DONALDSON CO INC
Form 10-Q
March 04, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED JANUARY 31, 2010**
OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM _________________ TO _________________.**

Commission File Number 1-7891

DONALDSON COMPANY, INC.

(Exact name of registrant as specified in its charter)

Delaware	**41-0222640**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

1400 West 94th Street
Minneapolis, Minnesota 55431
(Address of principal executive offices, including zip code)

Registrant s telephone number, including area code: **(952) 887-3131**

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

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

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

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

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Common Stock, $5 Par Value 77,241,936 shares as of January 31, 2010.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

DONALDSON COMPANY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS

(Thousands of dollars, except share and per share amounts)
(Unaudited)

	Three Months Ended January 31,		Six Months Ended January 31,	
	2010	2009	2010	2009
Net sales	$ 436,122	$ 460,601	$ 864,202	$ 1,033,861
Cost of sales	290,175	326,589	569,855	713,146
Gross margin	145,947	134,012	294,347	320,715
Operating expenses	106,896	106,165	202,852	223,181
Operating income	39,051	27,847	91,495	97,534
Other income, net	(1,281)	(2,574)	(1,801)	(5,678)
Interest expense	2,795	4,728	5,745	9,018
Earnings before income taxes	37,537	25,693	87,551	94,194
Income taxes	6,571	(8,100)	22,016	12,439
Net earnings	$ 30,966	$ 33,793	$ 65,535	$ 81,755
Weighted average shares outstanding	78,087,356	77,861,977	78,066,774	77,930,190
Diluted shares outstanding	79,406,326	78,900,265	79,375,443	79,368,020
Basic earnings per share	$ 0.40	$ 0.43	$ 0.84	$ 1.05
Diluted earnings per share	$ 0.39	$ 0.43	$ 0.83	$ 1.03
Dividends paid per share	$ 0.115	$ 0.115	$ 0.230	$ 0.225

See Notes to Condensed Consolidated Financial Statements.

DONALDSON COMPANY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(Thousands of dollars, except share amounts)
(Unaudited)

	Januar 31, 2010
ASSETS	
Current Assets	
Cash and cash equivalents	$ 180,6
Accounts receivable, less allowance of $6,809 and $7,387	287,9
Inventories	190,2
Prepaids and other current assets	68,3
Total current assets	727,2
Property, plant and equipment, at cost	885,5
Less accumulated depreciation	(514,5
Property, plant and equipment, net	371,0
Goodwill	168,1
Intangible assets, net	62,0
Other assets	45,9
Total Assets	$ 1,374,4
LIABILITIES AND SHAREHOLDERS EQUITY	
Current Liabilities	
Short-term borrowings	$ 25,6
Current maturities of long-term debt	5,5
Trade accounts payable	130,2
Other current liabilities	132,2
Total current liabilities	293,6
Long-term debt	251,7
Deferred income taxes	10,1
Other long-term liabilities	75,6
Total Liabilities	631,1
SHAREHOLDERS EQUITY	
Preferred stock, $1 par value, 1,000,000 shares authorized, no shares issued	
Common stock, $5 par value, 120,000,000 shares authorized, 88,643,194 issued	443,2
Retained earnings	672,5
Stock compensation plans	20,9
Accumulated other comprehensive loss	(11,2
Treasury stock, at cost 11,321,050 and 11,295,409 shares at January 31, 2010, and July 31, 2009, respectively	(382,1
Total Shareholders Equity	743,3
Total Liabilities and Shareholders Equity	$ 1,374,4

See Notes to Condensed Consolidated Financial Statements.

DONALDSON COMPANY, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Thousands of dollars)
(Unaudited)

	Six Months Ended January 31,	
	2010	**2009**
OPERATING ACTIVITIES		
Net earnings	$ 65,535	$ 81,755
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	30,549	29,101
Changes in operating assets and liabilities	(6,696)	(4,242)
Tax benefit of equity plans	(2,375)	(2,182)
Stock compensation plan expense	5,745	3,379
Other, net	(7,487)	(13,993)
Net cash provided by operating activities	85,271	93,818
INVESTING ACTIVITIES		
Net expenditures on property and equipment	(18,121)	(23,251)
Acquisitions, investments and divestitures, net	(250)	(74,626)
Net cash used in investing activities	(18,371)	(97,877)
FINANCING ACTIVITIES		
Purchase of treasury stock	(8,887)	(32,773)
Proceeds from long-term debt		80,560
Repayments of long-term debt	(5,255)	(5,854)
Change in short-term borrowings	(3,743)	(18,817)
Dividends paid	(17,792)	(17,411)
Tax benefit of equity plans	2,375	2,182
Exercise of stock options	3,443	2,494
Net cash provided by / (used in) financing activities	(29,859)	10,381
Effect of exchange rate changes on cash	(122)	(13,650)
Increase (decrease) in cash and cash equivalents	36,919	(7,328)
Cash and cash equivalents - beginning of year	143,687	83,357
Cash and cash equivalents - end of period	$ 180,606	$ 76,029

