control	Subtotal – Reportable Segments	All Other	Consolidated Total
Sales to external customers	\$992,061	\$300,993	\$660,020	\$1,953,074	\$ 3,693	\$1,956,767
Intersegment sales	3,040	26,950	3,050	33,040	(33,040)	—
Segment operating income	84,355	65,891	71,456	221,702	(84,763)	136,939

Nine Months Ended September 30, 2004

(Amounts in thousands)	Flowserve Pump	Flow Solutions	Flow Control	Subtotal – Reportable Segments	All Other	Consolidated Total
Sales to external customers	\$935,615	\$266,309	\$612,649	\$1,814,573	\$ 4,189	\$1,818,762
Intersegment sales	4,328	22,297	3,405	30,030	(30,030)	—
Segment operating income	64,620	54,524	53,712	172,856	(47,239)	125,617

14. Subsequent Events

Legal Matters

On October 6, 2005, a shareholder derivative lawsuit was filed purportedly on our behalf in the 193rd Judicial District of Dallas County, Texas. The lawsuit names as defendants Mr. Greer, Ms. Hombaker, 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 are named as a nominal defendant. Based primarily on the purported misstatements alleged in the above-described federal securities case, the plaintiff asserts claims against the defendants for breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment. The plaintiff alleges 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 have filed a motion seeking dismissal of the case.

On February 7, 2006, we received a subpoena from the SEC regarding goods and services that certain foreign subsidiaries delivered to Iraq from 1996 through 2003 during the United Nations Oil-for-Food program. This investigation includes a review of whether any inappropriate payments were made to Iraqi officials in violation of the Foreign Corrupt Practices Act. The investigation includes periods prior to, as well as subsequent to our acquisition of the foreign operations involved in the investigation. We may be subject to liabilities if violations are found regardless of whether they relate to periods before or subsequent to our acquisition.

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In addition, one of our foreign subsidiary's operations is cooperating with a foreign governmental investigation of that site's involvement in the United Nations Oil-for-Food program. This cooperation has included responding to an investigative trip by foreign authorities to the foreign subsidiary's site, providing relevant documentation to these authorities and answering their questions. We are unable to predict how or if the foreign authorities will pursue this matter in the future.

We believe that both the SEC and foreign authorities are investigating other companies from their actions arising from the United Nations Oil-for-Food program.

We are in the process of reviewing and responding to the SEC subpoena and assessing the implications of the foreign investigation, including the continuation of a thorough internal investigation. Our investigation is in the early stages and has included and will include a detailed review of contracts with the Iraqi government during the period in question and certain payments associated therewith. Additionally, we have and will continue to conduct interviews with employees with knowledge of the contracts and payments in question. We are in the early phases of our internal investigation and as a result are unable to make any definitive determination whether any inappropriate payments were made and accordingly are unable to predict the ultimate outcome of this matter.

We will continue to fully cooperate in both the SEC and the foreign investigations. Both investigations are in progress but, at this point, are incomplete. Accordingly, if the SEC and/or the foreign authorities take enforcement action with regard to these investigations, we may be required to pay fines, consent to injunctions against future conduct or suffer other penalties which could potentially materially impact our business financial statements and cash flows.

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 names as defendants Mr. Greer, Ms. Hombaker, and current board members Mr. Coble, Mr. Haymaker, Jr., Lewis M. Kling, Mr. Rusnack, Mr. Johnston, Mr. Rampacek, Mr. Sheehan, Ms. Harris, Mr. Rollans and Mr. Bartlett. We are named as a nominal defendant. Based primarily on certain of the purported misstatements alleged in the above-described federal securities case, the plaintiff asserts claims against the defendants for breaches of fiduciary duty. The plaintiff alleges that the purported breaches of fiduciary duty occurred between 2000 and 2004. The plaintiff seeks on our behalf an unspecified amount of damages, disgorgement by Mr. Greer and Ms. Hombaker of salaries, bonuses, restricted stock and stock options, and recovery of attorneys' fees and costs. We strongly believe that the suit was improperly filed and have filed a motion seeking dismissal of the case.

In March 2006, we initiated a process to determine our compliance posture with respect to U.S. export control laws and regulations. Upon initial investigation, it appears that some product transactions and technology transfers may technically not be in compliance with U.S. export control laws and regulations and require further review. With assistance from outside counsel, we are currently involved in a systematic process to conduct further review, which we believe will take about 18 months to complete given the complexity of the export laws and the scope of our investigation. Any potential violations of U.S. export control laws and regulations that are identified may result in civil or criminal penalties, including fines and/or other penalties. Because our review into this issue is ongoing, we are currently unable to determine the full extent of potential violations or the nature or amount of potential 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., or on our financial condition.

Other Matters

The Internal Revenue Service ("IRS") substantially concluded its audit of our U.S. federal income tax returns for the years 1999 through 2001 during December 2005. Based on its audit work, the IRS has issued proposed adjustments to increase taxable income during 1999 through 2001 by \$12.8 million, and to deny foreign tax credits of \$2.4 million in the aggregate. The tax liability resulting from these proposed adjustments will be offset with foreign tax credit carryovers and other refund claims, and therefore should not result in a material future cash payment, pending final review by the Joint Committee on Taxation. We anticipate this review will be completed by December 31, 2006. The effect of the adjustments to current and deferred taxes has been reflected in the consolidated financial statements for the applicable periods.

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

The following discussion and analysis should be read in conjunction with the information contained in the condensed consolidated financial statements and notes thereto included in this Quarterly Report and our 2005 Annual Report.

OVERVIEW

We produce engineered and industrial pumps, industrial valves, control valves, nuclear valves, valve actuation and precision mechanical seals, and provide a range of related flow management services worldwide, primarily for the process industries. Equipment manufactured and serviced by us is predominately used in industries that deal with difficult-to-handle and corrosive fluids as well as environments with extreme temperature, pressure, horsepower and speed. Our businesses are affected by economic conditions in the U.S. and other countries where our products are sold and serviced, by the cyclical nature of the petroleum, chemical, power, water and other industries served, by the relationship of the U.S. dollar to other currencies, and by the demand for and pricing of customers' products. We believe the impact of these conditions is somewhat mitigated by the strength and diversity of our product lines, geographic coverage and significant installed base, which provides potential for an annuity stream of revenue from parts and services.

RECENT DEVELOPMENTS

In an effort to better align our business portfolio with our core strategic objectives, in the first quarter of 2005, we made a definitive decision to divest the General Services Group ("GSG"), non-core service operations which provide online repair and other third-party services, and we engaged an investment banking firm to commence marketing. As a result, we reclassified the group to discontinued operations in the first quarter of 2005. Sales for GSG were \$103 million and \$116 million in 2005 and 2004, respectively. We performed an impairment analysis of GSG at March 31, 2005 on a held for sale basis and, after the allocation of goodwill, we recognized an impairment charge of \$5.9 million during the first quarter of 2005. The initial estimated fair value at March 31, 2005 was based upon investment banker's valuation of GSG's estimated fair value as well as initial bids received from potential purchasers. As the year progressed, the number of potential buyers diminished to one potential purchaser and the business underperformed due to the pending sale. As a result, the lone bidder reduced its initial offer and accordingly, we recognized additional impairment charges aggregating approximately \$24.2 million throughout 2005, of which \$0 and \$17.6 million were recorded in the second and third quarters, respectively, for total impairment charges in 2005 of \$30.1 million. GSG was sold on December 31, 2005 for approximately \$16 million in gross cash proceeds, including \$2 million held in escrow pending final settlement, subject to final working capital adjustments that remain under negotiation, while retaining approximately \$12 million of net accounts receivable. We used approximately \$11 million of the net cash proceeds to reduce our outstanding indebtedness in January 2006.

For further discussion of other recent developments, see "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations." included in our 2005 Annual Report.

RESULTS OF OPERATIONS – Three and Nine Months ended September 30, 2005 and 2004**Consolidated Results****Bookings, Sales and Backlog**

(Amounts in millions)	Three Months Ended September 30,	
	2005	2004
Bookings	\$ 794.2	\$ 664.7
Sales	649.5	623.4
Backlog	994.9	896.6

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(Amounts in millions)	Nine Months Ended September 30,	
	2005	2004
Bookings	\$ 2,230.1	\$ 1,997.7
Sales	1,956.8	1,818.8
Backlog	994.9	896.6

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, 2005 increased by \$123.1 million, or 18.5%, excluding currency benefits of approximately \$6 million, as compared with the same period in 2004. Bookings for the nine months ended September 30, 2005 increased by \$191.5 million, or 9.6%, excluding currency benefits of approximately \$41 million, as compared with the same period in 2004. The increases are primarily attributable to the strong industry conditions across all of our divisions, particularly the oil and gas, power, and chemical industries.

