

FLOWSERVE CORP  
Form 10-Q/A  
April 26, 2006

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

**FORM 10-Q/A  
Amendment No. 1**

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2004**  
**OR**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_.**

**Commission File No. 1-13179  
FLOWSERVE CORPORATION**  
(Exact Name of Registrant as Specified in Its Charter)

**New York**

**31-0267900**

(State or Other Jurisdiction of  
Incorporation or Organization)

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

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

**75039**

(Address of Principal Executive Offices)

(Zip code)

**(972) 443-6500**

(Registrant's Telephone Number, Including Area Code)

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

As of April 21, 2006, there were 56,522,193 shares of the issuer's common stock outstanding.

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**EXPLANATORY NOTE**

As previously reported in our Annual Report on Form 10-K for the year ended December 31, 2004 ( 2004 Annual Report ), we have restated our previously issued financial statements for 2002, 2003 and the first quarter of 2004. We refer to this restatement as the 2004 Restatement.

This Amendment No. 1 to our Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2004 ( Amended Quarterly Report ) includes the condensed consolidated financial statements for the three months ended March 31, 2004 and 2003, and all amounts referenced in this Amended Quarterly Report for prior periods and prior period comparisons, are presented on a restated basis. For a description of the restatement, see Note 2 to the accompanying consolidated financial statements and Note 2 to the consolidated financial statements included in our 2004 Annual Report.

This Amended Quarterly Report is being filed to correct errors made in the application of accounting principles generally accepted in the United States. The following items have been amended as a result of the 2004 Restatement:

- (i) Part I, Item 1, Financial Statements, has been revised to correct amounts included in our condensed consolidated financial statements for the three months ended March 31, 2004 and 2003 (See also Note 2 to our condensed consolidated financial statements for discussion of significant changes);
- (ii) Part I, Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations, has been revised to reflect the restatement of our condensed consolidated financial statements for the three months ended March 31, 2004 and 2003;
- (iii) Part I, Item 3, Quantitative and Qualitative Disclosures About Market Risk, has been revised to reflect the restatement of our condensed consolidated financial statements for the three months ended March 31, 2004 and 2003;
- (iv) Part I, Item 4, Controls and Procedures, has been revised to disclose certain matters identified in connection with the audit of our consolidated financial statements and internal controls over financial reporting for the year ended December 31, 2004; and
- (v) Part II, Item 1, Legal Proceedings, has been revised to disclose our current legal matters as of the date of filing this Amended Quarterly Report.

This Amended Quarterly Report should be read in conjunction with our 2004 Annual Report.

On February 13, 2006, we filed our 2004 Annual Report and included therein our consolidated financial statements as of December 31, 2004 and for the year then ended and our restated consolidated financial statements as of December 31, 2003 and for the years ended December 31, 2003 and 2002. We did not amend our Annual Reports on Form 10-K or Quarterly Reports on Form 10-Q for periods affected by the restatement that ended on or prior to December 31, 2003, and the financial statements and related financial information contained in such reports should no longer be relied upon.

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

|   | Three Months Ended March 31, |            |
|---|------------------------------|------------|
|   | <b>2004</b>                  | 2003       |
|   | (As                          | (As        |
| (Amounts in thousands, except per share data) | <b>restated)</b>             | restated)  |
| Sales   | \$ <b>605,148</b>            | \$ 557,218 |
| Cost of sales                                 | <b>426,269</b>               | 389,826    |
| Gross profit                                  | <b>178,879</b>               | 167,392    |
| Selling, general and administrative expense   | <b>140,113</b>               | 128,930    |
| Integration expense                           |                              | 6,410      |
| Restructuring expense                         |                              | 1,012      |
| Operating income                              | <b>38,766</b>                | 31,040     |
| Interest expense                              | <b>(20,086)</b>              | (21,136)   |
| Interest income                               | <b>256</b>                   | 913        |
| Loss on optional prepayments of debt          |                              | (159)      |
| Other (expense) income, net                   | <b>(3,677)</b>               | (1,611)    |
| Earnings before income taxes                  | <b>15,259</b>                | 9,047      |
| Provision for income taxes                    | <b>8,190</b>                 | 4,035      |
| Income from continuing operations             | <b>7,069</b>                 | 5,012      |
| Discontinued operations, net of tax           | <b>75</b>                    | 256        |
| Net earnings                                  | \$ <b>7,144</b>              | \$ 5,268   |
| Earnings per share:                           |                              |            |
| Basic:  |                              |            |
| Continuing operations                         | \$ <b>0.13</b>               | \$ 0.10    |
| Discontinued operations                       |                              |            |
| Net earnings                                  | \$ <b>0.13</b>               | \$ 0.10    |
| Diluted:                                      |                              |            |
| Continuing operations                         | \$ <b>0.13</b>               | \$ 0.10    |
| Discontinued operations                       |                              |            |
| Net earnings                                  | \$ <b>0.13</b>               | \$ 0.10    |

See accompanying notes to condensed consolidated financial statements.

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

| (Amounts in thousands)                               | Three Months Ended March 31, |                  |
|--|------------------------------|------------------|
|  | <b>2004</b>                  | 2003             |
|  | (As<br><b>restated</b> )     | (As<br>restated) |
| Net earnings   | \$ <b>7,144</b>              | \$ 5,268         |
| Other comprehensive income (expense):                |                              |                  |
| Foreign currency translation adjustments, net of tax | <b>(6,688)</b>               | 14,841           |
| Cash flow hedging activity, net of tax               | <b>(2,784)</b>               | (75)             |
| Other comprehensive (loss) income                    | <b>(9,472)</b>               | 14,766           |
| Comprehensive (loss) income                          | \$ <b>(2,328)</b>            | \$ 20,034        |

See accompanying notes to condensed consolidated financial statements.

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

|   | <b>March 31,<br/>2004<br/>(As<br/>restated)</b> | December<br>31,<br>2003 |
|---|---|-------------------------|
| (Amounts in thousands, except per share data)   |   |                         |
| <b>ASSETS</b>   |   |                         |
| Current assets:   |   |                         |
| Cash and cash equivalents   | \$ 39,674                                       | \$ 53,522               |
| Accounts receivable, net of allowance for doubtful accounts of \$15,997 and \$18,641      | 500,288   | 505,949                 |
| Inventories, net  | 415,683   | 412,374                 |
| Deferred taxes  | 67,872  | 64,585                  |
| Prepaid expenses and other  | 32,107  | 26,091                  |
| Total current assets  | <b>1,055,624</b>                                | 1,062,521               |
| Property, plant and equipment, net of accumulated depreciation of \$423,430 and \$411,836 | 440,894   | 443,864                 |
| Goodwill  | 872,826   | 871,960                 |
| Deferred taxes  | 32,161  | 31,741                  |
| Other intangible assets, net  | 166,013   | 169,084                 |
| Other assets, net   | 96,201  | 101,342                 |
| Total assets  | <b>\$ 2,663,719</b>                             | \$ 2,680,512            |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |   |                         |
| Current liabilities:  |   |                         |
| Accounts payable  | \$ 249,109                                      | \$ 250,614              |
| Accrued liabilities   | 280,929   | 286,433                 |
| Debt due within one year  | 82,327  | 71,035                  |
| Total current liabilities   | <b>612,365</b>                                  | 608,082                 |
| Long-term debt due after one year   | 857,694   | 879,766                 |
| Retirement obligations and other liabilities  | 373,541   | 370,201                 |
| 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  | 477,617   | 477,443                 |
| Retained earnings   | 417,272   | 410,128                 |
|   | <b>966,907</b>                                  | 959,589                 |
| Treasury stock, at cost 2,789 and 2,775 shares  | <b>(62,825)</b>                                 | (62,575)                |



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|  |                     |              |
|--|---------------------|--------------|
| Deferred compensation obligation           | <b>7,505</b>        | 7,445        |
| Accumulated other comprehensive loss       | <b>(91,468)</b>     | (81,996)     |
| Total shareholders' equity                 | <b>820,119</b>      | 822,463      |
| Total liabilities and shareholders' equity | <b>\$ 2,663,719</b> | \$ 2,680,512 |

See accompanying notes to condensed consolidated financial statements.

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

|   | Three Months Ended March 31, |           |
|---|------------------------------|-----------|
|   | <b>2004</b>                  | 2003      |
|   | (As                          | (As       |
|   | restated)                    | restated) |
| (Amounts in thousands)  |                              |           |
| <b>Cash flows Operating activities:</b>   |                              |           |
| Net earnings  | \$ 7,144                     | \$ 5,268  |
| Adjustments to reconcile net earnings to net cash provided by operating activities: |                              |           |
| Depreciation  | 15,349                       | 15,309    |
| Amortization of intangible and other assets   | 2,763                        | 2,578     |
| Amortization of deferred loan costs and discount                                    | 1,243                        | 1,242     |
| Loss on optional prepayments of debt  |                              | 159       |
| Net loss (gain) on the disposition of assets  | (1,293)                      | 753       |
| Change in assets and liabilities, net of acquisitions:                              |                              |           |
| Accounts receivable   | 781                          | 1,623     |
| Inventories   | (1,408)                      | 3,566     |
| Prepaid expenses and other  | (292)                        | (9,279)   |
| Other assets  | (667)                        | (3,783)   |
| Accounts payable  | 86                           | (17,240)  |
| Accrued liabilities and income taxes payable  | 5,952                        | 4,030     |
| Retirement obligations and other liabilities  | (6,586)                      | (2,108)   |
| Net deferred taxes  | (15,139)                     | 10,172    |
| Net cash flows provided by operating activities                                     | 7,933                        | 12,290    |
| <b>Cash flows Investing activities:</b>   |                              |           |
| Capital expenditures  | (6,918)                      | (5,536)   |
| Cash received for disposal of assets  | 3,626                        |           |
| Cash paid for acquisition   | (9,429)                      |           |
| Net cash flows used by investing activities   | (12,721)                     | (5,536)   |
| <b>Cash flows Financing activities:</b>   |                              |           |
| Net (repayments) borrowings under lines of credit                                   | (702)                        | 1,539     |
| Payments on long-term debt  | (8,022)                      | (20,000)  |
| Net cash flows used by financing activities   | (8,724)                      | (18,461)  |
| Effect of exchange rate changes on cash   | (336)                        | 1,183     |
| Net change in cash and cash equivalents   | (13,848)                     | (10,524)  |
| Cash and cash equivalents at beginning of year                                      | 53,522                       | 48,991    |
| Cash and cash equivalents at end of period  | \$ 39,674                    | \$ 38,467 |

See accompanying notes to condensed consolidated financial statements.