See Notes to Condensed Consolidated Financial Statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note A Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Donaldson Company, Inc. and subsidiaries (the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America and the instructions to Form 10 Q and Rule 10 01 of Regulation S X. Accordingly, they do not include all of the information and notes required for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included and are of a normal recurring nature. Operating results for the three and six month periods ended January 31, 2010, are not necessarily indicative of the results that may be expected for future periods. The year-end condensed balance sheet data was derived from audited financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America. For further information, refer to the consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended July 31, 2009.

Note B Inventories

The components of inventory as of January 31, 2010, and July 31, 2009, are as follows (thousands of dollars):

	January 31, 2010	July 31, 2009
Materials	$ 68,760	$ 71,518
Work in process	22,611	20,022
Finished products	98,914	88,698
Total inventories	$ 190,285	$ 180,238

Note C Accounting for Stock-Based Compensation

Stock-based employee compensation cost is recognized using the fair-value based method for all awards. The Company determined the fair value of its option awards using the Black-Scholes option pricing model. The following assumptions were used to value the options, including reload options which generally have a shorter contractual life, granted during the six months ended January 31, 2010: range of 16 days to 8 year expected life; expected volatility range of 24.4 percent to 29.7 percent; risk-free interest rate range of 0.01 percent to 3.9 percent; and annual dividend yield of 1.0 percent. The expected life selected for options granted during the period represents the period of time that the options are expected to be outstanding based on the contractual life and historical data of option holder exercise, and termination behavior. Expected volatilities are based upon historical volatility of the Company s stock over a period at least equal to the expected life of each option grant. Option grants are priced at the fair market value of the Company s stock on the date of grant. The weighted average fair value for options granted during the six months ended January 31, 2010, and 2009, was $13.31 per share and $8.54 per share, respectively. For the three months and six months ended January 31, 2010, the Company recorded pretax compensation expense associated with stock options of $5.0 million and $5.3 million, and recorded $1.9 million and $2.0 million of related tax benefit. For the three months and six months ended January 31, 2009, the Company recorded pretax compensation expense associated with stock options of $2.8 million and $3.2 million, and recorded $1.0 million and $1.2 million of related tax benefit.

The following table summarizes stock option activity during the six months ended January 31, 2010:

	Options Outstanding	**Weighted Average Exercise Price**
Outstanding at July 31, 2009	4,998,125	$26.94
Granted	603,443	$42.23
Exercised	(375,417)	$16.48
Canceled	(16,000)	$43.42
Outstanding at January 31, 2010	5,210,151	$29.41

The total intrinsic value of options exercised during the six months ended January 31, 2010, and 2009, was $9.5 million and $6.5 million, respectively.

The following table summarizes information concerning outstanding and exercisable options as of January 31, 2010:

Range of Exercise Prices	**Number Outstanding**	**Weighted Average Remaining Contractual Life (Years)**	**Weighted Average Exercise Price**	**Number Exercisable**	**Weighted Average Exercise Price**
$15 and below	356,242	0.86	$12.88	356,242	$12.88
$15 to $25	1,237,030	2.37	$18.01	1,237,030	$18.01
$25 to $35	2,399,120	5.12	$31.66	2,331,687	$31.62
$35 and above	1,217,759	8.55	$41.41	862,585	$41.23
	5,210,151	4.98	$29.41	4,787,544	$28.44

At January 31, 2010, the aggregate intrinsic value of options outstanding and exercisable was $50.5 million and $50.1 million, respectively.

As of January 31, 2010, there was $4.3 million of total unrecognized compensation cost related to non-vested stock options granted under the 2001 Master Stock Incentive Plan. This unvested cost is expected to be recognized during the remainder of Fiscal Years 2010, 2011, 2012, and 2013.