Sales for the three months ended September 30, 2005 increased by \$21.1 million, or 3.4%, excluding currency benefits of approximately \$5 million, as compared with the same period in 2004. Sales for the nine months ended September 30, 2005 increased by \$100.6 million, or 5.5%, excluding currency benefits of approximately \$37 million, as compared with the same period in 2004. Consistent with the increases in bookings, the increases are primarily attributable to strong market conditions across all of our divisions, particularly the engineered pump products and services, improved Russian and Asian valve markets and the oil and gas seal industry.

Net sales to international customers, including export sales from the U.S., were approximately 64% of sales for both the three and nine months ended September 30, 2005 compared with 67% in the same periods in 2004. Weaker non-U.S. currency effects was the primary factor for the increase in 2005.

Backlog represents the accumulation of uncompleted customer orders. Backlog at September 30, 2005 increased by \$152.6 million, or 17.0%, excluding negative currency effects of approximately \$54 million, as compared with September 30, 2004. The backlog increase compared with the prior year resulted from increased bookings during the nine months ended September 30, 2005.

Gross Profit and Gross Profit Margin

(Amounts in millions)	Three Months Ended September 30,	
	2005	2004
Gross profit	\$ 211.2	\$ 189.5
Gross profit margin	32.5%	30.4%

(Amounts in millions)	Nine Months Ended September 30,	
	2005	2004
Gross profit	\$ 625.1	\$ 554.1
Gross profit margin	31.9%	30.5%

Gross profit margin of 32.5% for the three months ending September 30, 2005 increased from 30.4% for the same period in 2004. Gross profit margin of 31.9% for the nine months ending September 30, 2005 increased from 30.5% for the same period in 2004. The increases are a result of increased sales of engineered parts and services, which generally have a higher margin, by our Flowserve Pump Divisions and cost savings achieved through our Continuous Improvement Process ("CIP") initiative.

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

	Three Months Ended September 30,	
(Amounts in millions)	2005	2004
SG&A expense	\$ 156.4	\$ 146.3
SG&A expense as a percentage of sales	24.1%	23.5%

	Nine Months Ended September 30,	
(Amounts in millions)	2005	2004
SG&A expense	\$ 488.1	\$ 428.5
SG&A expense as a percentage of sales	24.9%	23.6%

SG&A for the three months ended September 30, 2005 increased by \$9.0 million, or 6.2%, excluding currency effects of approximately \$1 million, as compared with the same period in 2004. The increase in SG&A is due primarily to an increase in professional fees of \$5.5 million generally related to audit and tax consulting fees. In addition, we had an increase in employee-related costs of \$2.9 million, which includes sales commissions, incentive compensation and equity incentive programs (\$1.1 million) and severance and transition expenses (\$1.0 million).

SG&A for the nine months ended September 30, 2005 increased by \$52.0 million, or 12.1%, excluding currency effects of approximately \$8 million, as compared with the same period in 2004, due primarily to increases in employee related costs and professional fees. Employee-related costs increased by \$31.1 million, which includes sales commissions, incentive compensation and equity incentive programs (\$11.3 million), severance and transition expenses (\$3.9 million) and modification of stock option expiration terms for former executives, current and former employees and board of directors (\$6.2 million). Professional fees increased primarily due to an increase of \$12.4 million in audit fees and \$12.8 million in fees related to tax consulting, accounting and internal audit assistance. These were partially offset by a \$10.0 million decrease in legal fees and expenses.

Operating Income

	Three Months Ended September 30,	
(Amounts in millions)	2005	2004
Operating income	\$ 54.8	\$ 43.2
Operating income as a percentage of sales	8.4%	6.9%

	Nine Months Ended September 30,	
(Amounts in millions)	2005	2004
Operating income	\$ 136.9	\$ 125.6
Operating income as a percentage of sales	7.0%	6.9%

Operating income for the three months ended September 30, 2005 increased by \$10.8 million, or 25.0%, excluding currency benefits of approximately \$1 million, as compared with the same period in 2004. Operating income for the nine months ended September 30, 2005 increased by \$6.9 million, or 5.5%, excluding currency benefits of approximately \$4 million, as compared with the same period in 2004. The increases are primarily a result of the increase in gross profit discussed above, partially offset by the increase in SG&A discussed above.

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Interest Expense, Interest Income and Loss on Repayment of Debt

(Amounts in millions)	Three Months Ended September 30,	
	2005	2004
Interest expense	\$ (19.0)	\$ (21.0)
Interest income	1.3	0.7
Loss on early extinguishment of debt	(27.9)	(1.0)

(Amounts in millions)	Nine Months Ended September 30,	
	2005	2004
Interest expense	\$ (58.9)	\$ (60.6)
Interest income	2.8	1.2
Loss on early extinguishment of debt	(27.7)	(1.0)

Interest expense for the three months ended September 30, 2005 decreased by \$2.0 million as compared with the same period in 2004. Interest expense for the nine months ended September 30, 2005 decreased by \$1.7 million, as compared with the same period in 2004. The decreases are primarily attributable to the refinancing of our 12.25% Senior Subordinated Notes with the proceeds of borrowings under our New Credit Facilities. Approximately 37.9% of our debt was at fixed rates at September 30, 2005, including the effects of \$265 million notional interest rate swaps.

Interest income was higher for both the three and nine months ended September 30, 2005 as compared with the same periods in 2004 due to a higher average cash balance in 2005.

For the three and nine months ended September 30, 2005, we recognized \$27.9 million and \$27.7 million, respectively, in expenses related to the write-off of unamortized prepaid financing fees, primarily due to our refinancing. See further discussion of our refinancing in the "Liquidity and Capital Resources" section of this Management's Discussion and Analysis and in Note 7 to our condensed consolidated financial statements included in this Quarterly Report. For the same periods in 2004, we recognized expenses of \$1.0 million, for the write-off of unamortized prepaid financing fees related to optional debt repayments of \$40.0 million.

Other Income (Expense), net

(Amounts in millions)	Three Months Ended September 30,	
	2005	2004
Other income (expense), net	\$ 0.4	\$ (4.0)

(Amounts in millions)	Nine Months Ended September 30,	
	2005	2004
Other income (expense), net	\$ (8.3)	\$ (8.8)

Other expense, net for the three months ended September 30, 2005 decreased by \$4.4 million as compared with the same period in 2004 primarily due to a decrease in foreign currency transaction losses.

Other expense, net for the nine months ended September 30, 2005 decreased by \$0.5 million as compared with the same period in 2004 due to decreases in foreign currency transaction losses, partially offset by increases in unrealized losses on forward exchange contracts.

Tax Expense and Tax Rate

(Amounts in millions)	Three Months Ended September 30,	
	2005	2004
Provision for income tax	\$ 4.5	\$ 10.6
Effective tax rate	46.5%	59.3%

(Amounts in millions)	Nine Months Ended September 30,	
	2005	2004
Provision for income tax	\$ 18.2	\$ 34.8
Effective tax rate	40.5%	61.6%

Our effective tax rate of 46.5% for the three months ended September 30, 2005 decreased from 59.3% for the same period in 2004. Our effective tax rate of 40.5% for the nine months ended September 30, 2005 decreased from 61.6% for the same period in 2004. The decreases are due primarily to the net impact of foreign operations.

Net (Loss) Earnings and (Loss) Earnings Per Share

(Amounts in millions)	Three Months Ended September 30,	
	2005	2004
Income from continuing operations	\$ 5.2	\$ 7.3
Net (loss) earnings	(10.0)	6.4
Net earnings per share from continuing operations — diluted	0.08	0.13
Net (loss) earnings per share — diluted	(0.19)	0.11
Average diluted shares	56.5	55.7

(Amounts in millions)	Nine Months Ended September 30,	
	2005	2004
Income from continuing operations	\$ 26.6	\$ 21.7
Net earnings	4.0	19.8
Net earnings per share from continuing operations — diluted	0.47	0.39
Net earnings per share — diluted	0.07	0.36
Average diluted shares	56.6	55.5

Income from continuing operations for the three months ended September 30, 2005 decreased as compared to the same period in 2004 primarily as a result of the loss on early extinguishment of debt recorded in connection with our refinancing, partially offset by the increase in operating income and decrease in provision for income tax discussed above. The increase in income from continuing operations for the nine months ended September 30, 2005 as compared with the same period in 2004 is a result of the increase in operating income, combined with the decrease in the tax provision discussed above, partially offset by the increase in loss on early extinguishment of debt recorded in conjunction with our refinancing.