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**FLOWSERVE CORPORATION  
(Unaudited)**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

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

**Basis of Presentation**

The accompanying condensed consolidated balance sheet as of March 31, 2004, and the related condensed consolidated statements of income and comprehensive income (loss) for the three months ended March 31, 2004 and 2003, and the condensed consolidated statements of cash flows for the three months ended March 31, 2004 and 2003, 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 Amended 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 restated consolidated financial statements for the year ended December 31, 2003 presented in our 2004 Annual Report, which was filed with the Securities and Exchange Commission (SEC) on February 13, 2006.

**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. For 2004 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 had unearned compensation of \$0.7 million and \$0.9 million at March 31, 2004 and December 31, 2003, 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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|   | Quarter Ended March 31,<br><b>2004</b><br>(As<br><b>restated</b> ) | 2003<br>(As<br>restated) |
|---|--|--------------------------|
| (Amounts in thousands, except per share data)   |  |                          |
| Net earnings, as reported   | \$ <b>7,144</b>  | \$ 5,268                 |
| Restricted stock compensation expense (income) included in net earnings, net of related tax effects                           | <b>(39)</b>  | 62                       |
| Less: Stock-based employee compensation expense determined under fair value method for all awards, net of related tax effects | <b>(419)</b>   | (588)                    |
| Pro forma net earnings  | \$ <b>6,686</b>  | \$ 4,742                 |
| Net earnings per share basic:   |  |                          |
| As reported   | \$ <b>0.13</b>   | \$ 0.10                  |
| Pro forma   | <b>0.12</b>  | 0.09                     |
| Net earnings per share diluted:   |  |                          |
| As reported   | \$ <b>0.13</b>   | \$ 0.10                  |
| Pro forma   | <b>0.12</b>  | 0.09                     |

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 March 31, 2004, are detailed in Note 1 of our 2004 Annual Report.

**Accounting Developments*****Pronouncements Implemented***

In December 2003, the FASB revised FIN No. 46, Consolidation of Variable Interest Entities, which addresses the consolidation of variable interest entities ( VIEs ) by business enterprises that are the primary beneficiaries. A VIE is an entity that does not have sufficient equity investment at risk to permit it to finance its activities without additional subordinated financial support, or whose equity investors lack the characteristics of a controlling financial interest. The primary beneficiary of a VIE is the enterprise that has the majority of the risks or rewards associated with the VIE. We have no interests in VIEs that require disclosure or consolidation under FIN 46, and therefore its implementation had no significant effect on our results of operations or financial position.

***Pronouncements Not Yet Implemented***

During December 2003, the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the Act ) was enacted in the United States. The Act generally permits plan sponsors that provide retiree prescription drug benefits that are actuarially equivalent to the benefits of Medicare Part D to be eligible for a non-taxable federal subsidy. As permitted by FASB Staff Position No. 106-1, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003, we have elected to defer accounting for any effects of the Act until December 31, 2004. We are evaluating the impact of the Act, including the emergence of specific authoritative guidance regarding the accounting treatment afforded the provisions of the Act, which could require us to change information previously reported.

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.



**Table of Contents****2. Restatement**

For the errors discussed below, we restated our condensed consolidated financial statements as of March 31, 2004 and for the three months ended March 31, 2004 and 2003 presented herein.

The following table sets forth the nature of significant 2004 Restatement errors and their impact on the previously reported net earnings:

**Summary of Restatement Issues Affecting Net Earnings  
For the Three Months Ended March 31, 2004 and 2003**

| (Amounts in thousands)               | 2004             | 2003     |
|--------------------------------------|------------------|----------|
| Net earnings, as previously reported | <b>\$ 10,287</b> | \$ 7,479 |
| Financial derivatives                | <b>(3,936)</b>   | (556)    |
| Intercompany reconciliations         | <b>331</b>       | (1,190)  |
| Pension expense                      | <b>(388)</b>     | 51       |
| Fixed assets and intangibles         | <b>(86)</b>      | (823)    |
| Other                                | <b>3,016</b>     | 553      |
| Tax matters                          | <b>(2,080)</b>   | (246)    |
| Net earnings, as restated            | <b>\$ 7,144</b>  | \$ 5,268 |

*Financial Derivatives* We identified errors in our accounting for financial derivatives related to foreign currency forward exchange contracts, which consisted of incorrectly recording unrealized gains and losses in other comprehensive loss for certain contracts that did not meet the criteria for hedge accounting. We also identified errors related to the recording of balances underlying the financial derivatives.

*Intercompany Reconciliations* Our accounting for intercompany transactions was adversely affected by information technology system conversions, acquisitions, and changes in corporate processes for recording intercompany transactions. Our initial analysis of intercompany transactions was expanded to include an assessment of intercompany balance differences at each of the reporting dates. Certain reconciling items were identified through this assessment that required adjustment to the consolidated statements of operations.

*Pension Expense* As part of a comprehensive review of our pension plans, we identified errors in the accounting for non-U.S. pension plans. Certain plan obligations had not been measured at the actuarially determined present value, which resulted in errors in our annual pension expense and related liabilities.

*Fixed Assets and Intangibles* As part of a comprehensive physical observation and assessment of fixed assets, we identified errors in our fixed asset processes related to disposals and abandonments that were not recorded in our accounting records necessitating adjustments to report the gains or losses on disposal in the appropriate periods. We also identified errors that resulted from not adjusting for the impact of purchase accounting within the general ledgers at certain locations of recently acquired businesses, amortization of leasehold improvements over periods in excess of the related lease terms, and errors in the amortization of intangible assets. These errors affected amounts reported for fixed assets, goodwill, other intangible assets, depreciation and amortization, loss on disposals, and foreign currency translation accounts.

*Other* We identified other errors as part of the restatement where the individual impact on net earnings was not as significant, which resulted from the following:

errors in the original allocation of the purchase price for acquired businesses to property, plant and equipment, goodwill, accrued liabilities and deferred income taxes;

errors in reconciliations of account balances;

errors in accounting for equity investments that were based on foreign accounting standards rather than accounting principles generally accepted in the United States of America ( GAAP ); and

other errors which were not deemed individually significant for separate disclosure.



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*Tax Matters* Due to significant employee turnover, information technology system limitations, corporate legal restructurings, several multinational acquisitions, and inadequate reconciliations, we identified errors in the amounts recorded in current and deferred income taxes. We undertook a process to identify our tax basis amounts, for both domestic and international locations, and performed a comprehensive review of our purchase accounting for recent acquisitions. This process included a detailed compilation of our book and tax differences at each of the reporting dates, as well as reconciliations of our income tax payable accounts to tax returns, as filed or as amended.

We also identified errors that occurred in applying purchase accounting to businesses acquired, including income tax liabilities arising in years prior to the acquisitions, which were corrected in the related balance sheet accounts. We also identified errors in our U.S. federal income tax returns filed for 1999 through 2001 as a result of an Internal Revenue Service examination of those years. We amended our tax returns for those years and reflected the impact of those amendments within current and deferred domestic income tax balance sheet accounts at each of the annual reporting dates through December 31, 2004.

Tax matters also includes the results of assessing the other restatement entries to determine which amounts had a corresponding impact on our provision for income taxes.

*Discontinued operations* We corrected our financial statements for presentation of discontinued operations. Our Government Marine Business Unit met the criteria for classification as a discontinued operation in the first quarter of 2004, as described further in Note 3.

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The following table presents the impact of the restatement adjustments, further described below, and of the business classified as discontinued operations in 2004 that is described in Note 3, on our consolidated statements of operations for the three months ended March 31, 2004 and 2003:

**Condensed Consolidated Statements of Operations Information  
For the Three Months Ended March 31, 2004 and 2003**

| (Amounts in thousands,<br>except per share data) | 2004                         |                |  | 2003                         |                |  |
|--|------------------------------|----------------|--|------------------------------|----------------|--|
|  | As<br>Previously<br>Reported | As<br>Restated | As<br>Restated<br>with<br>Discontinued<br>Operations | As<br>Previously<br>Reported | As<br>Restated | As<br>Restated<br>with<br>Discontinued<br>Operations |
| Sales  | \$ 611,350                   | \$ 610,869     | \$ 605,148   | \$ 564,269                   | \$ 562,334     | \$ 557,218   |
| Cost of sales                                    | 433,275                      | 431,072        | 426,269  | 395,715                      | 393,878        | 389,826  |
| Gross profit                                     | 178,075                      | 179,797        | 178,879  | 168,554                      | 168,456        | 167,392  |
| Selling, general and<br>administrative expense   | 142,400                      | 140,916        | 140,113  | 128,539                      | 129,586        | 128,930  |
| Integration expense                              |                              |                |  | 6,410                        | 6,410          | 6,410  |
| Restructuring expense                            |                              |                |  | 1,012                        | 1,012          | 1,012  |
| Operating income                                 | 35,675                       | 38,881         | 38,766   | 32,593                       | 31,448         | 31,040   |
| Interest expense                                 | (20,086)                     | (20,086)       | (20,086)   | (21,136)                     | (21,136)       | (21,136)   |
| Interest income                                  | 256                          | 256            | 256  | 889                          | 913            | 913  |
| Loss on debt repayment and<br>extinguishment     |                              |                |  | (159)                        | (159)          | (159)  |
| Other (expense) income,<br>net                   | 592                          | (3,677)        | (3,677)  | (769)                        | (1,613)        | (1,611)  |
| Earnings before income<br>taxes                  | 16,437                       | 15,374         | 15,259   | 11,418                       | 9,453          | 9,047  |
| Provision for income taxes                       | 6,150                        | 8,230          | 8,190  | 3,939                        | 4,185          | 4,035  |
| Income from continuing<br>operations             | 10,287                       | 7,144          | 7,069  | 7,479                        | 5,268          | 5,012  |
| Discontinued operations,<br>net of tax           |                              |                | 75   |                              |                | 256  |
| Net earnings                                     | \$ 10,287                    | \$ 7,144       | \$ 7,144   | \$ 7,479                     | \$ 5,268       | \$ 5,268   |
| Net earnings per share<br>basic:                 |                              |                |  |                              |                |  |
| Continuing operations                            | \$ 0.19                      | \$ 0.13        | \$ 0.13  | \$ 0.14                      | \$ 0.10        | \$ 0.10  |
| Discontinued operations                          |                              |                |  |                              |                |  |
| Net earnings                                     | \$ 0.19                      | \$ 0.13        | \$ 0.13  | \$ 0.14                      | \$ 0.10        | \$ 0.10  |

|                                 |    |             |    |             |    |             |                         |
|---------------------------------|----|-------------|----|-------------|----|-------------|-------------------------|
| Net earnings per share diluted: |    |             |    |             |    |             |                         |
| Continuing operations           | \$ | <b>0.19</b> | \$ | <b>0.13</b> | \$ | <b>0.13</b> | \$ 0.14 \$ 0.10 \$ 0.10 |
| Discontinued operations         |    |             |    |             |    |             |                         |
| Net earnings                    | \$ | <b>0.19</b> | \$ | <b>0.13</b> | \$ | <b>0.13</b> | \$ 0.14 \$ 0.10 \$ 0.10 |

Our restatement corrects the consolidated statements of operations for the following errors:

Sales decreased \$0.5 million and \$1.9 million for the three months ended March 31, 2004 and 2003, respectively, primarily due to errors that reported sales in a period later than determined in accordance with GAAP for which there is no significant impact on net earnings in the periods presented (\$0.3 million decrease in 2004 and \$1.9 million decrease in 2003) and other individually insignificant errors.