Note D Net Earnings Per Share

The Company s basic net earnings per share is computed by dividing net earnings by the weighted average number of outstanding common shares. The Company s diluted net earnings per share is computed by dividing net earnings by the weighted average number of outstanding common shares and dilutive shares relating to stock options, restricted stock, and stock incentive plans. Certain outstanding options were excluded from the diluted net earnings per share calculations because their exercise prices were greater than the average market price of the Company s common stock during those periods. For the three and six months ended January 31, 2010, there were 807,296 options and 995,046 options excluded from the diluted net earnings per share calculation, respectively. For the three and six months ended January 31, 2009, there were 1,725,001 options and 440,020 options excluded from the diluted net earnings per share calculation, respectively.

In June 2008, the Financial Accounting Standards Board (FASB) issued new guidance related to earnings per share. This guidance provides that unvested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share (EPS). The Company adopted the guidance in the first quarter of Fiscal 2010 and is required to retrospectively adjust all prior-period EPS data. The resulting impact of the adoption of the guidance was to include 0.1 million unvested restricted shares in the basic weighted average shares outstanding calculation for both the three months and six months ended January 31, 2010, and 2009. This resulted in no change in the Company s basic and diluted EPS as reported in the prior periods presented.

The following table presents information necessary to calculate basic and diluted net earnings per common share (thousands, except per share amounts):

	Three Months Ended January 31,		Six Months Ended January 31,	
	2010	2009	2010	2009
Weighted average shares outstanding – basic	78,087	77,862	78,067	77,930
Diluted share equivalents	1,319	1,038	1,308	1,438
Weighted average shares outstanding diluted	79,406	78,900	79,375	79,368
Net earnings for basic and diluted earnings per share computation	$ 30,966	$ 33,793	$ 65,535	$ 81,755
Net earnings per share basic	$ 0.40	$ 0.43	$ 0.84	$ 1.05
Net earnings per share diluted	$ 0.39	$ 0.43	$ 0.83	$ 1.03

<u>Note E</u> Shareholders Equity

The Company reports accumulated other comprehensive loss as a separate item in the shareholders equity section of the balance sheet.

Total comprehensive income (loss) and its components are as follows (thousands of dollars):

	Three Months Ended January 31,		Six Months Ended January 31,	
	2010	2009	2010	2009
Net earnings	$ 30,966	$ 33,793	$ 65,535	$ 81,755
Foreign currency translation loss	(18,306)	(14,581)	(3,025)	(116,372)
Net gain (loss) on hedging derivatives, net of deferred taxes	197	(396)	314	652
Pension and postretirement liability adjustment, net of deferred taxes	574	(252)	1,144	114
Total comprehensive income (loss)	$ 13,431	$ 18,564	$ 63,968	$ (33,851)

Total accumulated other comprehensive loss and its components at January 31, 2010, and July 31, 2009, are as follows (thousands of dollars):

	January 31, 2010	July 31, 2009
Foreign currency translation adjustment	$ 72,130	$ 75,155
Net loss on hedging derivatives, net of deferred taxes	(80)	(394)
Pension and postretirement liability, net of deferred taxes	(83,294)	(84,438)
Total accumulated other comprehensive loss	$ (11,244)	$ (9,677)

During the three months ended January 31, 2010, the Company repurchased 112,556 shares for $4.4 million at an average price of $39.23 per share. During the six months ended January 31, 2010, the Company repurchased 331,885 shares for $11.8 million at an average price of $35.54 per share. As of January 31, 2010, the Company had remaining authorization to repurchase up to 598,325 shares pursuant to the current authorization.

On February 24, 2010, the Company s Board of Directors declared a cash dividend in the amount of $0.12 per common share payable to stockholders of record on March 5, 2010. The dividend will be paid on March 19, 2010.