The net loss for the three months ended September 30, 2005 was significantly lower than income from continuing operations for the same period. This is primarily attributable to a \$17.6 million impairment recorded in the third quarter of 2005 for assets held for sale, which is included in discontinued operations. Net earnings for the nine months ended September 30, 2005 was significantly lower than income from continuing operations for the same period due primarily to an aggregate \$23.5 million impairment recorded during the period for assets held for sale, which is included in discontinued operations.

Average diluted shares were relatively flat in the first nine months of 2005 compared with the same period in 2004.

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Other Comprehensive Income (Loss)

	Three Months Ended September 30,	
(Amounts in millions)	2005	2004
Other comprehensive income (loss)	\$ 1.9	\$ (1.5)

	Nine Months Ended September 30,	
(Amounts in millions)	2005	2004
Other comprehensive income (loss)	\$ (22.5)	\$ (15.4)

Other comprehensive income (loss) changed from a loss of \$1.5 million for the quarter ended September 30, 2004 to income of \$1.9 million for the quarter ended September 30, 2005 primarily reflecting an increase in unrealized gain on hedging activity partially offset by a strengthening of the Euro and British pound during the three months ended September 30, 2005.

Other comprehensive loss for the nine months ended September 30, 2005 increased \$7.1 million as compared with the same period in 2004, reflecting a strengthening of the Euro and British pound during the nine-month period ended September 30, 2005, as compared with the same period in 2004.

Business Segments

We conduct our business through three business segments that represent our major product areas: Flowserve Pump Division ("FPD") for engineered pumps, industrial pumps and related services; Flow Control Division ("FCD") for industrial valves, manual valves, control valves, nuclear valves, valve actuators and related services; and Flow Solutions Division ("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, distribute and service engineered and industrial pumps and pump systems, replacement parts and related equipment, principally to industrial markets. FPD has 27 manufacturing facilities worldwide, of which nine are located in North America, 11 in Europe, four in South America and three in Asia. FPD also has more than 50 service centers, which are either free standing or co-located in a manufacturing facility. In March 2004, we acquired the remaining 75% interest in TKL, a leading Australian designer, manufacturer and supplier of centrifugal pumps, railway track work products and steel castings. As a result of this acquisition, we strengthened our product offering in the mining industry, broadened our manufacturing capacity in the Asia Pacific region and gained foundry capacity.

	Three Months Ended September 30,	
(Amounts in millions)	2005	2004
Bookings	\$ 436.5	\$ 349.7
Sales	322.0	323.8
Gross profit	90.0	82.9
Gross profit margin	27.9%	25.6%
Operating income	29.0	23.5
Operating income as a percentage of sales	9.0%	7.3%
Backlog	690.9	628.3

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(Amounts in millions)	Nine Months Ended September 30,	
	2005	2004
Bookings	\$ 1,138.6	\$ 1,011.1
Sales	995.1	939.9
Gross profit	268.2	235.7
Gross profit margin	27.0%	25.1%
Operating income	84.4	64.6
Operating income as a percentage of sales	8.5%	6.9%
Backlog	690.9	628.3

Bookings for the three months ended September 30, 2005 increased by \$82.1 million, or 23.5%, excluding currency benefits of approximately \$5 million, as compared with the same period in 2004. All regions contributed to the increased bookings, due to strong market conditions for oil and gas, power, and chemical products.

Bookings for the nine months ended September 30, 2005 increased by \$104.8 million, or 10.4%, excluding currency benefits of approximately \$23 million, as compared with the same period in 2004. Continued improvement in oil and gas, water, and power markets resulted in improved bookings across all regions.

Sales for the three months ended September 30, 2005 decreased by \$5.4 million, or 1.7%, excluding currency benefits of approximately \$4 million, as compared with the same period in 2004. The decrease is due primarily to a number of large projects that were in process during the period and shipped subsequent to September 30, 2005.

Sales for the nine months ended September 30, 2005 increased by \$34.1 million, or 3.6%, excluding currency benefits of approximately \$21 million, as compared with the same period in 2004. The addition of TKL in March 2004 and improved markets for engineered products and services were the primary drivers of the increase.

Gross profit margin of 27.9% for the three months ending September 30, 2005 increased from 25.6% for the same period in 2004 as a result of a more favorable product mix.

Gross profit margin of 27.0% for the nine months ending September 30, 2005 increased from 25.1% for the same period in 2004. The increase is a result of a more profitable product mix and increased sales, which favorably impacts our absorption of fixed costs.

Operating income for the three months ended September 30, 2005 increased by \$5.5 million, or 23.4% as compared with the same period in 2004. Currency had a negligible impact on operating income for the quarter. The improvement was a result of increased gross profit for the period as described above.

Operating income for the nine months ended September 30, 2005 increased by \$17.6 million, or 27.2%, excluding currency benefits of approximately \$2 million, as compared with the same period in 2004. Increased gross profit positively impacted operating income, as described above, partially offset by an increase in SG&A due to increased marketing and information technology costs.

Flow Control Division

Our second largest business segment is FCD, which designs, manufactures and distributes a broad portfolio of industrial valve products, including modulating and finite valves, actuators and controls. FCD leverages its experience and application know-how by offering a complete menu of engineered services to complement its expansive product portfolio. FCD has more than 4,000 employees at its manufacturing and service facilities in 19 countries around the world, with only five of its 22 manufacturing operations located in the U.S.

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(Amounts in millions)	Three Months Ended September 30,	
	2005	2004
Bookings	\$ 250.6	\$ 228.9
Sales	224.7	211.8
Gross profit	72.1	65.1
Gross profit margin	32.1%	30.7%
Operating income	25.3	18.8
Operating income as a percentage of sales	11.3%	8.9%
Backlog	246.5	234.6

(Amounts in millions)	Nine Months Ended September 30,	
	2005	2004
Bookings	\$ 770.3	\$ 725.6
Sales	663.1	616.1
Gross profit	216.0	192.7
Gross profit margin	32.6%	31.3%
Operating income	71.5	53.7
Operating income as a percentage of sales	10.8%	8.7%
Backlog	246.5	234.6

Bookings for the three months ended September 30, 2005 increased by \$21.7 million, or 9.5% as compared with the same period in 2004. Currency had a nominal effect for the period. The increase is primarily attributable to the continued strengthening of key end-markets, most notably the chemical and mining markets in Asia.

Bookings for the nine months ended September 30, 2005 increased by \$32.1 million, or 4.4%, excluding currency benefits of approximately \$13 million as compared with the same period in 2004. This increase is due to higher demand in the industrial and commercial markets and increased project sales, particularly in Asia and Russia.

Sales for the three months ended September 30, 2005 increased by \$12.9 million, or 6.1%, as compared with the same period in 2004. Currency had a nominal effect for the period. The increase in sales is the result of price increases implemented in the latter half of 2004, higher Asian chemical sales and improved U.S. petrochemical and Russian power markets.

Sales for the nine months ended September 30, 2005 increased by \$35.3 million, or 5.7%, excluding currency benefits of approximately \$12 million as compared with the same period in 2004. This increase is a result of the aforementioned continued strengthening of key-end markets, particularly within Asia and Russia, as well as the positive impact of the price increases implemented in the latter half of 2004.

Gross profit margin of 32.1% for the three months ended September 30, 2005 increased from 30.7% for the same period in 2004. Gross profit margin of 32.6% for the nine months ended September 30, 2005 increased from 31.3% for the same period in 2004. The improvements reflect the benefit of operating efficiencies realized as a result of our various initiatives to reduce manufacturing costs and to achieve cost savings via supply chain, offset in part by an increase in the original equipment manufacturer business, which has a comparatively lower margin than the aftermarket business.

Operating income for the three months ended September 30, 2005 increased by \$6.5 million, or 34.6% as compared with the same period in 2004. Currency had a nominal effect for the period. This increase is driven by the improvement in gross profit, while partially offset by higher value of SG&A costs associated with increased headcount and higher information technology costs, although the decrease in SG&A as a percentage of sales contributed 100 basis points to operating margin.