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|  | <b>2004</b>       | 2003       |
|--|-------------------|------------|
| Intercompany reconciliations                     | \$ <b>154</b>     | \$ 1,190   |
| Pension expense                                  | <b>(62)</b>       | (388)      |
| Other (mainly errors in account reconciliations) | <b>(2,295)</b>    | (2,639)    |
| Total cost of sales                              | <b>\$ (2,203)</b> | \$ (1,837) |

Selling, general and administrative expense decreased for the three months ended March 31, 2004 and increased for the three months ended March 31, 2003, primarily due to errors in the following (in thousands):

|   | <b>2004</b>       | 2003     |
|---|-------------------|----------|
| Intercompany reconciliations                      | \$ <b>(486)</b>   | \$       |
| Pension expense                                   | <b>451</b>        | 337      |
| Fixed assets and intangibles                      | <b>117</b>        | 836      |
| Other (mainly errors in account reconciliations)  | <b>(1,566)</b>    | (126)    |
| Total selling, general and administrative expense | <b>\$ (1,484)</b> | \$ 1,047 |

Other expense, net increased \$4.3 million and \$0.8 million for the three months ended March 31, 2004 and 2003, respectively, primarily due to errors in the accounting for foreign currency forward contracts that did not meet the criteria for hedge accounting (\$3.9 million in 2004 and \$0.6 million in 2003) and other individually insignificant errors.

Provision for income taxes increased \$2.1 million and \$0.2 million for the three months ended March 31, 2004 and 2003, respectively, primarily due to corrections in deferred tax accounts and the income tax effect of the errors described above. Included in this was \$0.4 million and \$0.7 million for the three months ended March 31, 2004 and 2003, respectively, due to the tax impact on the restatement items.

The following table presents the impact of the restatement adjustments on our consolidated statements of comprehensive income (loss) for the three months ended March 31, 2004 and 2003:

**Condensed Consolidated Statements of Comprehensive Income (Loss) Information  
For the Three Months Ended March 31, 2004 and 2003**

|  | <b>2004</b>      |                   | <b>2003</b>     |                 |
|--|------------------|-------------------|-----------------|-----------------|
|  | As               | As                | As              | As              |
|  | Previously       |                   | Previously      |                 |
| (Amounts in thousands)                               | <b>Reported</b>  | <b>Restated</b>   | <b>Reported</b> | <b>Restated</b> |
| Net earnings   | \$ <b>10,287</b> | \$ <b>7,144</b>   | \$ 7,479        | \$ 5,268        |
| Other comprehensive income (expense):                |                  |                   |                 |                 |
| Foreign currency translation adjustments, net of tax | <b>4,480</b>     | <b>(6,688)</b>    | 5,556           | 14,841          |
| Cash flow hedging activity, net of tax               | <b>(565)</b>     | <b>(2,784)</b>    | (216)           | (75)            |
| Other comprehensive income (loss)                    | <b>3,915</b>     | <b>(9,472)</b>    | 5,340           | 14,766          |
| Comprehensive income (loss)                          | <b>\$ 14,202</b> | <b>\$ (2,328)</b> | \$ 12,819       | \$ 20,034       |

The errors in the consolidated statements of comprehensive income (loss) mainly result from accounting for foreign currency translations relating to the IDP acquisition in 2000 where fair value step-ups for property, plant and equipment were not pushed down to the local entity, which impacted recording subsequent asset disposals,

depreciation and the related foreign currency translation effects and financial derivatives.

The errors identified in the consolidated balance sheet at March 31, 2004, described below, mainly resulted from (i) misapplication of purchase accounting for businesses acquired; (ii) not recording adjustments resulting from reconciling intercompany balances; (iii) not actuarially determining non-U.S. pension obligations and accounting for them in accordance

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with GAAP; (iv) incorrect deferred tax asset and liability balances; (v) not recording liabilities (including liabilities for purchased intellectual property, litigation and tax penalties); (vi) recording the effect of the foreign currency translations relating to the restatement; and (vii) recording the adjustments to the consolidated statements of operations set forth above. The errors in applying purchase accounting resulted from incorrectly accounting for deferred taxes in the acquisitions of Ingersoll Dresser Pump Co. ( IDP ) in 2000 and the Flow Control Division of Invensys plc ( IFC ) in 2002 and accounting for foreign currency translations relating to the IDP acquisition in 2000 where fair value step-ups for property, plant and equipment were not pushed down to the local entity, which impacted recording subsequent asset disposals, depreciation and the related foreign currency translation effects.

The following table presents the impact of the restatement adjustments, further described below, and of the business classified as discontinued operations that is described in Note 3, on our consolidated balance sheet as of March 31, 2004:

**Condensed Consolidated Balance Sheet Information**

|  | <b>March 31, 2004</b> |                    |                     |
|--|-----------------------|--------------------|---------------------|
|  | <b>As</b>             |                    | <b>As Restated</b>  |
|  | <b>Previously</b>     | <b>As Restated</b> | <b>with</b>         |
| (Amounts in thousands)                       | <b>Reported</b>       |                    | <b>Discontinued</b> |
|  |                       |                    | <b>Operations</b>   |
| <b>ASSETS</b>                                |                       |                    |                     |
| Current assets:                              |                       |                    |                     |
| Cash and cash equivalents                    | \$ 39,674             | \$ 39,674          | \$ 39,674           |
| Accounts receivable, net                     | 497,499               | 502,867            | 500,288             |
| Inventories, net                             | 440,212               | 422,700            | 415,683             |
| Deferred taxes                               | 81,208                | 67,872             | 67,872              |
| Prepaid expenses and other                   | 29,112                | 22,511             | 32,107              |
| Total current assets                         | 1,087,705             | 1,055,624          | 1,055,624           |
| Property, plant and equipment, net           | 438,326               | 442,424            | 440,894             |
| Goodwill                                     | 872,482               | 872,826            | 872,826             |
| Deferred taxes                               | 144,937               | 32,161             | 32,161              |
| Other intangible assets, net                 | 163,865               | 166,013            | 166,013             |
| Other assets, net                            | 88,265                | 94,671             | 96,201              |
| Total assets                                 | \$ 2,795,580          | \$ 2,663,719       | \$ 2,663,719        |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>   |                       |                    |                     |
| Current liabilities:                         |                       |                    |                     |
| Accounts payable                             | \$ 258,582            | \$ 251,131         | \$ 249,109          |
| Accrued liabilities                          | 286,877               | 278,907            | 280,929             |
| Debt due within one year                     | 78,579                | 82,327             | 82,327              |
| Deferred taxes                               | 20,019                |                    |                     |
| Total current liabilities                    | 644,057               | 612,365            | 612,365             |
| Long-term debt due after one year            | 857,694               | 857,694            | 857,694             |
| Retirement obligations and other liabilities | 458,894               | 373,541            | 373,541             |
| Shareholders' equity                         | 834,935               | 820,119            | 820,119             |

|   |              |              |              |
|---|--------------|--------------|--------------|
| Total liabilities and shareholders equity | \$ 2,795,580 | \$ 2,663,719 | \$ 2,663,719 |
|---|--------------|--------------|--------------|

The restatement of the condensed consolidated balance sheet corrects for the following errors:

Accounts receivable, net, increased \$5.4 million at March 31, 2004, primarily from recording an accounts receivable factoring arrangement in one foreign location, previously reported as a sale, as a secured borrowing (\$3.7 million), and errors in accounting for one long-term contract that was accounted for using the percentage of completion method in which we did not include the estimated cost of the work performed by subcontractors as part of our total estimated

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Cost of sales decreased for the three months ended March 31, 2004 and 2003, primarily due to errors in the following (in thousands):

costs in determining the percentage of completion accounting for the overall contract (\$4.0 million). Neither of these items had a significant impact on net earnings in the periods presented. These errors were partially offset by errors in account reconciliations and other individually insignificant items (\$2.3 million).

Inventories, net decreased \$17.5 million at March 31, 2004, primarily due to errors in the following (in thousands):

|   |             |
|---|-------------|
| Long-term contract accounting                                     | \$ (9,724)  |
| Inventory valuation obsolete and slow moving                      | (2,383)     |
| Inventory valuation LIFO  | (1,947)     |
| Inventory valuation lower of cost or market adjustment            | (1,295)     |
| Intercompany reconciliations                                      | (943)       |
| Other adjustments to correct reconciliation of underlying records | (1,220)     |
| Total inventories, net  | \$ (17,512) |

*Long-Term Contract Accounting* We identified a long-term contract in which costs related to the contracts were not recorded in the appropriate periods and resulted in corrections to inventories in prior periods. This error did not have a significant impact on net earnings in the periods presented.

*Inventory Valuation* We corrected our financial statements for inconsistencies in the application of our accounting policy for obsolete and slow moving inventory, errors in our last-in, first-out ( LIFO ) calculations, and errors in adjusting for lower-of-cost-or-market considerations. The inconsistencies related to (i) obsolete and slow moving inventory mainly resulting from limitations in our systems and processes that did not effectively identify excess inventory quantities; and (ii) the inventories of acquired businesses where our identification of slow moving items was not performed timely. The errors in LIFO and lower-of-cost-or-market resulted from inaccurate calculations. This error did not have a significant impact on net earnings in the periods presented.

Prepaid expenses and other decreased \$6.6 million at March 31, 2004, primarily due to reclassification in tax matters (\$7.0 million) partially offset by other reconciling items (\$0.4 million).

Current and non-current deferred tax assets decreased \$13.3 million and \$112.8 million at March 31, 2004, respectively, to correct errors in recording deferred taxes for purchase accounting, the tax effects of restatement errors, and the tax effects of errors in accumulated other comprehensive loss. Non-current deferred tax assets have been primarily restated to properly net assets and liabilities. See also decrease in non-current deferred tax liability.