Note F **Segment Reporting**

The Company has two reportable segments, Engine Products and Industrial Products, that have been identified based on the internal organization structure, management of operations, and performance evaluation. Corporate and Unallocated includes corporate expenses determined to be non-allocable to the segments, and interest income and expense. The Company is an integrated enterprise, characterized by substantial intersegment cooperation, cost allocations, and sharing of assets. Therefore, the Company does not represent that these segments, if operated independently, would report the operating profit and other financial information shown below. Segment detail is summarized as follows (thousands of dollars):

	Engine Products	Industrial Products	Corporate and Unallocated	Total Company
Three Months Ended January 31, 2010:				
Net sales	$ 249,650	$ 186,472		$ 436,122
Earnings before income taxes	26,556	14,993	(4,012)	37,537
Three Months Ended January 31, 2009:				
Net sales	$ 242,090	$ 218,511		$ 460,601
Earnings before income taxes	10,399	17,423	(2,129)	25,693
Six Months Ended January 31, 2010:				
Net sales	$ 493,622	$ 370,580		$ 864,202
Earnings before income taxes	57,456	37,329	(7,234)	87,551
Assets	625,441	501,578	247,435	1,374,454
Six Months Ended January 31, 2009:				
Net sales	$ 550,867	$ 482,994		$ 1,033,861
Earnings before income taxes	46,544	51,991	(4,341)	94,194
Assets	643,692	524,260	222,139	1,390,091

The Engine Products and Industrial Products segments incurred $0.5 million and $4.6 million of restructuring expenses for the three months ended January 31, 2010, respectively, and $1.4 million and $5.0 million of restructuring expenses for the six months ended January 31, 2010, respectively. Since the inception of the restructuring program in Fiscal 2009, the Engine Products and Industrial Products segments have incurred $8.6 million and $15.1 million of restructuring expenses, respectively.

There were no Customers over 10 percent of net sales for the three and six months ended January 31, 2010 and 2009. There were no Customers over 10 percent of gross accounts receivable as of January 31, 2010 and 2009.

Note G **Goodwill and Other Intangible Assets**

Goodwill is assessed for impairment between annual assessments whenever events or circumstances make it more likely than not that an impairment may have occurred. For the six months ended January 31, 2010, no events or circumstances have indicated a need for an interim goodwill assessment. The results of this assessment showed that the fair values of the reporting units to which goodwill is assigned continue to be higher than the book values of the respective reporting units, resulting in no goodwill impairment. No goodwill was impaired during the six months ended January 31, 2010, or 2009. The Company has allocated goodwill to reporting units within its Industrial Products and Engine Products segments. Following is a reconciliation of goodwill for the six months ending January 31, 2010 (thousands of dollars):

	Engine Products	Industrial Products	Total Goodwill
Balance as of July 31, 2009	$ 61,582	$ 107,445	$ 169,027
Foreign exchange translation	(157)	(762)	(919)
Balance as of January 31, 2010	$ 61,425	$ 106,683	$ 168,108

As of January 31, 2010, other intangible assets were $62.1 million, a $3.3 million decrease from the balance of $65.4 million at July 31, 2009. The decrease in other intangible assets is due to amortization of existing assets and foreign exchange translation. There were no intangible asset additions during the six months ended January 31, 2010.

Note H Guarantees

The Company and Caterpillar Inc. equally own the shares of Advanced Filtration Systems Inc. (AFSI), an unconsolidated joint venture, and guarantee certain debt of the joint venture. As of January 31, 2010, the joint venture had $35.4 million of outstanding debt of which the Company guarantees half. For both the three and six months ended January 31, 2010, the Company recorded $0.2 million of earnings for this equity method investment. During the three and six months ended January 31, 2009, the Company recorded $0.5 million and $0.9 million, respectively, of earnings for this equity method investment. During the three and six months ended January 31, 2010, the Company also recorded royalty income of $1.3 million and $2.5 million, respectively, related to AFSI. During the three and six months ended January 31, 2009, the Company recorded royalty income of $1.3 million and $3.0 million, respectively, related to AFSI.

The Company estimates warranty costs using standard quantitative measures based on historical warranty claim experience and evaluation of specific Customer warranty issues. Following is a reconciliation of warranty reserves for the six months ended January 31, 2010, and 2009 (thousands of dollars):

	January 31, 2010	July 31, 2009
Beginning balance	$ 9,215	$ 11,523
Accruals for warranties issued during the reporting period	3,702	1,478
Adjustments related to pre-existing warranties (including changes in estimates)	(873)	(758)
Less settlements made during the period	(1,775)	(1,970)
Ending balance	$ 10,269	$ 10,273

At January 31, 2010, the Company had a contingent liability for standby letters of credit totaling $20.0 million that have been issued and are outstanding. The letters of credit guarantee payment to third parties in the event the Company is in breach of a specified bond financing agreement and insurance contract terms as detailed in each letter of credit. At January 31, 2010, there were no amounts drawn upon these letters of credit.