Operating income for the nine months ended September 30, 2005 increased by \$16.4 million, or 30.6%, excluding currency benefits of approximately \$1 million as compared with the same period in 2004. This increase is driven by the improvement in gross profit, offset partially by the aforementioned higher value of SG&A costs associated with increased

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headcount and higher information technology costs, although the decrease in SG&A as a percentage of sales contributed 80 basis points to operating margin.

Flow Solutions Division

Through FSD, we design, manufacture and distribute mechanical seals, sealing systems and parts, and provide related services, principally to industrial markets. FSD has seven manufacturing operations, three of which are located in the U.S. FSD operates 64 QRCs worldwide, including 25 sites in North America, 14 in Europe, and the remainder in South America and Asia. Our ability to manufacture engineered seal products within 72 hours from the customer's request — through design, engineering, manufacturing, testing and delivery — is a significant competitive advantage. Based on independent industry sources, we believe that we are the second largest mechanical seal supplier in the world.

(Amounts in millions)	Three Months Ended September 30,	
	2005	2004
Bookings	\$ 116.5	\$ 98.5
Sales	113.2	95.9
Gross profit	50.0	42.2
Gross profit margin	44.1%	44.0%
Operating income	23.0	18.8
Operating income as a percentage of sales	20.3%	19.6%
Backlog	67.0	46.6

(Amounts in millions)	Nine Months Ended September 30,	
	2005	2004
Bookings	\$ 353.1	\$ 294.0
Sales	327.9	288.6
Gross profit	144.3	126.3
Gross profit margin	44.0%	43.8%
Operating income	65.9	54.5
Operating income as a percentage of sales	20.1%	18.9%
Backlog	67.0	46.6

Bookings for the three months ended September 30, 2005 increased by \$16.8 million, or 17.0%, excluding currency benefits of approximately \$1 million, as compared with the same period in 2004. Bookings for the nine months ended September 30, 2005 increased by \$53.3 million, or 18.1%, excluding currency benefits of approximately \$6 million, as compared with the same period in 2004. The bookings' improvements generally reflect FSD's emphasis on end user business and success in establishing longer-term customer alliance programs. Increased market conditions and a focus on customer service also contributed to the increase.

Sales for the three months ended September 30, 2005 increased by \$16.4 million, or 17.1%, excluding currency benefits of approximately \$1 million, as compared with the same period in 2004. Sales for the nine months ended September 30, 2005 increased by \$34.7 million, or 12.0%, excluding currency benefits of approximately \$5 million, as compared with the same period in 2004. As discussed above, the improved market conditions, combined with heightened levels of service and customer alliance programs have contributed to the sales growth.

Gross profit margin of 44.1% and 44.0% for the three and nine months ending September 30, 2005, respectively, were relatively flat as compared with the same period in 2004.

Operating income for the three months ended September 30, 2005 increased by \$4.2 million, or 22.3%, as compared with the same period in 2004. Currency had a negligible impact on operating income for the quarter. Operating income for the nine months ended September 30, 2005 increased by \$10.3 million, or 18.9%, excluding currency benefits of approximately

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\$1 million, as compared with the same period in 2004. These improvements reflect the benefits of increased sales, as well as the operating efficiencies resulting from our CIP initiative.

LIQUIDITY AND CAPITAL RESOURCES

Cash Flow Analysis

(Amounts in millions)	Nine Months Ended September 30,	
	2005	2004
Net cash flows provided by operating activities	\$ 19.9	\$ 86.8
Net cash flows used by investing activities	(27.7)	(33.9)
Net cash flows used by financing activities	(19.2)	(66.0)

Cash generated by operations and borrowings available under our existing revolving credit facility are our primary sources of short-term liquidity. Our sources of operating cash include the sale of our products and services. Our cash balance at September 30, 2005 was \$35.2 million, as compared with \$63.8 million at December 31, 2004.

Cash flows provided by operating activities in the first nine months of 2005 were \$19.9 million, compared with \$86.8 million in the first nine months of 2004. Working capital, excluding cash, was a use of operating cash flow of \$32.9 million in the first nine months of 2005, compared with a source of \$3.8 million in the prior year period. Working capital for the current period primarily reflects an increase of \$38.8 million in inventories versus the prior year, which corresponds to the increase in business volume and sales activity, and a decrease of \$34.7 million in retirement obligations and other liabilities due primarily to increased funding of pension plans (see below). These were partially offset by a decrease in accounts receivable of \$12.8 million primarily due to improving collections.

We made the following quarterly contributions to our U.S. defined benefit pension plans:

Quarter ending:	2005	2004
	(Amounts in millions)	
March 31	\$ 4.1	\$ 0.2
June 30	7.7	8.1
September 30	32.0	5.3
December 31	1.0	1.7
	\$ 44.8	\$ 15.3

Cash flows used by investing activities in the first nine months of 2005 were \$27.7 million, compared with \$33.9 million in the first nine months of 2004. Cash outflows in 2005 and 2004 were due primarily to capital expenditures, as well as the acquisition of TKL in March 2004 (described below).

Cash flows used by financing activities in the first nine months of 2005 were \$19.2 million, compared with \$66.0 million in the first nine months of 2004. Cash outflows in both periods were primarily due to net payments of long-term debt.

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.

We have a substantial number of outstanding stock options granted in past years to employees under our stock option plans which have been unexercisable for an extended period due to our non-current filing status of all our SEC financial reports. These outstanding options include options for 809,667 shares held by our former Chairman, President and Chief Executive Officer, C. Scott Greer. Given the significant increase in our share price during the period in which optionees have been unable to exercise their options, it is possible that many holders may want to exercise soon after they are first able to do so. We will reopen our stock option exercise program and allow optionees to exercise their options once we become current.

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with our SEC financial reporting obligations and have registered the issuance of our common shares upon exercise of such stock options with the SEC. We currently expect this to occur in 2006. If the holders of a large number of these options promptly exercise following such reopening, there would be some dilutive impact on our earnings per share. We anticipate that a significant number of stock option exercises at one time would positively impact our cash flow, however, we are still evaluating the extent of such impact and alternatives to satisfy our obligation under the stock option program, up to and including repurchasing shares on the market to offset some or all of the dilutive impact on our earnings per share which could negatively impact our cash flow. The impacts on our cash flow and earnings per share are dependent upon share price, number of shares and strike price of shares exercised.

Acquisitions

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.

In March 2004, we acquired the remaining 75% interest in TKL for approximately \$12 million. We paid for the acquisition with cash generated by operations. Prior to the acquisition, we held a 25% interest in TKL. As a result of this acquisition, we strengthened our product offering in the mining industry, broadened our manufacturing capacity in the Asia Pacific region and gained foundry capacity.

Capital Expenditures

Capital expenditures were \$25.5 million for the nine months ended September 30, 2005 compared with \$28.5 million for the same period in 2004. Capital expenditures were funded primarily by operating cash flows. Capital expenditures in 2005 focused on new product development, information technology infrastructure and cost reduction opportunities. Capital expenditures in 2004 were invested in new and replacement machinery and equipment and information technology. For the full year 2005, our capital expenditures were approximately \$49 million. Certain of our facilities may face capacity constraints in the foreseeable future, which may lead to higher capital expenditure levels.

We received cash on disposal of a divestiture of a small distribution business of \$3.6 million in the first quarter of 2004.

Financing

New Credit Facilities

On August 12, 2005, we entered into New 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. We used the proceeds of borrowings under our New Credit Facilities to refinance our 12.25% Senior Subordinated Notes and indebtedness outstanding under our 2000 Credit Facilities. Further, we replaced the letter of credit agreement that guaranteed our EIB credit facility (described below) with a letter of credit issued as part of the New Credit Facilities.

Borrowings under our New 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 New 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 December 31, 2005 was 1.75% for LIBOR borrowings.

The loans under our New Credit Facilities are subject to mandatory repayment with, in general:

- 100% of the net cash proceeds of asset sales; and
- Unless we attain and maintain investment grade credit ratings:
 - 75% of our excess cash flow, subject to a reduction based on the ratio of our total debt to consolidated EBITDA;
 - 50% of the proceeds of any equity offerings; and
 - 100% of the proceeds of any debt issuances (subject to certain exceptions).

We may prepay loans under our New Credit Facilities in whole or in part, without premium or penalty. During the fourth quarter of 2005, we made scheduled and optional principal payments of \$1.5 million and \$38.4 million, respectively.