Property, plant and equipment, net increased \$4.1 million at March 31, 2003, to correct the accounting for foreign currency translations relating to the IDP acquisition where fair value was not pushed down to the local entities general ledgers, disposals and abandonment of assets, depreciation and amortization due to disposals and excessive amortization periods for leasehold improvements and errors in account reconciliations. These corrections were due to errors in the following (in thousands):

|   |           |
|---|-----------|
| Currency translation impact of push-down accounting | \$ 10,990 |
| Disposals and abandonments                          | (7,874)   |
| Depreciation and amortization                       | 1,387     |
| Other reconciling items                             | (405)     |



Total property, plant and equipment, net

\$ 4,098

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Goodwill increased \$0.3 million at March 31, 2004 primarily to correct purchase accounting related to the acquisitions of IDP in 2000 and IFC in 2002. These corrections were due to errors in the following (in thousands):

|                              |            |
|------------------------------|------------|
| Intercompany reconciliations | \$ (7,133) |
| Fixed assets                 | 3,133      |
| Deferred income taxes        | 4,007      |
| Other                        | 337        |
| <br>Total goodwill           | <br>\$ 344 |

Other intangibles, net increased \$2.1 million at March 31, 2004, primarily to correct the accounting for purchased intellectual property (\$1.8 million) and other reconciling items.

Other assets, net increased \$6.4 million at March 31, 2004, to reclassify over-funded pension plans to assets (\$11.5 million), partially offset by the write down of the value of equity investments based on GAAP conforming adjustments (\$4.5 million) and other reconciling items (\$0.6 million).

Accounts payable decreased \$7.5 million at March 31, 2004, to record the adjustments resulting from intercompany account reconciliations (\$8.5 million) and other reconciling items (\$0.7 million) partially offset by an accrual on long-term contract costs (\$1.7 million).

Accrued liabilities decreased \$8.0 million at March 31, 2004, to correct errors in the following (in thousands):

|                                 |                |
|---------------------------------|----------------|
| Tax matters                     | \$ (14,781)    |
| Intercompany reconciliations    | (702)          |
| Long-term contract accounting   | (1,016)        |
| Purchased intellectual property | 3,389          |
| Unclaimed property              | 3,327          |
| Financial derivatives           | (527)          |
| Other accruals                  | 2,340          |
| <br>Total accrued liabilities   | <br>\$ (7,970) |

*Unclaimed Property* We identified errors in accounting for unclaimed property primarily for unapplied cash and customer credits related to accounts receivable and for checks issued to vendors and to other payees that were not presented for payment. We previously recorded such items as income and removed these amounts from our balance sheet accounts. The correction reinstates such amounts within accrued liabilities as we began a process of filing with various states under voluntary disclosure agreements. This error did not have a significant impact on net earnings in the periods presented.

Debt due within one year increased \$3.7 million at March 31, 2004, to correct the accounts receivable factoring arrangement as a secured borrowing rather than as a sale.

Current and non-current deferred tax liabilities decreased \$20.0 million and \$95.2 million, respectively, at March 31, 2004, to correct errors in deferred taxes, the tax effects of errors in the restatement and the tax effects of errors in accumulated other comprehensive loss. Non-current deferred tax liabilities have been primarily restated to properly net assets and liabilities. See also decrease in non-current deferred tax assets.

Retirement obligations and other liabilities increased by \$9.9 million at March 31, 2004, excluding the decrease of \$95.2 million in non-current deferred tax liabilities discussed above, primarily to reclassify over-funded pension plans to other assets, net as described above (\$11.5 million) and other reconciling items (\$4.2 million) offset by correcting the actuarially determined obligations and accounting for several non-U.S. pension plans in accordance with GAAP and the related liabilities that meet the criteria of a defined benefit plan (\$5.8 million).

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Our consolidated statements of cash flows for the three months ended March 31, 2004 and 2003, were also restated for the items discussed above. The following table presents the major subtotals in our 2004 and 2003 consolidated statements of cash flows and the related impact of the restatement adjustments discussed above:

**Condensed Consolidated Statements of Cash Flows Information  
For the Three Months Ended March 31, 2004 and 2003**

|  | 2004                         |                | 2003                         |                |
|--|------------------------------|----------------|------------------------------|----------------|
|  | As<br>Previously<br>Reported | As<br>Restated | As<br>Previously<br>Reported | As<br>Restated |
| (Amounts in thousands)                         |                              |                |                              |                |
| Net cash flows provided (used) by:             |                              |                |                              |                |
| Operating activities                           | \$ 7,207                     | \$ 7,933       | \$ 13,575                    | \$ 12,290      |
| Investing activities                           | (12,697)                     | (12,721)       | (5,536)                      | (5,536)        |
| Financing activities                           | (8,022)                      | (8,724)        | (20,000)                     | (18,461)       |
| Effect of exchange rate changes on cash        | (336)                        | (336)          | 1,183                        | 1,183          |
| Net change in cash and cash equivalents        | (13,848)                     | (13,848)       | (10,778)                     | (10,524)       |
| Cash and cash equivalents at beginning of year | 53,522                       | 53,522         | 49,245                       | 48,991         |
| Cash and cash equivalents at end of period     | \$ 39,674                    | \$ 39,674      | \$ 38,467                    | \$ 38,467      |

The footnotes contained in these condensed consolidated financial statements also reflect the impact of the restatement discussed in this footnote.

**3. Discontinued Operations**

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.

GMBU generated the following results of operations:

|   | Three Months Ended March<br>31, |                          |
|---|---------------------------------|--------------------------|
|   | 2004<br>(As<br>restated)        | 2003<br>(As<br>restated) |
| (Amounts in millions)                       |                                 |                          |
| Sales                                       | \$ 5.7                          | \$ 5.1                   |
| Cost of sales                               | 4.8                             | 4.1                      |
| Selling, general and administrative expense | 0.8                             | 0.6                      |
| Earnings before income taxes                | 0.1                             | 0.4                      |
| Provision for income taxes                  |                                 | 0.2                      |

|   |    |            |    |     |
|---|----|------------|----|-----|
| Results for discontinued operations, net of tax | \$ | <b>0.1</b> | \$ | 0.2 |
|---|----|------------|----|-----|

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GMBU's assets and liabilities have been reclassified to prepaid expenses and other, property, plant and equipment, net, accounts payable and accrued liabilities to reflect discontinued operations. As of March 31, 2004 and December 31, 2003, GMBU's assets and liabilities consisted of the following:

(Amounts in millions)

|                                    | <b>March 31,<br/>2004<br/>(As<br/>restated)</b> | December<br>31,<br>2003 |
|------------------------------------|---|-------------------------|
| Accounts receivable, net           | \$ 2.6  | \$ 3.9                  |
| Inventory, net                     | 7.0   | 5.7                     |
| Property, plant and equipment, net | 1.5   | 1.6                     |
| Goodwill                           | 7.8   | 7.8                     |
| Other intangible assets, net       | 1.4   | 1.4                     |
| <b>Total assets</b>                | <b>\$ 20.3</b>                                  | <b>\$ 20.4</b>          |
| Accounts payable                   | \$ 2.0  | \$ 3.3                  |
| Accrued liabilities                | 1.0   | 2.0                     |
| <b>Total liabilities</b>           | <b>\$ 3.0</b>                                   | <b>\$ 5.3</b>           |

**4. Acquisitions**

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.

**5. Goodwill**

The changes in the carrying amount of goodwill for the three months ending March 31, 2004 follow:

| (Amounts in thousands)                            | <b>Flowserve<br/>Pump</b> | <b>Flow<br/>Solutions</b> | <b>Flow<br/>Control</b> | <b>Total</b>      |
|---|---------------------------|---------------------------|-------------------------|-------------------|
| Balance as of December 31, 2003                   | \$ 473,554                | \$ 32,266                 | \$ 366,140              | \$ 871,960        |
| Resolution of other contingencies                 | 528                       |                           | (713)                   | (185)             |
| Currency translation                              | (531)                     | (372)                     | 1,954                   | 1,051             |
| <b>Balance as of March 31, 2004 (as restated)</b> | <b>\$ 473,551</b>         | <b>\$ 31,894</b>          | <b>\$ 367,381</b>       | <b>\$ 872,826</b> |

**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 March 31, 2004, we have approximately \$119.2 million of notional amount in outstanding contracts with third parties. As of March 31, 2004, the maximum length of any forward contract in place was 15 months.

Certain of our forward contracts do not qualify for hedge accounting. The fair value of these outstanding forward contracts at March 31, 2004 was an asset of \$1.4 million and an asset of \$4.7 million at December 31, 2003.

Unrealized losses from the changes in the fair value of these forward contracts of \$3.9 million and \$0.6 million for the quarters ended March 31, 2004 and 2003, respectively, are included in other (expense) income, net in the consolidated statements of operations. The fair value of outstanding forward contracts qualifying for hedge accounting at March 31, 2004 was an asset of \$0.4 million and a liability of \$2.3 million at December 31, 2003. Unrealized gains from the changes in the fair value of qualifying forward contracts and the associated underlying exposures of \$84,000 and \$30,000, net of tax, for the quarters ended March 31, 2004 and 2003, respectively, are included in other comprehensive income (loss).

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 March 31, 2004, we have \$175 million of notional amount in outstanding interest rate swaps with third parties. As of March 31, 2004, the maximum remaining length of any interest rate contract in

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place was approximately 32 months. The fair value of the interest rate swap agreements was a liability of \$7.7 million and \$7.6 million at March 31, 2004 and December 31, 2003, respectively. Unrealized gains (losses) from the changes in fair value of our interest rate swap agreements, net of reclassifications, were \$1.7 million and \$(0.3) million, net of tax, for the quarters ended March 31, 2004 and 2003, respectively, and are included in other comprehensive income (loss).

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. Additionally, we are exposed to risk of our derivative contracts not qualifying for hedge accounting.

**7. Debt**

Debt, including capital lease obligations, consisted of:  
(Amounts in thousands)

|  | <b>March 31,<br/>2004<br/>(As<br/>restated)</b> | December<br>31,<br>2003 |
|--|---|-------------------------|
| Term Loan Tranche A:   |   |                         |
| U.S. Dollar Tranches, interest rate of 3.63% in 2004 and 3.74% in 2003 | \$ 191,982                                      | \$ 200,004              |
| Euro Tranche, interest rate of 4.63% in 2004 and 4.65% in 2003         | 12,022  | 12,292                  |
| Term Loan Tranche C, interest rate of 3.88% in 2004 and 4.00% in 2003  | 465,473   | 465,473                 |
| Senior Subordinated Notes, net of discount, coupon of 12.25%:          |   |                         |
| U.S. Dollar denominated  | 186,805   | 186,739                 |
| Euro denominated   | 79,249  | 80,998                  |
| Receivable factoring obligations                                       | 3,748   | 4,543                   |
| Capital lease obligations and other                                    | 742   | 752                     |
| <br>   |   |                         |
| Debt and capital lease obligations                                     | <b>940,021</b>                                  | 950,801                 |
| Less amounts due within one year                                       | <b>82,327</b>                                   | 71,035                  |
| <br>   |   |                         |
| Total debt due after one year  | <b>\$ 857,694</b>                               | \$ 879,766              |

**2000 Credit Facilities**

As of March 31, 2004 and December 31, 2003, our 2000 Credit Facilities were composed of Tranche A and Tranche C term loans and a revolving line of credit. Tranche A consisted of a U.S. dollar denominated tranche and a Euro denominated tranche, the latter of which was a term note due in 2006. During the three months ended March 31, 2004, we made scheduled debt payments of \$8.0 million. During the remainder of 2004, we made scheduled, mandatory and optional principal payments of \$19.5 million, \$167.9 million and \$160.0 million, respectively.