Note I Employee Benefit Plans

The Company and certain of its international subsidiaries have defined benefit pension plans for many of their hourly and salaried employees. There are two types of domestic plans. The first type of domestic plan is a traditional defined benefit pension plan primarily for production employees. The second is a plan for salaried workers that provides defined benefits pursuant to a cash balance feature whereby a participant accumulates a benefit comprised of a percentage of current salary that varies with years of service, interest credits, and transition credits. The international plans generally provide pension benefits based on years of service and compensation level.

Net periodic pension costs for the Company s pension plans include the following components (thousands of dollars):

	Three Months Ended January 31,		Six Months Ended January 31,	
	2010	2009	2010	2009
Service cost	$ 3,320	$ 3,643	$ 6,638	$ 7,556

Interest cost		4,923		4,689		9,845		9,338
Expected return on assets		(7,157)		(7,491)		(14,313)		(14,583)
Transition amount amortization		59		59		119		97
Prior service cost amortization		74		112		148		218
Actuarial loss amortization		732		511		1,464		565
Total periodic benefit cost	$	1,951	$	1,523	$	3,901	$	$3,191

The Company s general funding policy for its pension plans is to make at least the minimum contributions as required by applicable regulations. Additionally, the Company may elect to make additional contributions up to the maximum tax deductible contribution. For the six months ended January 31, 2010, the Company made contributions of $10.0 million to its U.S. pension plans and $2.1 million to its non-U.S. pension plans. The Company does not anticipate making any additional contributions to its U.S. pension plans in Fiscal 2010 and estimates that it will contribute up to an additional $2.6 million to its non-U.S. pension plans during the remainder of Fiscal 2010.

Note J Financial Instruments and Fair Values

The Company uses forward exchange contracts to manage its exposure to fluctuations in foreign exchange rates. The Company also uses interest rate swaps to manage its exposure to changes in the fair value of its fixed-rate debt resulting from interest rate fluctuations. It is the Company s policy to enter into derivative transactions only to the extent true exposures exist; the Company does not enter into derivative transactions for speculative or trading purposes. The Company enters into derivative transactions only with counterparties with high credit ratings. These transactions may expose the Company to credit risk to the extent that the instruments have a positive fair value, but the Company has not experienced any material losses, nor does the Company anticipate any material losses.

The Company enters into forward exchange contracts of generally less than one year to hedge forecasted transactions between its subsidiaries, and to reduce potential exposure related to fluctuations in foreign exchange rates for existing recognized assets and liabilities. It also utilizes forward exchange contracts for anticipated intercompany and third-party transactions such as purchases, sales, and dividend payments denominated in local currencies. Forward exchange contracts are designated as cash flow hedges as they are designed to hedge the variability of cash flows associated with the underlying existing recognized or anticipated transactions. Changes in the value of derivatives designated as cash flow hedges are recorded in other comprehensive income (loss) in shareholders equity until earnings are affected by the variability of the underlying cash flows. At that time, the applicable amount of gain or loss from the derivative instrument that is deferred in shareholders equity is reclassified to earnings. Effectiveness is measured using spot rates to value both the hedge contract and the hedged item. The excluded forward points, as well as any ineffective portions of hedges, are recorded in earnings through the same line as the underlying transaction. During the first six months of Fiscal 2010, $0.2 million of losses were recorded due to the exclusion of forward points from the assessment of hedge effectiveness.

These unrealized losses and gains are reclassified, as appropriate, when earnings are affected by the variability of the underlying cash flows during the term of the hedges. The Company expects to record $0.3 million of net deferred losses from these forward exchange contracts during the next twelve months.

The Company is exposed to changes in the fair value of its fixed-rate debt resulting from interest rate fluctuations. To hedge this exposure, the Company entered into two fixed-to-variable interest rate swaps for $80 million and $25 million. These interest rate swaps are accounted for as fair value hedges. Changes in the payment of interest resulting from the interest rate swaps are recorded as an offset to interest expense.