EIB Credit Facility

On April 14, 2004, we and one of our European subsidiaries, Flowserve B.V., entered into an agreement with EIB, pursuant to which EIB agreed to loan us up to €70 million, with the ability to draw funds in multiple currencies, to finance in part specified research and development projects undertaken by us in Europe. Borrowings under the EIB credit facility bear interest at a fixed or floating rate of interest agreed to by us and EIB with respect to each borrowing under the facility. Loans under the EIB credit facility are subject to mandatory repayment, at EIB's discretion, upon the occurrence of certain events, including a change of control or prepayment of certain other indebtedness. In addition, the EIB credit facility contains covenants that, among other things, limit our ability to dispose of assets related to the financed project and require us to deliver to EIB our audited annual financial statements within 30 days of publication. Our obligations under the EIB credit facility are guaranteed by a letter of credit outstanding under our New Credit Facilities.

In August 2004, we borrowed \$85 million at a floating interest rate based on 3-month U.S. LIBOR that resets quarterly. As of September 30, 2005, the interest rate was 3.80%. The maturity of the amount drawn is June 15, 2011, but may be repaid at any time without penalty. Concurrent with borrowing the \$85 million we entered into a derivative contract with a third party financial institution, swapped this principal amount to €70.6 million and fixed the LIBOR portion of the interest rate to a fixed interest rate of 4.19% through the scheduled repayment date. Additional discussion of the derivative, is included in Note 6 to our condensed consolidated financial statements, included in this Quarterly Report.

Additional discussion of our New Credit Facilities, EIB credit facility and 2000 Credit Facilities, is included in Note 7 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 the credit facilities discussed above. These agreements are more fully described in "Item 3. Quantitative and Qualitative Disclosures about Market Risk."

Accounts Receivable Securitization

In October 2004, one of our wholly owned subsidiaries entered into an accounts receivable securitization whereby we could obtain up to \$75 million in financing by securitizing certain U.S.-based receivables with a third party. In October 2005, we terminated this accounts receivable securitization facility. In connection with the termination, we borrowed approximately \$48 million under our New Credit Facilities to repurchase our receivables then held by such third party. See additional discussion of our accounts receivable securitization program in Note 7 to our condensed consolidated financial statements included in this Quarterly Report.

2000 Credit Facilities

On August 8, 2000, we entered into senior credit facilities comprised of a \$275.0 million Tranche A term loan, a \$475.0 million Tranche B term loan and a \$300.0 million revolving line of credit, hereinafter collectively referred to as our "2000 Credit Facilities." In connection with our acquisition of Invensys' flow control division in May 2002, we amended and restated our 2000 Credit Facilities to provide for (1) an incremental \$95.3 million Tranche A term loan and (2) a \$700.0 million Tranche C term loan. The proceeds of the incremental Tranche A term loan and the Tranche C term loan were used to finance a portion of the acquisition purchase price and to repay in full the Tranche B term loan.

Borrowings under our 2000 Credit Facilities bore interest at a rate equal to, at our option, either (1) the base rate (which was based on the prime rate most recently announced by the administrative agent under our 2000 Credit Facilities or the Federal Funds rate plus 0.50%) or (2) London Interbank Offered Rate ("LIBOR"), plus, in the case of Tranche A term loan and loans under the revolving line of credit, an applicable margin determined by reference to the ratio of our total debt to consolidated EBITDA, and, in the case of Tranche C term loan, an applicable margin based on our long-term debt ratings.

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Amounts outstanding under the 2000 Credit Facilities were repaid in August 2005 using the proceeds from the New Credit Facilities.

Senior Subordinated Notes

At September 30, 2005, we had no amounts outstanding on our Senior Subordinated Notes. The Senior Subordinated Notes were originally issued in 2000 at a discount to yield 12.5%, but have a coupon interest rate of 12.25%. Interest on these notes was payable semi-annually in February and August. In August 2005, all remaining Senior Subordinated Notes outstanding were called by us at 106.125% of face value as specified in the loan agreement and repaid, along with accrued interest.

Debt Covenants and Other Matters

Our 2000 Credit Facilities that have now been refinanced, the letter of credit facility guaranteeing our obligations under the EIB credit facility, and the agreements governing our domestic receivables program each required us to deliver to creditors thereunder our audited annual consolidated financial statements within a specified number of days following the end of each fiscal year. In addition, the indentures governing our 12.25% Senior Subordinated Notes required us to timely file with the SEC our annual and quarterly reports. As a result of the restatement of our prior period financial statements as disclosed in our 2004 Annual Report and the new obligations regarding internal controls attestation under Section 404, we did not timely issue our financial statements for the year ended December 31, 2004 and 2005 and the quarterly periods ended June 30, 2004, September 30, 2004, March 31, 2005, June 30, 2005, September 30, 2005 and March 31, 2006, and were unable to timely file with the SEC our Annual Report on Form 10-K and Quarterly Reports on Form 10-Q for such periods. Prior to the refinancing of our 2000 Credit Facilities and the replacement of the standby letter of credit facility, we obtained waivers thereunder extending the deadline for the delivery of our financial statements to the lenders under our 2000 Credit Facilities and the letter of credit facility guaranteeing the EIB credit facility and, as a result of obtaining such waivers, we were not in default as a result of the delay in the delivery of our financial statements. We did not seek or obtain a waiver under the indentures governing our 12.25% Senior Subordinated Notes with respect to our inability to timely file with the SEC the required reports and, prior to the refinancing of our 12.25% Senior Subordinated Notes, were in default thereunder.

Our New Credit Facilities contain covenants requiring us to deliver to lenders leverage and interest coverage financial covenants and our audited annual and unaudited quarterly financial statements. Under the leverage covenant, the maximum permitted leverage ratio steps down beginning with the fourth quarter of 2006, with a further step-down beginning with the fourth quarter of 2007. Under the interest coverage covenant, the minimum required interest coverage ratio steps up beginning with the fourth quarter of 2006, with a further step-up beginning with the fourth quarter of 2007. Compliance with these financial covenants under our New Credit Facilities is tested quarterly, and we have complied with the financial covenants as of December 31, 2005. Further, we are required to furnish within 50 days of the end of each of the first three quarters of each year our consolidated balance sheet, and related statements of operations, shareholders' equity and cash flows.

Our New Credit Facilities also contain covenants restricting our and our subsidiaries' ability to dispose of assets, merge, pay dividends, repurchase or redeem capital stock and indebtedness, incur indebtedness and guarantees, create liens, enter into agreements with negative pledge clauses, make certain investments or acquisitions, enter into sale and leaseback transactions, enter into transactions with affiliates, make capital expenditures, engage in any business activity other than our existing business or any business activities reasonably incidental thereto. With the waiver for delivery of the December 31, 2004 audited financial statements, we are currently in compliance with all debt covenants under the New Credit Facilities.

CONTRACTUAL OBLIGATIONS AND COMMERCIAL COMMITMENTS

The following table presents a summary of our contractual obligations at September 30, 2005:

(Amounts in millions)	Payments Due By Period				
	Remainder of 2005	2006 – 2007	2008 – 2009	2010 & Beyond	Total
Long-term debt	\$ 1.5	\$ 12.0	\$ 12.0	\$659.5	\$685.0
Fixed interest payments (1)	1.5	13.1	10.4	7.5	32.5
Variable interest payments (2)	8.6	68.1	67.0	76.6	220.3
Capital lease obligations	0.2	0.4	—	—	0.6
Operating leases	4.7	29.5	16.1	19.3	69.6
Purchase obligations: (3)					
Inventory	189.7	0.6	0.0	—	190.3
Non-inventory	11.6	1.0	0.4	—	13.0

- (1) Fixed interest payments include payments on fixed and synthetically fixed rate debt.
- (2) Variable interest payments under our New Credit Facilities were estimated using a base rate of three-month LIBOR as of September 30, 2005.
- (3) Purchase obligations are presented at the face value of the purchase order, excluding the effects of early termination provisions. Actual payments could be less than amounts presented herein.

The following table presents a summary of our commercial commitments at September 30, 2005:

(Amounts in millions)	Commitment Expiration By Period				
	Remainder of 2005	2006 – 2007	2008 – 2009	2010 & Beyond	Total
Letters of credit	\$ 53.3	\$ 250.9	\$ 18.6	\$ 1.3	\$324.1
Surety bonds	2.3	27.8	1.1	—	31.2

We expect to satisfy these commitments through performance under our contracts.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Management's discussion and analysis are based on our condensed consolidated financial statements and related footnotes contained within this report. Our more critical accounting policies used in the preparation of the consolidated financial statements were discussed in our 2005 Annual Report. These critical policies, for which no significant changes have occurred in the nine months of 2005, include:

- Revenue Recognition;
- Allowance for Doubtful Accounts;
- Inventories and Related Reserves;
- Deferred Taxes and Tax Valuation Allowances;
- Tax Reserves;
- Restructuring and Integration Expense;
- Legal and Environmental Accruals;
- Warranty Accruals;
- Retirement and Postretirement Benefits; and
- Valuation of Goodwill, Indefinite-Lived Intangible Assets and Other Long-Lived Assets.