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 the London Interbank Offered Rate ( 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 allows us to issue up to \$200 million in letters of credit. No amounts were outstanding under the revolving line of credit at March 31, 2004 or December 31, 2003. We had outstanding letters of credit of \$45.7 million under the revolving line of credit, which reduced borrowing capacity to \$254.3 million at March 31, 2004, compared with a borrowing capacity of \$257.3 million at December 31, 2003.



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, 2003, no additional principal payments became due in 2004 under this provision.

**Table of Contents****Senior Subordinated Notes**

At March 31, 2004, we had \$188.5 million and 65 million (equivalent to \$80.0 million at March 31, 2004) face value of Senior Subordinated Notes outstanding. 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.

**EIB Credit Facility**

On April 14, 2004, we and one of our European subsidiaries, Flowserve B.V., entered into an agreement with European Investment Bank ( 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 prepayment, 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. The maturity of the loan 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.

**Debt Covenants**

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.

**8. 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 as described in Note 7, such factoring was generally limited to \$50 million, based on the due date of the factored receivables. The limit on factoring was raised to \$75 million under the New Credit Facilities, which were entered into in August 2005, and are fully described in Note 7.

At March 31, 2004 and December 31, 2003, respectively, we had received, using end of period exchange rates, a U.S. dollar equivalent of approximately \$23 million and \$24 million, respectively, in cash from our most significant factoring agreement, which represents the factor's purchase of approximately \$28 million and \$30 million of our receivables, respectively.

Additionally, we maintain numerous other individually less significant factoring agreements. In the aggregate, the total cash received from the factoring of receivables under these agreements totaled approximately \$23 million and \$25 million at March 31, 2004 and December 31, 2003, respectively. One of these agreements was determined to represent a leveraged borrowing, as opposed to a sale of receivables. Accordingly, we have reported the aggregate cash received from this facility as a component of short-term debt in the amount of \$3.7 million and \$4.5 million at March 31, 2004 and December 31, 2003, respectively.

In the first quarter of 2004, under all of our factoring agreements globally, we recognized, using quarter-end exchange rates, losses of approximately \$0.4 million in factoring receivables, which compares with a total loss of \$1.6 million in 2003.

**Table of Contents****9. 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:

|                                   | <b>March 31,<br/>2004<br/>(As<br/>restated)</b> | December<br>31,<br>2003 |
|-----------------------------------|---|-------------------------|
| (Amounts in thousands)            |   |                         |
| Raw materials                     | \$ 123,147                                      | \$ 115,695              |
| Work in process                   | 233,635   | 229,049                 |
| Finished goods                    | 232,013   | 230,234                 |
| Less: Progress billings           | (99,430)  | (92,490)                |
| Less: Excess and obsolete reserve | (46,454)  | (43,354)                |
|                                   | <b>442,911</b>                                  | 439,134                 |
| LIFO reserve                      | (27,228)  | (26,760)                |
| Net inventory                     | \$ 415,683                                      | \$ 412,374              |

Percent of inventory accounted for by:

|      |     |     |
|------|-----|-----|
| LIFO | 50% | 50% |
| FIFO | 50% | 50% |

**10. Restructuring Costs IFC  
Restructuring Costs**

In conjunction with the acquisition of IFC during 2002, we initiated a restructuring program designed to reduce costs and eliminate excess capacity by closing 18 valve facilities, including 10 service facilities, and reducing sales and related support personnel. Our actions, some of which were approved and committed to in 2002 with the remaining actions approved and committed to in 2003, are expected to result in a gross reduction of approximately 889 positions and a net reduction of approximately 662 positions. Net position eliminations represent the gross positions eliminated from the closed facilities offset by positions added at the receiving facilities, which are required to produce the products transferred into the receiving facilities.

We established a restructuring program reserve upon acquisition of IFC, and recognized additional accruals of \$4.5 million in 2003 for this program, including \$2.0 million during the first quarter, primarily related to the closure of certain valve service facilities and the related reductions in workforce. Cash expenditures against the accrual were \$11.6 million in 2003, including \$4.1 million during the first quarter, and \$1.3 million during the first quarter of 2004. The remaining accrual of \$8.0 million reflects payments to be made in 2004 and beyond for severance obligations due to terminated personnel in Europe of \$4.8 million as well as lease and other contract termination and exit costs of \$3.2 million.

Cumulative costs associated with the closure of Flowserve facilities of \$7.2 million through December 31, 2003, have been recognized as restructuring expense in operating results, whereas cumulative costs associated with the closure of IFC facilities of \$17.9 million, including related deferred taxes of \$6.2 million, became part of the purchase price allocation of the transaction. The effect of these closure costs increased the amount of goodwill otherwise recognizable as a result of the IFC acquisition.

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The following illustrates activity related to the IFC restructuring reserve:

| (Amounts in millions)        | <b>Severance</b> | <b>Other Exit<br/>Costs</b> | <b>Total</b> |
|------------------------------|------------------|-----------------------------|--------------|
| Balance at January 1, 2003   | \$ 10.7          | \$ 5.7                      | \$ 16.4      |
| Additional accruals          | 3.8              | 0.7                         | 4.5          |
| Cash expenditures            | (8.8)            | (2.8)                       | (11.6)       |
| Balance at December 31, 2003 | 5.7              | 3.6                         | 9.3          |
| Cash expenditures            | (0.9)            | (0.4)                       | (1.3)        |
| Balance at March 31, 2004    | \$ 4.8           | \$ 3.2                      | \$ 8.0       |

**Integration Costs IFC**

We did not incur acquisition-related integration expenses in 2004. During the first quarter of 2003, we incurred acquisition-related integration expense in conjunction with IFC, which is summarized below:

| (Amounts in millions)       | <b>2003</b> |
|-----------------------------|-------------|
| Personnel and related costs | \$ 3.7      |
| Transfer of product lines   | 1.7         |
| Asset impairments           | 0.2         |
| Other                       | 0.8         |
| IFC integration expense     | \$ 6.4      |
| Cash expense                | \$ 6.2      |
| Non-cash expense            | 0.2         |
| IFC integration expense     | \$ 6.4      |

The acquisition-related activities resulted in integration costs as categorized above and further defined as follows. Personnel and related costs include payroll, benefits, consulting fees, and retention and integration performance bonuses paid to our employees and contractors for the development, management and execution of the integration plan. Transfer of product lines includes costs associated with the transfer of product lines as well as realignment required in the receiving facilities. Asset impairments reflect the loss on disposal of property, plant and equipment at the facilities closed and disposal of inventory for discontinued product lines when the facilities were combined. The other category includes costs associated with information technology integration, legal entity consolidations, legal entity name changes, signage, new product literature and others. None of these items individually amounted to greater than \$0.5 million.

**Remaining Restructuring and Integration Costs IFC**

At December 31, 2003, we largely completed restructuring and integration activities related to IFC, except for payments to be made for certain European activities. We expect to incur no additional restructuring and integration costs related to this integration program. Payments from the restructuring accrual will continue throughout 2004 and into 2005 due to the timing of severance obligations in Europe.

**Table of Contents****11. Warranty Reserve**

The following is a summary of the activity in our warranty reserve:

| (Amounts in thousands)        | 2004<br>(As<br>restated) | 2003<br>(As<br>restated) |
|-------------------------------|--------------------------|--------------------------|
| Balance at January 1,         | \$ 19,233                | \$ 15,899                |
| Accruals for warranty expense | 7,210                    | 4,653                    |
| Settlements made              | (5,844)                  | (5,108)                  |
| Balance as of March 31,       | \$ 20,599                | \$ 15,444                |

**12. Earnings Per Share**

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

| (Amounts in thousands, except per share amounts)                   | Quarter Ended March 31,<br>2004<br>(As<br>restated) | 2003<br>(As<br>restated) |
|--|---|--------------------------|
| Income from continuing operations                                  | \$ 7,069  | \$ 5,012                 |
| Net earnings   | \$ 7,144  | \$ 5,268                 |
| Denominator for basic earnings per share weighted average shares   | 55,171  | 55,151                   |
| Effect of potentially dilutive securities                          | 258   | 82                       |
| Denominator for diluted earnings per share weighted average shares | 55,429  | 55,233                   |
| Net earnings per share:  |   |                          |
| Basic:   |   |                          |
| Continuing operations  | \$ 0.13   | \$ 0.10                  |
| Net earnings   | 0.13  | 0.10                     |
| Diluted:   |   |                          |
| Continuing operations  | \$ 0.13   | \$ 0.10                  |
| Net earnings   | 0.13  | 0.10                     |

Options outstanding with an exercise price greater than the average market price of the common stock were not included in the computation of diluted earnings per share.

The following summarizes options to purchase common stock that were excluded from the computations of potentially dilutive securities:

|                                 | Quarter Ended March 31,<br>2004 | 2003      |
|---------------------------------|---------------------------------|-----------|
| Total number excluded           | 1,175,307                       | 2,855,340 |
| Weighted average exercise price | \$ 27.18                        | \$ 22.33  |

**13. 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 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

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a formal order of private investigation into issues regarding this restatement and any other issues that arise from the investigation. We continue to cooperate with the SEC in this matter.

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 ( Complaint ). The Complaint alleges that federal securities violations occurred between February 6, 2001 and September 27, 2002 and names as defendants Mr. C. Scott Greer, our former Chairman, President and Chief Executive Officer, Ms. Renee J. Hornbaker, our former Vice President and Chief Financial Officer, PricewaterhouseCoopers LLP, our independent registered public accounting firm, and Banc of America Securities LLC and Credit Suisse First Boston LLC, which served as underwriters for two of our public stock offerings during the relevant period. The Complaint asserts claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, and Sections 11 and 15 of the Securities Act of 1933. The lead plaintiff seeks unspecified compensatory damages, forfeiture by Mr. Greer and Ms. Hornbaker of unspecified incentive-based or equity-based compensation and profits from any stock sales, and recovery of costs. On November 22, 2005, the Court entered an order denying the defendants' motions to dismiss the Complaint on the pleadings in their entirety. 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.

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.