The following summarizes the Company s fair value of outstanding derivatives at January 31, 2010, and July 31, 2009, on the Consolidated Balance Sheets (thousands of dollars):

	January 31, 2010	July 31, 2009
Asset derivatives recorded under the caption Prepaids and other current assets		
Foreign exchange contracts	$ 396	$ 493
Asset derivatives recorded under the caption Other assets		
Interest rate swap asset	$ 1,888	$
Liability derivatives recorded under the caption Other current liabilities		
Foreign exchange contracts	$ 2,009	$ 2,366

The impact on other comprehensive loss (OCI) and earnings from foreign exchange contracts that qualified as cash flow hedges for the six months ended January 31, 2010, and 2009, was as follows (thousands of dollars):

	January 31, 2010	July 31, 2009
Net carrying amount at beginning of year	$ (650)	$ 189
Cash flow hedges deferred in OCI	(1,162)	(272)
Cash flow hedges reclassified to income (effective portion)	1,664	622
Change in deferred taxes	(159)	16
Net carrying amount at January 31	$ (307)	$ 555

The Company s derivative financial instruments present certain market and counterparty risks; however, concentration of counterparty risk is mitigated as the Company deals with a variety of major banks worldwide. In addition, only conventional derivative financial instruments are utilized. The Company would not be materially impacted if any of the counterparties to the derivative financial instruments outstanding at January 31, 2010, failed to perform according to the terms of its agreement. At this time, the Company does not require collateral or any other form of securitization to be furnished by the counterparties to its derivative instruments.

The fair values of the Company s financial assets and financial liabilities listed below reflect the amounts that would be received to sell the assets or paid to transfer the liabilities in an orderly transaction between market participants at the measurement date (exit price). The fair values are based on inputs other than quoted prices that are observable for the asset or liability. These inputs include foreign currency exchange rates and interest rates. The financial assets and financial liabilities are primarily valued using standard calculations / models that use as their basis readily observable market parameters. Industry standard data providers are the primary source for forward and spot rate information for both interest rates and currency rates.

	Significant Other Observable Inputs (Level 2)	
	January 31, 2010	July 31, 2009
Forward exchange contracts net liability position	$ (1,613)	$ (1,873)
Interest rate swaps net asset position	1,888	

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Note K Commitments and Contingencies

The Company records provisions with respect to identified claims or lawsuits when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Claims and lawsuits are reviewed quarterly and provisions are taken or adjusted to reflect the status of a particular matter. The Company believes the recorded reserves in its consolidated financial statements are adequate in light of the probable and estimable outcomes. The recorded liabilities were not material to the Company s financial position, results of operation, and liquidity and the Company does not believe that any of the currently identified claims or litigation will materially affect its financial position, results of operation, and liquidity.

On March 31, 2008, S&E Quick Lube, a filter distributor, filed a lawsuit in U.S. District Court for the District of Connecticut alleging that twelve filter manufacturers, including the Company, engaged in a conspiracy to fix prices, rig bids and allocate U.S. Customers for aftermarket automotive filters. This lawsuit seeks various remedies, including injunctive relief and monetary damages of an unspecified amount, and is a purported class action on behalf of direct purchasers of automotive aftermarket filters from the defendants. Parallel purported class actions, including on behalf of a variety of direct and indirect purchasers of aftermarket filters, have been filed by other plaintiffs in a variety of jurisdictions in the United States and Canada. The U.S cases have been consolidated into a single multi-district litigation in the Northern District of Illinois. In addition, on April 16, 2009, the Attorney General of the State of Florida filed a complaint in the U.S. District Court for the Northern District of Illinois based on these same allegations. The Company will vigorously defend the claims raised in these lawsuits. The Company understands that the Antitrust Division of the Department of Justice (DOJ) was investigating the allegations raised in these suits and issued subpoenas in connection with that investigation. The Company was not contacted by the DOJ in connection with the DOJ investigation, but public reports indicate that the DOJ officially closed that investigation in January 2010.

<u>Note L</u> Income Taxes

The effective tax rate for the three months and six months ended January 31, 2010, was 17.5 percent and 25.1 percent, respectively. The effective tax rate for the three months and six months ended January 31, 2009, was a benefit of (31.5 percent) and an effective rate of 13.2 percent, respectively. The six months ended January 31, 2010, contained $4.4 million of discrete tax benefits from the expiration of the statute of limitations at a foreign subsidiary and other discrete tax items. The prior year six month period contained $16.7 million of discrete tax benefits, which predominantly occurred in the second quarter, primarily related to changes to uncertain tax position reserves in connection with the effective settlements of court cases and examinations in various jurisdictions covering various years. Disregarding the discrete items, the average underlying tax rate improved over the prior year by 80 basis points to 30.2 percent from 31.0 percent mainly due to the mix of earnings between tax jurisdictions.