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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 financial position 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 position, results of operations and cash flows in future periods.

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 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 our Audit Committee.

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.

Forward-Looking Information is Subject to Risk and Uncertainty

This Quarterly Report and other written reports and oral statements we make from time-to-time contain various “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, Section 21E of the Securities Exchange Act of 1934 and the Private Securities Litigation Reform Act of 1995 and include assumptions about our future financial and market conditions, operations and results. In some cases forward looking statements can be identified by terms such as “may,” “will,” “should,” “expect,” “plans,” “seeks,” “anticipate,” “believe,” “estimate,” “predicts,” “potential,” “continue,” “intends,” or other comparable terminology. These statements are not historical facts or guarantees of future performance but instead are based on current expectations and are subject to significant risks, uncertainties and other factors, many of which are outside of our control. Among the many factors that could cause actual results to differ materially from the forward-looking statements are:

- we have material weaknesses in our internal control over financial reporting;
- continuing delays in our filing of our periodic public reports and any SEC, New York Stock Exchange or debt rating agencies’ actions resulting therefrom;
- the possibility of adverse consequences of the pending securities litigation and on-going SEC investigations;
- we may be exposed to product liability and warranty claims if the use of our products results, or is alleged to result, in bodily injury and/or property damage or our products fail to perform as expected;
- the possibility of adverse consequences of governmental tax audits of our tax returns, including the IRS audit of our U.S. tax returns for the years 2002 through 2004;
- there are a substantial amount of outstanding stock options which have been unexercisable for an extended period due to our non-current filing status of all our SEC financial reports. Given the significant increase in our share price during this exercise unavailability period, it is possible that many holders may want to exercise promptly when first able to do so. We currently expect to allow stock options to be exercised in late 2006. If the holders of a large number of these shares do then promptly exercise once they are able to do so, there would be some dilutive impact on the outstanding shares. We are still evaluating the impact of the reopening the stock option exercise program on our cash flows;
- the costs of energy, metal alloys, nickel and other raw materials have increased and our operating margins and results of operations could be adversely affected if we are unable to pass such increases on to our customers;
- all of our bookings may not lead to completed sales, therefore we may not be able to convert bookings into revenues at acceptable, if any, profit margins, since such profit margins cannot be assured nor be necessarily assumed to follow historical trends;
- our business depends on the levels of capital investment and maintenance expenditures by our customers, which in turn are affected by the cyclical nature of their markets and liquidity;
- work stoppages and other labor matters could adversely impact our business;
- changes in the financial markets and the availability of capital could adversely impact our business operations;
- we sell our products in highly competitive markets, which puts pressure on our profit margins and limits our ability to maintain or increase the market share of our products;
- we may not be able to continue to expand our market presence through acquisitions, and any future acquisitions may present unforeseen integration difficulties or costs;
- a substantial portion of our operations is conducted and located outside of the U.S. and economic, political and other risks associated with international operations could adversely affect our business in the U.S. and other countries and regions;
- our ability to comply with the laws and regulations affecting our international operations, including the U.S. export laws, and the effect of any noncompliance;
- political risks, military actions or trade embargoes affecting customer markets, including the continuing conflict in Iraq and its potential impact on Middle Eastern markets and global petroleum producers;

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- our sales are substantially dependent upon the petroleum, chemical, power and water industries and any down turn in these industries could adversely impact such sales;
- a substantial portion of our business consists of international operations and therefore an adverse movement in currency exchange rates could adversely impact our profits;
- we operate and manage our business on a number of different computer systems, including several aging Enterprise Resource Planning systems that rely on manual processes, which could adversely affect our ability to accurately report our financial condition, results of operations and cash flows;
- our relative geographical profitability and its impact on our ability to utilize foreign tax credits;
- the recognition of significant expenses associated with realigning operations of acquired companies with those of our company;
- our ability to meet the financial covenants and other restrictive covenants in our debt agreements may limit our operating and financial flexibility;
- the loss of services of any of our key personnel could adversely affect our ability to implement our business strategy;
- any terrorist attacks and the response of the U.S. to such attacks or to the threat of such attacks could adversely impact our business operations, including the ability to deliver our products;
- our ability to protect our intellectual property affects our competitive position;
- changes in prevailing interest rates and our effective interest costs could make borrowing more costly in the future; and
- compliance with regulatory and other legal obligations could require substantial costs and prohibit or restrict our operations.

A detailed discussion of these and other risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included in “Item 1A. Risk Factors.” of our 2005 Annual Report, filed with the SEC on June 30, 2006. It is not possible to foresee or identify all the factors that may affect our future performance or any forward-looking information, and new risk factors can emerge from time to time. Given these risks and uncertainties, you should not place undue reliance on forward-looking statements as a prediction of actual results.

All forward-looking statement included in this Quarterly Report are based on information available to us on the date of this Quarterly Report. We undertake no obligation to revise or update any forward-looking statement or disclose any facts, events or circumstances that occur after the date hereof that may affect the accuracy of any forward-looking statement.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

We have market risk exposure arising from changes in interest rates and foreign currency exchange rate movements.

Our earnings are impacted by changes in short-term interest rates as a result of borrowings under our 2000 Credit Facilities, which bear interest based on floating rates. At September 30, 2005, after the effect of interest rate swaps, we have approximately \$420.0 million of variable rate debt obligations outstanding with a weighted average interest rate of 5.8%. A hypothetical change of 100-basis points in the interest rate for these borrowings, assuming constant variable rate debt levels, would have changed interest expense by approximately \$3.2 million for the nine months ended September 30, 2005.

We are exposed to credit-related losses in the event of non-performance by counterparties to financial instruments including interest rate swaps, but we expect all counterparties to meet their obligations given their creditworthiness. As of September 30, 2005, we have \$265 million of notional amount in outstanding interest rate swaps with third parties with maturities through June 2011 compared to \$210 million as of the same period in 2004.

We employ a foreign currency hedging strategy to minimize potential losses in earnings or cash flows from unfavorable foreign currency exchange rate movements. These strategies also minimize potential gains from favorable exchange rate movements. Foreign currency exposures arise from transactions, including firm commitments and anticipated transactions, denominated in a currency other than an entity's functional currency and from foreign-denominated revenues and profits translated back into U.S. dollars. Based on a sensitivity analysis at September 30, 2005, a 10% adverse change in the foreign currency exchange rates could impact our results of operations for the nine months ended September 30, 2005 by \$7.7 million as shown below:

(Amounts in millions)	
Euro	\$ 2.4
Swiss franc	0.9
Canadian dollar	0.7
Singapore dollar	0.7
Indian rupee	0.6
Venezuelan bolivar	0.5
Australian dollar	0.3
British pound	0.3
Mexican peso	0.3
Argentina peso	0.3
Brazil real	0.3
All other	0.4
Total	<u>\$ 7.7</u>

Exposures are hedged primarily with foreign currency forward contracts that generally have maturity dates less than one year. Company policy allows foreign currency coverage only for identifiable foreign currency exposures and, therefore, we do not enter into foreign currency contracts for trading purposes where the objective would be to generate profits. As of September 30, 2005, we have a U.S. dollar equivalent of \$210.5 million in outstanding forward contracts with third parties compared with \$83.4 million at September 30, 2004.

Generally, we view our investments in foreign subsidiaries from a long-term perspective, and therefore, do not hedge these investments. We use capital structuring techniques to manage our investment in foreign subsidiaries as deemed necessary.

We realized gains (losses) associated with foreign currency translation of \$0.7 million and \$3.4 million for the three months ended September 30, 2005 and 2004, respectively, and \$(24.5) million and \$(11.0) million for the nine months ended September 30, 2005 and 2004, respectively, which are included in other comprehensive income (loss). Transactional currency gains and losses arising from transactions outside of our sites' functional currencies and changes in fair value of forward contracts that do not qualify for hedge accounting are included in our consolidated results of operations. We realized foreign currency losses of \$(1.0) million and \$4.6 million for the three months ended September 30, 2005 and 2004, respectively, and

\$8.2 million and \$10.4 million for the nine months ended September 30, 2005 and 2004, respectively, which is included in other (income) expense, net in the accompanying consolidated statements of operations. The currency losses in 2005 compared with 2004 reflect strengthening of the Euro and the Singapore dollar versus the U.S. dollar.