**Table of Contents****14. Retirement and Postretirement Benefits**

Components of the net periodic cost (benefit) for the quarters ended March 31, 2004 and 2003 were as follows:

| (Amounts in millions)                 | U.S.<br>Defined Benefit Plans |        | Non-U.S.<br>Defined Benefit Plans |        | Postretirement<br>Medical Benefits |        |
|---------------------------------------|-------------------------------|--------|-----------------------------------|--------|------------------------------------|--------|
|                                       | 2004                          | 2003   | 2004                              | 2003   | 2004                               | 2003   |
| Net periodic cost (benefit)           |                               |        |                                   |        |                                    |        |
| Service cost                          | \$ 3.5                        | \$ 3.4 | \$ 0.9                            | \$ 0.6 | \$ 0.1                             | \$     |
| Interest cost                         | 3.8                           | 3.9    | 2.2                               | 1.9    | 1.3                                | 1.5    |
| Expected return on plan assets        | (4.3)                         | (4.3)  | (1.1)                             | (0.9)  |                                    |        |
| Curtailments/settlements              |                               | (0.1)  |                                   |        |                                    |        |
| Amortization of unrecognized net loss | 0.6                           | 0.2    | 0.3                               | 0.4    | 0.4                                | 0.3    |
| Amortization of prior service costs   | (0.3)                         | (0.3)  |                                   |        | (0.8)                              | (0.8)  |
| Net cost recognized                   | \$ 3.3                        | \$ 2.8 | \$ 2.3                            | \$ 2.0 | \$ 1.0                             | \$ 1.0 |

**15. Income taxes**

For the three months ended March 31, 2004, we earned \$15.3 million before taxes and provided for income taxes of \$8.2 million, resulting in an effective tax rate of 53.7%. The effective tax rate varied from the U.S. federal statutory rate primarily as a result of the impact of increased foreign earnings repatriation used to pay down U.S. debt.

**16. 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 Control Division; and

Flow Solutions 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 excluding special items, such as restructuring and integration costs related to the IFC acquisition. We believe that special items, while indicative of efforts to integrate acquired companies such as IFC and IDP into our business, do not reflect ongoing business results. We believe investors and other users of our financial statements can better evaluate and analyze historical and future business trends if special items are excluded from each segment's operating income. Operating income before special items is not a recognized measure under GAAP and should not be viewed as an alternative to, or a better indicator of, GAAP measures of performance.

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.



Effective January 1, 2004, we realigned certain small sites between segments. Accordingly, the segment information for all periods presented herein has been reported under our revised organizational structure.

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

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| <b>Three Months Ended March 31, 2004</b><br>(As restated) | <b>Flowserve</b> | <b>Flow</b>      | <b>Flow</b>    | <b>Subtotal<br/>Reportable</b> | <b>Consolidated</b>  |              |
|---|------------------|------------------|----------------|--------------------------------|----------------------|--------------|
| <b>(amounts in thousands)</b>                             | <b>Pump</b>      | <b>Solutions</b> | <b>Control</b> | <b>Segments</b>                | <b>All<br/>Other</b> | <b>Total</b> |
| Sales to external customers                               | \$ 295,572       | \$ 87,838        | \$ 220,438     | \$ 603,848                     | \$ 1,300             | \$ 605,148   |
| Intersegment sales  | 1,657            | 7,000            | 1,335          | 9,992                          | (9,992)              |              |
| Segment operating income                                  | 18,596           | 17,187           | 12,259         | 48,042                         | (9,276)              | 38,766       |

| <b>Three Months Ended March 31, 2003</b><br>(As restated)      | <b>Flowserve</b> | <b>Flow</b>      | <b>Flow</b>    | <b>Subtotal<br/>Reportable</b> | <b>Consolidated</b>  |              |
|--|------------------|------------------|----------------|--------------------------------|----------------------|--------------|
| <b>(amounts in thousands)</b>                                  | <b>Pump</b>      | <b>Solutions</b> | <b>Control</b> | <b>Segments</b>                | <b>All<br/>Other</b> | <b>Total</b> |
| Sales to external customers                                    | \$ 276,653       | \$ 78,961        | \$ 200,490     | \$ 556,104                     | \$ 1,114             | \$ 557,218   |
| Intersegment sales   | 2,975            | 6,111            | 2,496          | 11,582                         | (11,582)             |              |
| Segment operating income (before special items) <sup>(1)</sup> | 20,795           | 15,890           | 10,669         | 47,354                         | (8,892)              | 38,462       |

<sup>(1)</sup> Special items reflect costs associated with the IFC acquisition including \$6.4 million of integration expense and \$1.0 million of restructuring expense.

A reconciliation of total consolidated operating income before special items to consolidated earnings before income taxes follows:

| <b>(amounts in thousands)</b>                              | <b>Quarter Ended March 31,</b> |                      |
|--|--------------------------------|----------------------|
|  | <b>2004</b>                    | <b>2003</b>          |
|  | <b>(As restated)</b>           | <b>(As restated)</b> |
| Total consolidated operating income (before special items) | <b>\$ 38,766</b>               | \$ 38,462            |
| Less:  |                                |                      |
| Net interest expense                                       | <b>(19,830)</b>                | (20,223)             |
| Loss on optional prepayments of debt                       |                                | (159)                |
| Other (expense) income, net                                | <b>(3,677)</b>                 | (1,611)              |
| Special items:   |                                |                      |
| Integration expense  |                                | 6,410                |
| Restructuring expense                                      |                                | 1,012                |
| Earnings before income taxes                               | <b>\$ 15,259</b>               | \$ 9,047             |

**17. Subsequent  
Events**

***Financing Matters***

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.

In March 2005, we obtained consents from our major lenders that enhanced our flexibility under our 2000 Credit Facilities 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 New 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

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guaranteeing our obligations under the EIB credit facility described in Note 7 with a letter of credit issued under the new revolving line of credit.

We incurred \$9.3 million in fees related to the new facilities, of which \$0.3 million were expensed in 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 2005. In addition to the total loan costs of \$10.8 million that were expensed, we recorded a charge of \$16.5 million for premiums paid to call the Senior Subordinated Notes, for a total loss on extinguishment of \$27.3 million recorded in 2005. The remaining \$9.0 million of fees related to the new facilities were capitalized and combined with the remaining \$1.3 million of previously unamortized deferred loan costs for a total of \$10.3 million in deferred loan costs included in other assets, net. These costs will be 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 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 Earnings before Interest, Taxes, Depreciation and Amortization ( EBITDA ), which at December 31, 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, during 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 rates 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. 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.

As a result of the 2004 Restatement 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 the quarterly periods ended June 30, 2004, September 30, 2004, March 31, 2005, June 30, 2005 and September 30, 2005, 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 such waivers, were not in default. We did not seek or obtain a waiver under the indentures governing our

12.25% Senior

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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. However, our debt is properly classified as non-current in our balance sheet as we demonstrated our ability and intent to obtain new long-term credit facilities in August 2005.

We have determined, utilizing our restated financial information, that on multiple occasions we did not comply with some of the financial covenants in our 2000 Credit Facilities, which are no longer in effect. We believe that we could have undertaken readily available actions to maintain compliance or obtained a waiver or amendment to the 2000 Credit Facilities had the new restated results then been known. We have complied with all other non-financial covenants under our 2000 Credit Facilities. We believe that these covenant violations have no impact on our New Credit Facilities and that the amounts outstanding under the 2000 Credit Facilities are properly classified in our consolidated balance sheet.

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. Delivery of the December 31, 2004 audited consolidated financial statements was required by December 31, 2005 and delivery of the December 31, 2005 audited financial statements is required by May 30, 2006. We received a waiver from our lenders to deliver the December 31, 2004 audited financial statements by February 28, 2006. The December 31, 2004 audited financial statements were delivered February 13, 2006. 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. 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.

***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. Hornbaker, 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 we delivered to Iraq from 1996 through 2003 during the United Nations Oil-for-Food Program. We are in the process of reviewing and responding to the subpoena and intend to cooperate with the SEC. We believe that other companies in our industry (as well as in other industries) have received similar subpoenas and requests for information.

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. Hornbaker, and current board members

Hugh K. Coble, George T. Haymaker, Jr., Lewis M. Kling, 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 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

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occurred between 2000 and 2004. The plaintiff seeks on our behalf an unspecified amount of damages, disgorgement by Mr. Greer and Ms. Hornbaker of salaries, bonuses, restricted stock and stock options, and recovery of attorneys fees and costs. We strongly believe that the suit was improperly filed and intend to file a motion seeking dismissal of the case.

Since we manufacture and sell our products globally, we are subject to risks associated with doing business internationally. 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 require further research to determine compliance with U.S. export control laws and regulations. With assistance from outside counsel, we are currently involved in a systematic process to conduct further research. 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 suspension of the privilege to engage in export transactions or to have our foreign affiliates receive U.S.-origin goods, software or technology. Because our research into this issue is ongoing, we are unable to determine the extent of any violations or the nature or amount of any potential penalties to which we might be subject to in the future. As a result, we cannot currently predict whether the resolution of this matter will materially adversely affect our financial position or results of operations. At this time, we have not made any provision in our consolidated financial statements for any fines or penalties that might be incurred relating to this matter.

***Stock Matters***

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 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),

Share-Based Payment. 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 SEC Form S-8 Registration Statement 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, *Accounting for Stock Issued to Employees*, of approximately \$1 million in 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.

***Other Matters***

In the first quarter of 2005, we made a definitive decision to sell certain non-core service operations, collectively called the General Services Group ( GSG ) and engaged an investment banking firm to commence marketing. As a result, we reclassified the operation to discontinued operations in the first quarter of 2005. Sales for GSG were \$116 million in 2004. Total assets at December 31, 2004 ascribed to GSG were approximately \$63 million. We performed an impairment analysis of long-lived assets on a held and used basis, and concluded that no impairment was warranted as of December 31, 2004. GSG was sold on December 31, 2005 for approximately \$16 million in gross cash proceeds, subject to final working capital adjustments, while retaining approximately \$12 million of net accounts receivable. We used approximately \$11 million of the net cash proceeds to reduce our indebtedness. In 2005, we recorded an impairment loss of approximately \$31 million related to GSG.

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To promote continuity of senior management, in March 2005 our Board of Directors approved a Transitional Executive Security Plan, which provides cash and stock-based incentives to key management personnel to remain employed by us for the near term. As a result of this plan, we recorded additional compensation expenses in 2005 of approximately \$3 million. See Transitional Executive Security Plan in Item 11 of our 2004 Annual Report for a detailed discussion on this plan.

During 2005, we made a number of modifications to our stock plans, including the acceleration 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, we recorded additional compensation expenses in 2005 of approximately \$7 million based upon the intrinsic values of the awards, primarily related to severance agreements with former executives, on the dates the modifications were made.

As a result of the severance and executive search payments related to the management changes of approximately \$2 million, expenses under the Transitional Executive Security Plan described above and stock compensation expense resulting from the modification of our stock option plans described above, we recorded total incremental compensation expense of approximately \$12 million in 2005.