The Company s uncertain tax positions are affected by the tax years that are under audit or remain subject to examination by the relevant taxing authorities. The following tax years, in addition to the current year, remain subject to examination, at least for certain issues, by the major tax jurisdictions indicated:

Major Jurisdictions	**Open Tax Years**
Belgium	2005 through 2009
China	2000 through 2009
France	2006 through 2009
Germany	2004 through 2009
Italy	2003 through 2009
Japan	2009
Mexico	2004 through 2009
Thailand	2005 through 2009
United Kingdom	2008 through 2009
United States	2007 through 2009

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At January 31, 2010, the total unrecognized tax benefits were $17.7 million, and accrued interest and penalties were $2.2 million. The Company recognizes interest accrued related to unrecognized tax benefits in income tax expense. If the Company were to prevail on all unrecognized tax benefits recorded, substantially all of the amount recorded would reduce the effective tax rate. With an average statute of limitations of about 5 years, up to $1.1 million of the unrecognized tax benefits could potentially expire in the next 12 month period, unless extended by audit. It is reasonably possible that an additional reduction in unrecognized tax benefits may occur within the fiscal year due to settlement of several worldwide tax disputes; however, quantification of an estimated range and timing cannot be made at this time.

<u>Note M</u>   Restructuring

The following is a reconciliation of restructuring reserves (in thousands of dollars):

Balance at July 31, 2008	$	
Accruals for restructuring during the reporting period		17,755
Less settlements made during the period		(13,915)
Balance at July 31, 2009	$	3,840
Accruals for restructuring during the reporting period		6,350
Less settlements made during the period		(3,430)
Balance at January 31, 2010	$	6,760

Certain restructuring actions commenced in Fiscal 2009 in response to the dramatic downturn in the worldwide economy. These actions and related costs carried over into Fiscal 2010. For the three months and six months ended January 31, 2010, gross margin and operating expenses included $3.4 million and $1.7 million of restructuring expenses, respectively, and $4.2 million and $2.2 million, respectively. For the three months and six months ended January 31, 2009, gross margin and operating expenses included $1.9 million and $2.3 million of restructuring expenses, respectively. These restructuring expenses primarily relate to employee severance costs.

The Company expects to settle its existing liability during Fiscal 2010, but it does anticipate additional restructuring charges during the remainder of Fiscal 2010 for actions under consideration by management.

<u>Note N</u>   Subsequent Events

The Company has evaluated and reviewed for subsequent events that would impact the financial statements for the six months ended January 31, 2010, through the issuance date of the financials.

<u>Note O</u>   New Accounting Standards

In June 2009, the FASB updated the accounting standards related to the consolidation of variable interest entities (VIEs). The standard amends current consolidation guidance and requires additional disclosures about an enterprise's involvement in VIEs. The standard is effective for interim and annual reporting periods beginning after November 15, 2009. The adoption of the revised standard is not expected to have a material impact on the Company s financial statements.

In December 2008, the FASB issued guidance that expands an employer s disclosures about plan assets of a defined benefit pension or other postretirement plans. This guidance is effective for fiscal years ending after December 15, 2009.   The Company is currently evaluating the impact of adopting this guidance on its defined benefit pension and other postretirement plan note disclosures.

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

The Company is a worldwide manufacturer of filtration systems and replacement parts. The Company s product mix includes air and liquid filtration systems, and exhaust and emission control products. Products are manufactured at 40 plants around the world and through three joint ventures.

The Company has two reporting segments: Engine Products and Industrial Products. Products in the Engine Products segment consist of air filtration systems, exhaust and emissions systems, liquid filtration systems, and replacement parts. The Engine Products segment sells to original equipment manufacturers (OEMs) in the construction, mining, agriculture, aerospace, defense, and truck markets, and to OEM dealer networks, independent distributors, private label accounts, and large equipment fleets. Products in the Industrial Products segment consist of dust, fume, and mist collectors, compressed air purification systems, liquid filtration systems, air filtration systems for gas turbines, and specialized air filtration systems for diverse applications including computer hard disk drives. The Industrial Products segment sells to various industrial end-users, OEMs of gas-fired turbines, and OEMs and end-users requiring clean air and liquids.