Item 4. Controls and Procedures.

Disclosure Controls and Procedures

Disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) are controls and other procedures that are designed to provide reasonable assurance that the information that we are required to disclose in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

In connection with the preparation of this Quarterly Report, our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as of September 30, 2005. In making this evaluation, our management considered the matters relating to the material weaknesses described in our 2004 Annual Report and our 2005 Annual Report. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were not effective at the reasonable assurance level as of September 30, 2005.

A material weakness is a control deficiency, or combination of control deficiencies, that result in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. As more fully described in “Management’s Report on Internal Control Over Financial Reporting” in Item 9A of our 2004 Annual Report, management identified the following material weaknesses in our internal control over financial reporting as of December 31, 2004, which also existed as of September 30, 2005:

We did not maintain (1) an effective control environment, (2) effective monitoring controls to determine the adequacy of its internal control over financial reporting and related policies and procedures, (3) effective controls over certain of our period-end financial close and reporting processes, (4) effective segregation of duties over automated and manual transaction processes, (5) effective controls over the preparation, review and approval of account reconciliations, (6) effective controls over the complete and accurate recording and monitoring of intercompany accounts, (7) effective controls over the recording of journal entries, both recurring and non-recurring, (8) effective controls over the existence, completeness and accuracy of fixed assets and related depreciation and amortization expense, (9) effective controls over the completeness and accuracy of revenue, deferred revenue, accounts receivable and accrued liabilities, (10) effective controls over the completeness, accuracy, valuation and existence of our inventory and related cost of sales accounts, (11) effective controls over the completeness and accuracy of our reporting of certain non-U.S. pension plans, (12) effective controls over the complete and accurate recording of rights and obligations associated with our accounts receivable factoring and securitization transactions, (13) effective controls over our accounting for certain derivative transactions, (14) effective controls over our accounting for equity investments, (15) effective controls over our accounting for income taxes, including income taxes payable, deferred income tax assets and liabilities and the related income tax provision, (16) effective controls over our accounting for mergers and acquisitions, (17) effective controls over the completeness and accuracy of certain accrued liabilities and the related operating expense accounts, (18) effective controls over the completeness, accuracy and validity of payroll and accounts payable disbursements to ensure that they were adequately reviewed and approved prior to being recorded and reported, (19) effective controls over the completeness, accuracy and validity of spreadsheets used in our financial reporting process to ensure that access was restricted to appropriate personnel, and that unauthorized modification of the data or formulas within spreadsheets was prevented, and (20) effective controls over the accuracy, valuation and disclosure of our goodwill and intangible asset accounts and the related amortization and impairment expense accounts, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”).

As more fully described in “Management’s Report on Internal Control Over Financial Reporting” included in Item 9A of our 2005 Annual Report, management identified the following material weakness in our internal control over financial reporting as of December 31, 2005, which also existed as of September 30, 2005: we did not maintain

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effective controls over the completeness, accuracy and valuation of stock-based employee compensation expense, based on criteria established in *Internal Control — Integrated Framework* issued by COSO.

In light of the material weaknesses identified above, we performed additional analyses and other procedures to ensure that our unaudited condensed consolidated financial statements included in this Quarterly Report were prepared in accordance with GAAP. As a result of these procedures, we believe that the unaudited condensed consolidated financial statements included in this Quarterly Report present fairly, in all material respects, our financial position, results of operations and cash flows for the periods presented in conformity with GAAP.

Plan for Remediation of Material Weaknesses

In response to the identified material weaknesses, our management, with oversight from our audit committee, has dedicated significant resources, including the engagement of external consultants, to support management in its efforts to improve our control environment and to remedy the identified material weaknesses. As more fully described in our 2004 Annual Report, the ongoing remediation efforts subsequent to December 31, 2004 are focused on (i) expanding our organizational capabilities to improve our control environment; (ii) implementing process changes to strengthen our internal control and monitoring activities; and (iii) implementing adequate information technology general controls.

We believe that these remediation efforts will continue to improve our internal control over financial reporting, as well as our disclosure controls and procedures. However, not all of the material weaknesses described above were remediated by December 31, 2005, our next reporting “as of” date under Section 404. Our management, with the oversight of our audit committee, will continue to take steps to remedy known material weaknesses as expeditiously as possible.

Changes in Internal Control over Financial Reporting

There have been no material changes in our internal control over financial reporting during the three months ended September 30, 2005 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings.

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. Any such products were encapsulated and used only as components of process equipment, and we do not believe that any emission of respirable asbestos fibers occurred during the use of this equipment. We believe that a high percentage of the applicable claims are covered by applicable insurance or indemnities from other companies.

On February 4, 2004, we received an informal inquiry from the SEC requesting the voluntary production of documents and information related to our February 3, 2004 announcement that we would restate our financial results for the nine months ended September 30, 2003 and the full years 2002, 2001 and 2000. On June 2, 2004, we were advised that the SEC had issued a formal order of private investigation into issues regarding this restatement and any other issues that arise from the investigation. On May 31, 2006, we were informed by the staff of the SEC that it had concluded this investigation without recommending any enforcement action against us.

During the quarter ended September 30, 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. Hombaker, 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. Hombaker 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. The case is currently set for trial on March 27, 2007. We continue to believe that the lawsuit is without merit and are vigorously defending the case.

On October 6, 2005, a shareholder derivative lawsuit was filed purportedly on our behalf in the 193rd Judicial District of Dallas County, Texas. The lawsuit names as defendants Mr. Greer, Ms. Hombaker, 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 are named as a nominal defendant. Based primarily on the purported misstatements alleged in the above-described federal securities case, the plaintiff asserts claims against the defendants for breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment. The plaintiff alleges 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 have filed a motion seeking dismissal of the case.

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 names as defendants Mr. Greer, Ms. Hombaker, and current board members Mr. Coble, Mr. Haymaker, Jr., Lewis M. Kling, Mr. Rusnack, Mr. Johnston, Mr. Rampacek, Mr. Sheehan, Ms. Harris, Mr. Rollans and Mr. Bartlett. We are named as a nominal defendant. Based primarily on certain of the purported misstatements alleged in the above-described federal securities case, the plaintiff asserts claims against the defendants for breaches of fiduciary duty. The plaintiff alleges that the purported breaches of fiduciary duty occurred between 2000 and 2004. The plaintiff seeks on our behalf an unspecified amount of damages, disgorgement by Mr. Greer and Ms. Hombaker of salaries, bonuses, restricted stock and stock options, and recovery of attorneys’ fees and costs. We strongly believe that the suit was improperly filed and have filed a motion seeking dismissal of the case.

On February 7, 2006, we received a subpoena from the SEC regarding goods and services that certain foreign subsidiaries delivered to Iraq from 1996 through 2003 during the United Nations Oil-for-Food program. This investigation

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includes a review of whether any inappropriate payments were made to Iraqi officials in violation of the Foreign Corrupt Practices Act. The investigation includes periods prior, to as well as subsequent to our acquisition of the foreign operations involved in the investigation. We may be subject to liabilities if violations are found regardless of whether they relate to periods before or subsequent to our acquisition.

In addition, one of our foreign subsidiary's operations is cooperating with a foreign governmental investigation of that site's involvement in the United Nations Oil-for-Food program. This cooperation has included responding to an investigative trip by foreign authorities to the foreign subsidiary's site, providing relevant documentation to these authorities and answering their questions. We are unable to predict how or if the foreign authorities will pursue this matter in the future.

We believe that both the SEC and foreign authorities are investigating other companies from their actions arising from the United Nations Oil-for-Food program.

We are in the process of reviewing and responding to the SEC subpoena and assessing the implications of the foreign investigation, including the continuation of a thorough internal investigation. Our investigation is in the early stages and has included and will include a detailed review of contracts with the Iraqi government during the period in question and certain payments associated therewith. Additionally, we have and will continue to conduct interviews with employees with knowledge of the contracts and payments in question. We are in the early phases of our internal investigation and as a result are unable to make any definitive determination whether any inappropriate payments were made and accordingly are unable to predict the ultimate outcome of this matter.