We have recently concluded an Internal Revenue Service ( IRS ) audit of our U.S. federal income tax returns for the years 1999 through 2001. 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 \$2.9 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. The effect of the adjustments to current and deferred taxes has been reflected in the consolidated financial statements for annual periods covered by the 2004 Restatement.

**Table of Contents****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 Amended Quarterly Report and the 2004 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****Restatement**

This Amended Quarterly Report includes our restated consolidated financial statements as of March 31, 2004 and December 31, 2003 and for the three months ended March 31, 2004 and 2003 resulting from our 2004 Restatement.

The 2004 Restatement corrects errors made in the application of GAAP, including errors with respect to inventory valuation, long-term contract accounting, intercompany accounts, pension expense, fixed assets and intangibles, financial derivatives, unclaimed property, tax matters, and other adjustments from unreconciled accounts. The 2004 Restatement is more fully described in Note 2 to our restated condensed consolidated financial statements included in this Amended Quarterly Report and in Note 2 to our 2004 Annual Report.

The impact of the 2004 Restatement decreased sales for the three months ended March 31, 2004 and 2003 by \$0.5 million and \$1.9 million, respectively, decreased net earnings for the three months ended March 31, 2004 and 2003 by \$3.1 million and \$2.2 million, respectively, and decreased total assets, total liabilities and total shareholders equity at March 31, 2004 by \$131.9 million, \$117.1 million and \$14.8 million, respectively. The decreases in total assets and total liabilities are due primarily to the proper netting of deferred tax assets and liabilities. Diluted net earnings per share decreased by \$0.06 and \$0.04 per share for the three months ended March 31, 2004 and 2003, respectively.

For further discussion of other recent developments, see Note 17 to our condensed consolidated financial statements included in this Amended Quarterly Report and Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations included in our 2004 Annual Report.

**RESULTS OF OPERATIONS Three Months ended March 31, 2004 and 2003****Consolidated Results****Bookings, Sales and Backlog**

| (Amounts in millions) | Quarter Ended March 31, |               |
|-----------------------|-------------------------|---------------|
|                       | 2004                    | 2003          |
|                       | (As restated)           | (As restated) |
| Bookings              | \$662.8                 | \$607.9       |
| Sales                 | 605.1                   | 557.2         |
| Backlog               | 873.0                   | 789.6         |

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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 March 31, 2004 increased by \$10.1 million, or 1.7%, excluding currency benefits of approximately \$45 million, as compared with the same period in 2003. The increase is primarily due to increase in bookings by our Flow Control Division, particularly in the oil and gas market, one of our primary served markets, which was spurred by increased crude oil prices. The increase is also due to a \$3.6 million increase in bookings resulting from our Flowserve Pump Division's acquisition of the remaining 75% of TKL in March 2004. The increase was partially offset by our Flowserve Pump Division's increased selectivity in not pursuing lower margin project-related business. Overall business to the petroleum industry remained robust. In addition, we have also seen improving activity in the U.S. nuclear power market in the first quarter.

Sales for the three months ended March 31, 2004 increased by \$7.2 million, or 1.3%, excluding currency benefits of approximately \$41 million, as compared with the same period in 2003. The increase primarily reflects the increase in overall market conditions as experienced by our Flow Control Division and Flow Solutions Division and a \$4.6 million increase in sales resulting from our acquisition of the remaining 75% of TKL in March 2004, and is partially offset by decreased sales into the water market by our Flowserve Pump Division.

Net sales to international customers, including export sales from the U.S., were 61% of sales in the first quarter of 2004 compared with 53% in the same period in 2003. Stronger non-U.S. currency effects was the primary factor for the increase in 2004 compared with the prior period.

Backlog represents the accumulation of uncompleted customer orders. Backlog at March 31, 2004 increased by \$29.0 million, or 3.7%, excluding currency benefits of approximately \$54 million, as compared with March 31, 2003. The backlog increase compared with the prior year resulted from increased bookings during the first quarter of 2004.

**Gross Profit and Gross Profit Margin**

| (Amounts in millions) | Quarter Ended March 31, |               |
|-----------------------|-------------------------|---------------|
|                       | 2004                    | 2003          |
|                       | (As restated)           | (As restated) |
| Gross profit          | \$178.9                 | \$167.4       |
| Gross profit margin   | 29.6%                   | 30.0%         |

Gross profit margin of 29.6% for the three months ending March 31, 2004 decreased slightly as compared with the same period in 2003. This primarily reflects an unfavorable product mix experienced by our Flowserve Pump Division as well as decreased sales by this same division, which unfavorably impacts our absorption of fixed costs.

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

| (Amounts in millions)                 | Quarter Ended March 31, |               |
|---------------------------------------|-------------------------|---------------|
|                                       | 2004                    | 2003          |
|                                       | (As restated)           | (As restated) |
| SG&A expense                          | \$140.1                 | \$128.9       |
| SG&A expense as a percentage of sales | 23.2%                   | 23.1%         |

SG&A for the three months ended March 31, 2004 increased by \$2.9 million, or 2.2%, excluding currency effects of approximately \$8 million, as compared with the same period in 2003. The increase in SG&A is due to higher professional fees of \$1.7 million generally related to the restatement and other legal matters and higher incentive compensation accruals of \$1.9 million.



**Table of Contents****Integration and Restructuring Expense**

| (Amounts in millions) | Quarter Ended March 31,  |                  |
|-----------------------|--------------------------|------------------|
|                       | <b>2004</b>              | 2003             |
|                       | (As<br><b>restated</b> ) | (As<br>restated) |
| Integration expense   | \$                       | \$ 6.4           |
| Restructuring expense |                          | 1.0              |

There were no integration or restructuring expenses in the first quarter of 2004 due to the substantial completion of the program at the end of 2003. The integration and restructuring expenses in 2003 relate to the integration of IFC into the Flow Control Division. Integration expense represents period costs associated with IFC acquisition-related reorganizations such as relocation of product lines from closed to receiving facilities, realignment of receiving facilities, performance and retention bonuses, idle manufacturing costs, costs related to the integration team and asset impairments. Restructuring expense represents severance and other exit costs related to our valve facility closures and reductions in work force. We have largely completed our restructuring and integration activities related to IFC, except for completion of certain European integration activities. See the discussion on Restructuring and Acquisition Related Charges included in this Management's Discussion and Analysis for a more detailed description of the integration and restructuring program.

**Operating Income**

| (Amounts in millions)                     | Quarter Ended March 31,  |                  |
|---|--------------------------|------------------|
|   | <b>2004</b>              | 2003             |
|   | (As<br><b>restated</b> ) | (As<br>restated) |
| Operating income                          | <b>\$38.8</b>            | \$ 31.0          |
| Operating income as a percentage of sales | <b>6.4%</b>              | 5.6%             |

Operating income for the three months ended March 31, 2004 increased by \$3.5 million, or 11.3%, excluding currency benefits of approximately \$4 million, as compared with the same period in 2003. The increase is primarily a result of the decrease of \$7.4 million in integration and restructuring expenses, partially offset by the increase in SG&A discussed above.

**Interest Expense, Interest Income and Loss on Repayment of Debt**

| (Amounts in millions)                | Quarter Ended March 31,  |                  |
|--------------------------------------|--------------------------|------------------|
|                                      | <b>2004</b>              | 2003             |
|                                      | (As<br><b>restated</b> ) | (As<br>restated) |
| Interest expense                     | <b>\$20.1</b>            | \$ 21.1          |
| Interest income                      | <b>0.3</b>               | 0.9              |
| Loss on optional prepayments of debt |                          | 0.2              |

Interest expense for the three months ended March 31, 2004 decreased by \$1.0 million, or 5.0%, as compared with the same period in 2003 due to reduced debt levels associated with optional and scheduled debt paydowns since March 31, 2003. Approximately 47% of our debt was at fixed rates at March 31, 2004, including the effects of \$175 million notional interest rate swaps.

Interest income for the three months ended March 31, 2004 decreased by \$0.6 million as compared with the same period in 2003 due to a lower average cash balance in 2004.

During the first three months of 2004, we recognized no expenses related to the write-off of unamortized prepaid financing fees as there were no optional debt repayments. In the prior year, we incurred expense related to optional debt prepayments of \$0.2 million in the first quarter.



**Table of Contents****Other (Expense) Income, net**

| (Amounts in millions)       | Quarter Ended March 31, |           |
|-----------------------------|-------------------------|-----------|
|                             | 2004                    | 2003      |
|                             | (As                     | (As       |
|                             | <b>restated)</b>        | restated) |
| Other (expense) income, net | <b>\$ (3.7)</b>         | \$ (1.6)  |

Other expense, net for the three months ended March 31, 2004 increased by \$2.1 million as compared with the same period in 2003 primarily due to increases in unrealized losses on forward contracts that did not qualify for hedge accounting, partially offset by realized and unrealized foreign currency transaction gains.

**Tax Expense and Tax Rate**

| (Amounts in millions)    | Quarter Ended March 31, |           |
|--------------------------|-------------------------|-----------|
|                          | 2004                    | 2003      |
|                          | (As                     | (As       |
|                          | <b>restated)</b>        | restated) |
| Provision for income tax | <b>\$ 8.2</b>           | \$ 4.0    |
| Effective tax rate       | <b>53.7%</b>            | 44.6%     |

Our effective tax rate of 53.7% for the three months ended March 31, 2004 increased from 44.6% for the same period in 2003. The increase primarily resulted from increased foreign earnings repatriation in 2004 used to pay down U.S. debt. We utilized prior year foreign tax credit carry forwards against the tax liability resulting from these repatriations. However, the benefit of a significant portion of these foreign tax credit carry forwards was recognized in prior years effective tax rates.

**Net Earnings and Earnings Per Share**

| (Amounts in millions)                                     | Quarter Ended March 31, |           |
|---|-------------------------|-----------|
|   | 2004                    | 2003      |
|   | (As                     | (As       |
|   | <b>restated)</b>        | restated) |
| Income from continuing operations                         | <b>\$ 7.1</b>           | \$ 5.0    |
| Net earnings  | <b>7.1</b>              | 5.3       |
| Net earnings per share from continuing operations diluted | <b>0.13</b>             | 0.10      |
| Net earnings per share diluted                            | <b>0.13</b>             | 0.10      |
| Average diluted shares                                    | <b>55.4</b>             | 55.2      |

Net earnings for the three months ended March 31, 2004 increased by \$1.8 million, or 34.0%, as compared with the same period in 2003, and net earnings per share increased \$0.03, or 30.0%, over the same period. The improvement reflects the decrease of \$7.4 million in integration and restructuring expenses and lower interest expense, partially offset in part by the impact of a lower gross margin as well as higher SG&A. Average diluted shares were relatively flat in the first quarter of 2004 compared with the prior year period.