The following discussion of the Company s financial condition and results of operations should be read in conjunction with the condensed Consolidated Financial Statements and Notes thereto and other financial information included elsewhere in this report.

<u>Overview</u>

The Company reported diluted net earnings per share of $0.39 for the second quarter of Fiscal 2010, down from $0.43 in the second quarter of the prior year. Net earnings for the quarter were $31.0 million, compared to $33.8 million in the second quarter of the prior year. Included in the above results are pre-tax restructuring expenses of $5.1 million and $4.3 million in the quarters ended January 31, 2010 and 2009, respectively. In addition, net earnings and earnings per share were down in Fiscal 2010 due to the incremental discrete tax benefits of $11 million recognized in Fiscal 2009. The Company reported sales in the second quarter of Fiscal 2010 of $436.1 million, a decrease of 5.3 percent from $460.6 million in the second quarter of the prior year. The impact of foreign currency translation increased reported sales by 5.2 percent in the quarter.

The Company s operating income in the second quarter of Fiscal 2010 increased 40 percent and its operating margin improved to 9.0 percent from 6.0 percent in the prior year period. The Company benefited from the savings generated by restructuring activities and the continued success of employee teams executing ongoing product and process cost reduction initiatives. The Company s sales mix also helped to improve margins as its higher margin replacement filter sales again exceeded its first-fit sales.

The Company s year-over-year sales decreased by 5 percent this quarter, but were up on a sequential basis for the third consecutive quarter. With the continued improvement in the Company s overall business conditions, combined with the benefits from the completed cost reduction and restructuring activities, the Company expects both sales and earnings comparisons to be positive in the second half of Fiscal 2010 as compared to Fiscal 2009.

The Company s diversified portfolio of filtration businesses helped improve performance with most of the Company s early-cycle businesses returning to year-over-year growth, including Aftermarket and On-Road Products in the Engine Products segment and Special Applications Products in the Industrial Products segment. Some of the Company s mid-cycle businesses are now stabilizing. As global economic conditions continue to slowly improve, the Company expects more of its businesses to return to year-over-year growth.

Results of Operations

Sales in the United States decreased $29.7 million or 15.2 percent for the second quarter of Fiscal 2010 compared to the second quarter of the prior year. Total international sales in U.S. dollars increased $5.2 million or 2.0 percent in the second quarter compared to the prior year. In U.S. dollars, Europe sales decreased $8.6 million or 5.9 percent, Asia sales increased $9.0 million or 9.4 percent, and other international sales increased $4.9 million or 21.2 percent for the second quarter of Fiscal 2010 as compared to the prior year period. Translated at constant exchange rates, total international sales decreased 7.2 percent over the prior year quarter. For the six month period ended January 31, 2010, sales in the United States decreased $96.0 million or 22.2 percent from the prior year, and total international sales in U.S. dollars decreased $73.6 million or 12.2 percent from the prior year.

The impact of foreign currency translation during the second quarter of Fiscal 2010 increased net sales by $24.2 million, or 5.2 percent from the prior year second quarter. The impact of foreign currency translation on the year-to-date results as of the second quarter of Fiscal 2010 increased net sales by $30.8 million. Worldwide sales for the second quarter of Fiscal 2010, excluding the impact of foreign currency translation, decreased 10.6 percent from the second quarter of the prior year. The impact of foreign currency translation increased net earnings by $1.4 million and $1.5 million for the three and six month periods ended January 31, 2010, respectively.

Although net sales excluding foreign currency translation and net earnings excluding foreign currency translation are not measures of financial performance under GAAP, the Company believes they are useful in understanding its financial results. Both measures enable the Company to obtain a clearer understanding of the operating results of its foreign entities without the varying effects that changes in foreign currency exchange rates may have on those results. A shortcoming of these financial measures is that they do not reflect the Company s actual results under GAAP. Management does not intend for these items to be considered in isolation or as a substitute for the related GAAP measures.

Following is a reconciliation to the most comparable GAAP financial measure of these non-GAAP financial measures (thousands of dollars):

	Three Months Ended January 31,		**Six Months Ended January 31,**	
	2010	**2009**	**2010**	**2009**
Net sales, excluding foreign currency translation	$ 411,964	$ 484,770	$ 833,435	$ 1,054,437
Foreign currency translation	24,158	(24,169)	30,767	(20,576)
Net sales	$ 436,122	$ 460,601	$ 864,202	$ 1,033,861