We will continue to fully cooperate in both the SEC and the foreign investigations. Both investigations are in progress but, at this point, are incomplete. Accordingly, if the SEC and/or the foreign authorities take enforcement action with regard to these investigations, we may be required to pay fines, consent to injunctions against future conduct or suffer other penalties which could potentially materially impact our business financial statements and cash flows.

In March 2006, we initiated a process to determine our compliance posture with respect to U.S. export control laws and regulations. Upon initial investigation, it appears that some product transactions and technology transfers may not technically been in compliance with U.S. export control laws and regulations and require further review. With assistance from outside counsel, we are currently involved in a systematic process to conduct further review which we believe will take about 18 months to complete given the complexity of the export laws and the scope of the investigation. Any potential violations of U.S. export control laws and regulations that are identified may result in civil or criminal penalties, including fines and/or other penalties. Because our review into this issue is ongoing, we are currently unable to determine the full extent of potential violations or the nature or amount of potential 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 United States, or on our financial condition.

As of May 1, 2005, due to the non-current status of our filings with the SEC in accordance with the Securities Exchange Act of 1934, our Registration Statements on Form S-8 were no longer available to cover offers and sales of securities to our employees and other persons. Since that date, the acquisition of interests in our common stock fund under our 401(k) plan by plan participants may have been subject to the registration requirements of the Securities Act of 1933 or applicable state securities laws and may not have qualified for an available exemption from such requirements. Federal securities laws generally provide for a one-year rescission right for an investor who acquires unregistered securities in a transaction that is subject to registration and for which no exemption was available. As such, an investor successfully asserting a rescission right during the one-year time period has the right to require an issuer to repurchase the securities acquired by the investor at the price paid by the investor for the securities (or if such security has been disposed of, to receive damages with respect to any loss on such disposition), plus interest from the date of acquisition. These rights may apply to affected participants in our 401(k) plan. Based on our current stock price, we believe that our current potential liability for rescission claims is not material to our financial condition or results of operations; however, our potential liability could become material in the future if our stock price were to fall below participants' acquisition prices for their interest in our stock fund during the one-year period following the unregistered acquisitions.

We have been involved as a potentially responsible party ("PRP") at 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.

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. We are also involved in a substantial number of labor claims, including one case where we had a confidential settlement reflected in our 2004 results.

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 probable contingencies, to the extent believed to be reasonably estimable and probable, which we believe to be reasonable 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.

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.

Item 1A. Risk Factors.

There have been no material changes to the risk factors presented in “Item 1A. Risk Factors.” included in our 2005 Annual Report, filed with the SEC on June 30, 2006.

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

As of May 1, 2005, due to the non-current status of our filings with the SEC in accordance with the Securities Exchange Act of 1934, our Registration Statements on Form S-8 were no longer available to cover offers and sales of securities to our employees and other persons. Since that date, the acquisition of interests in our common stock fund under our 401(k) plan by plan participants may have been subject to the registration requirements of the Securities Act of 1933 or applicable state securities laws and may not have qualified for an available exemption from such requirements. Federal securities laws generally provide for a one-year rescission right for an investor who acquires unregistered securities in a transaction that is subject to registration and for which no exemption was available. As such, an investor successfully asserting a rescission right during the one-year time period has the right to require an issuer to repurchase the securities acquired by the investor at the price paid by the investor for the securities (or if such security has been disposed of, to receive damages with respect to any loss on such disposition), plus interest from the date of acquisition. These rights may apply to affected participants in our 401(k) plan and their affected interest in this plan may involve up to 270,000 shares of our common stock acquired pursuant to the 401(k) plan during 2005 and an indeterminate number of shares acquired during 2006. Based on our current stock price, we believe that our current potential liability for rescission claims is not material to our financial condition or results of operations; however, our potential liability could become material in the future if our stock price were to fall below participants’ acquisition prices for their interest in our stock fund during the one-year period following the unregistered acquisitions.

During the third quarter of 2005, we issued an aggregate of 140,800 shares of restricted stock to employees pursuant to the 2004 Stock Compensation Plan. We believe these securities are not subject to registration under the “no sale” principle or were otherwise issued pursuant to exemptions from registration under Section 4(2) of the Securities Act of 1933 as transactions by an issuer not involving a public offering.

Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased (1)	Weighted Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan (2)	Maximum Number of Shares That May Yet Be Purchased Under the Plan (2)
July 1-31, 2005	12,588	\$ 30.74	N/A	N/A
August 1-31, 2005	2,861	35.93	N/A	N/A
September 1-30, 2005	—	—	N/A	N/A
Total	<u>15,449</u>	<u>\$ 31.70</u>	<u>N/A</u>	<u>N/A</u>

- (1) Represents 12,633 shares that were tendered by employees to satisfy minimum tax withholding amounts for restricted stock awards and 2,816 shares of common stock purchased by a rabbi trust that we established in connection with our director deferral plans pursuant to which non-employee directors may elect to defer directors' cash compensation to be paid at a later date in the form of common stock.
- (2) We do not have a publicly announced program for repurchase of shares of our common stock.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Submission of Matters to a Vote of Security Holders.

None.

Item 5. Other Information.

None.

Item 6. Exhibits.

Set forth below is a list of exhibits included as part of this Quarterly Report:

Exhibit No.	Description
3.1	1988 Restated Certificate of Incorporation of The Duriron Company, Inc., filed as Exhibit 3.1 to Flowserve Corporation's (f/k/a The Duriron Company) Annual Report on Form 10-K for the year ended December 31, 1988.
3.2	1989 Amendment to Certificate of Incorporation, filed as Exhibit 3.2 to Flowserve Corporation's Annual Report on Form 10-K for the year ended December 31, 1989.
3.3	1996 Certificate of Amendment of Certificate of Incorporation, filed as Exhibit 3.4 to Flowserve Corporation's Annual Report on Form 10-K for the year ended December 31, 1995.
3.4	April 1997 Certificate of Amendment of Certificate of Incorporation, filed as part of Annex VI to the Joint Proxy Statement/ Prospectus, which is part of Flowserve Corporation's Registration Statement on Form S-4, dated June 19, 1997.
3.5	July 1997 Certificate of Amendment of Certificate of Incorporation, filed as Exhibit 3.6 to Flowserve Corporation's Quarterly Report on Form 10-Q for the quarter ended June 30, 1997.
3.6	Amended and Restated By-Laws of Flowserve Corporation, as amended, filed as Exhibit 3.9 to Flowserve Corporation's Annual Report on Form 10-K for the year ended December 31, 2003.
10.1	Credit Agreement, dated as of August 12, 2005, among the Company, the lenders referred to therein, the Bank of America, N.A., as swingline lender, administrative agent and collateral agent, filed as Exhibit 10.1 to the Company's Current Report on Form 8-K dated as of August 12, 2005.
10.2	Employment Agreement between the Company and Lewis M. Kling, dated July 28, 2005, filed as Exhibit 10.1 to the Company's Current Report on Form 8-K, dated as of July 28, 2005.
31.1	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

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

FLOWERVE CORPORATION
(Registrant)

Date: July 27, 2006

/s/ Lewis M. Kling
Lewis M. Kling
President and Chief Executive Officer

Date: July 27, 2006

/s/ Mark A. Blinn
Mark A. Blinn
Vice President and Chief Financial Officer

Exhibits Index

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**CERTIFICATION BY PRINCIPAL EXECUTIVE OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002**

I, Lewis M. Kling, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Flowserve Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ Lewis M. Kling

Lewis M. Kling
President and Chief Executive Officer

Date: July 27, 2006

**CERTIFICATION BY PRINCIPAL FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002**

I, Mark A. Blinn, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Flowserve Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ Mark A. Blinn

Mark A. Blinn
Vice President and Chief Financial Officer

Date: July 27, 2006

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, Lewis M. Kling, President and Chief Executive Officer of Flowserve Corporation (the "Company"), certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

(1) the quarterly report of the Company on Form 10-Q for the period ended September 30, 2005, as filed with the Securities and Exchange Commission on the date hereof (the "Quarterly Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) the information contained in the Quarterly Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Lewis M. Kling

Lewis M. Kling
President and Chief Executive Officer

Date: July 27, 2006

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, Mark A. Blinn, Vice President and Chief Financial Officer of Flowserve Corporation (the "Company"), certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

(1) the quarterly report of the Company on Form 10-Q for the period ended September 30, 2005, as filed with the Securities and Exchange Commission on the date hereof (the "Quarterly Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) the information contained in the Quarterly Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Mark A. Blinn

Mark A. Blinn
Vice President and Chief Financial Officer

Date: July 27, 2006