**Other Comprehensive Income (Loss)**

| (Amounts in millions)             | Quarter Ended March 31, |           |
|-----------------------------------|-------------------------|-----------|
|                                   | 2004                    | 2003      |
|                                   | (As                     | (As       |
|                                   | <b>restated)</b>        | restated) |
| Other comprehensive income (loss) | <b>\$ (9.5)</b>         | \$ 14.8   |

Other comprehensive income (loss) for the three months ended March 31, 2004 decreased \$24.3 million as compared with the same period in 2003, primarily reflects a weakening of the Euro during the three-month period ended March 31, 2004, as compared with a strengthening of the Euro during the same period in 2003, as well as an



increase in unrealized hedging losses.

**Table of Contents****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 excluding special items, such as restructuring and integration costs related to the IFC acquisition. We believe that special items, while indicative of efforts to integrate IFC in our business, do not reflect ongoing business results. We believe investors and other users of our financial statements can better evaluate and analyze historical and future business trends if special items are excluded from each segment's operating income. Operating income before special items is not a recognized measure under GAAP and should not be viewed as an alternative to, or a better indicator of, GAAP measures of performance. Effective January 1, 2004, we realigned certain small sites between segments. Accordingly, the segment information for all periods presented herein has been reported under our revised organizational structure. See Note 16 to our condensed consolidated financial statements included in this Amended 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, 10 in Europe, and eight in South America and Asia. FPD also has 65 service centers, which are either free standing or co-located in a manufacturing facility.

| (Amounts in millions)                     | Quarter Ended March 31, |               |
|---|-------------------------|---------------|
|   | 2004                    | 2003          |
|   | (As restated)           | (As restated) |
| Bookings                                  | \$318.5                 | \$305.8       |
| Sales                                     | 297.2                   | 279.6         |
| Gross profit                              | 71.2                    | 69.3          |
| Gross profit margin                       | 23.9%                   | 24.8%         |
| Operating income                          | 18.6                    | 20.8          |
| Operating income as a percentage of sales | 6.3%                    | 7.4%          |
| Backlog                                   | 589.6                   | 525.2         |

Bookings for the three months ended March 31, 2004 decreased by \$9.0 million, or 2.9%, excluding currency benefits of approximately \$22 million, as compared with the same period in 2003. The decrease is due to increased selectivity on lower margin projects, particularly in the oil and gas industry. This was slightly offset by \$3.6 million increase in bookings resulting from our acquisition of the remaining 75% of TKL in March 2004.

Sales for the three months ended March 31, 2004 decreased by \$3.1 million, or 1.1%, excluding currency benefits of approximately \$21 million, as compared with the same period in 2003. The decrease is due to a lower volume of shipments to the water market, slightly offset by a \$4.6 million increase in sales resulting from our acquisition of the remaining 75% of TKL in March 2004.

Gross profit margin of 23.9% for the three months ending March 31, 2004 decreased from 24.8% for the same period in 2003. The decrease is primarily attributable to an unfavorable product mix that reflects low margin project business booked in previous periods and a low shippable backlog of aftermarket parts.

Operating income for the three months ended March 31, 2004, decreased by \$3.9 million, or 18.9%, excluding currency benefits of approximately \$2 million, as compared with the same period in 2003. The decrease is primarily due to the decline in gross profit margin due to the unfavorable product mix discussed above, and an increase in incentive compensation of \$0.9 million. These were slightly offset by a \$0.4 million increase in operating income resulting from our acquisition of TKL in March 2004.



**Table of Contents****Flow Control Division**

Through FCD, we design, manufacture and distribute industrial valves, manual valves, control valves, nuclear valves, actuators and related equipment, and provide a variety of flow control-related services. We manufacture valves and actuators through five major manufacturing plants in the U.S. and 17 major manufacturing plants outside the U.S. We have 51 valve service centers, of which 34 are related to GSG, that are generally free standing and principally based in the U.S. As a result of our 2002 acquisition of IFC, we believe we are one of the world's leading suppliers of valves and related products and services to the chemical industry. Based on independent industry sources, we believe that we are the second largest industrial valve supplier on a global basis. We believe that our comprehensive portfolio of valve products and services is a key source of our competitive advantage. Further, our focus on service and severe corrosion and erosion applications is a key competency.

| (Amounts in millions)  | Quarter Ended March 31, |               |
|--|-------------------------|---------------|
|  | 2004                    | 2003          |
|  | (As restated)           | (As restated) |
| Bookings   | \$254.4                 | \$216.7       |
| Sales  | 221.8                   | 203.0         |
| Gross profit   | 65.6                    | 59.9          |
| Gross profit margin  | 29.6%                   | 29.5%         |
| Operating income (before special items)                          | 12.3                    | 10.7          |
| Integration expense  |                         | 6.4           |
| Restructuring expense  |                         | 1.0           |
| Operating income (after special items)                           | 12.3                    | 3.3           |
| Operating income (before special items) as a percentage of sales | 5.5%                    | 5.3%          |
| Backlog  | 246.2                   | 229.0         |

Bookings for the three months ended March 31, 2004 increased by \$19.9 million, or 9.2%, excluding currency benefits of approximately \$18 million, as compared with the same period in 2003. The increase is due to strengthening in all regions and sectors of our flow control business, partially offset by a slight decline in our industrial services group. This strengthening primarily impacted our project business, but is indicative of overall market improvement.

Sales for the three months ended March 31, 2004 increased by \$3.7 million, or 1.8%, excluding currency benefits of approximately \$15 million, as compared with the same period in 2003. The increase is primarily due to our project business, particularly serving the process and control valve markets in our Europe, Middle East and Africa (EMA) region. This is partially offset by a \$3.0 million decline in sales by our industrial services group.

Gross profit margin of 29.6% for the three months ending March 31, 2004 was relatively flat as compared with the same period in 2003.

Operating income (before special items) for the three months ended March 31, 2004, excluding currency benefits of approximately \$1 million, was relatively flat as compared with the same period in 2003. This is due primarily to a comparable margin on increased sales, partially offset by an increase in incentive compensation of \$1.2 million and higher information technology costs associated with divisional and company-wide initiatives. Special items during 2003 are associated with the acquisition and integration of IFC into FCD.

**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, four of which are located in North America, two are in Europe and one is in Singapore. FSD operates 62 QRCs worldwide, including 24 such sites in North America, 14 in Europe, and the remainder located in South America and Asia. Our ability to turn around engineered seal products within 72 hours from the customer's request, through design, engineering, manufacturing, testing and delivery, is our major source of competitive advantage. Based on independent industry sources, we believe that we are the second largest mechanical seal supplier on a global basis.



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| (Amounts in millions)                     | Quarter Ended March 31, |               |
|---|-------------------------|---------------|
|   | 2004                    | 2003          |
|   | (As restated)           | (As restated) |
| Bookings                                  | \$ 99.7                 | \$ 91.0       |
| Sales                                     | 94.8                    | 85.1          |
| Gross profit                              | 41.8                    | 37.6          |
| Gross profit margin                       | 44.1%                   | 44.2%         |
| Operating income                          | 17.2                    | 15.9          |
| Operating income as a percentage of sales | 18.1%                   | 18.7%         |
| Backlog                                   | 45.9                    | 40.8          |

Bookings for the three months ended March 31, 2004 increased by \$3.5 million, or 3.8%, excluding currency benefits of approximately \$5 million, as compared with the same period in 2003. The bookings improvement generally reflects FSD's emphasis on end user business and success in establishing longer-term customer alliance programs. Increased demand from oil and gas and chemical markets also contributed to the increase.

Sales for the three months ended March 31, 2004 increased by \$4.8 million, or 5.7%, excluding currency benefits of approximately \$5 million, as compared with the same period in 2003. 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% for the three months ending March 31, 2004 was relatively flat as compared with the same period in 2003.

Operating income for the three months ended March 31, 2004, excluding currency benefits of approximately \$1 million, was relatively flat as compared with the same period in 2003.

**RESTRUCTURING AND ACQUISITION RELATED CHARGES****Restructuring Costs**

In conjunction with the IFC acquisition during 2002, we initiated a restructuring program designed to reduce costs and eliminate excess capacity by closing 18 valve facilities, including 10 service facilities, and reducing sales and related support personnel. Our actions, some of which were approved and committed to in 2002 with the remaining actions approved and committed to in 2003, are expected to result in a gross reduction of approximately 889 positions and a net reduction of approximately 662 positions. Net position eliminations represent the gross positions eliminated from the closed facilities offset by positions added at the receiving facilities, which are required to produce the products transferred into the receiving facilities.

We established a restructuring program reserve upon acquisition of IFC, and recognized additional accruals of \$4.5 million in 2003 for this program, including \$2.0 million during the first quarter, primarily related to the closure of certain valve service facilities and the related reductions in workforce. Cash expenditures against the accrual were \$11.6 million in 2003, including \$4.1 million during the first quarter, and \$1.3 million during the first quarter of 2004. The remaining accrual of \$8.0 million reflects payments to be made in 2004 and beyond for severance obligations due to terminated personnel in Europe of \$4.8 million as well as lease and other contract termination and exit costs of \$3.2 million.

Cumulative costs associated with the closure of Flowserve facilities of \$7.2 million through December 31, 2003, have been recognized as restructuring expense in operating results, whereas cumulative costs associated with the closure of IFC facilities of \$17.9 million, including related deferred taxes of \$6.2 million, became part of the purchase price allocation of the transaction. The effect of these closure costs increased the amount of goodwill otherwise recognizable as a result of the IFC acquisition.

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The following illustrates activity related to the IFC restructuring reserve:

| (Amounts in millions)        | <b>Severance</b> | <b>Other Exit<br/>Costs</b> | <b>Total</b> |
|------------------------------|------------------|-----------------------------|--------------|
| Balance at January 1, 2003   | \$ 10.7          | \$ 5.7                      | \$ 16.4      |
| Additional accruals          | 3.8              | 0.7                         | 4.5          |
| Cash expenditures            | (8.8)            | (2.8)                       | (11.6)       |
| Balance at December 31, 2003 | 5.7              | 3.6                         | 9.3          |
| Cash expenditures            | (0.9)            | (0.4)                       | (1.3)        |
| Balance at March 31, 2004    | \$ 4.8           | \$ 3.2                      | \$ 8.0       |

**Remaining Restructuring and Integration Costs IFC**

We did not incur acquisition-related integration expenses in 2004 as, by December 31, 2003, we had largely completed restructuring and integration activities related to IFC, except for payments to be made for certain European activities. We expect to incur no additional restructuring and integration costs. Payments from the restructuring accrual will continue throughout 2004 and into 2005 due to the timing of severance obligations in Europe. For discussion of integration costs incurred in 2003 as a result of our acquisition of IFC, see Note 10 to the accompanying restated condensed consolidated financial statements included in this Amended Quarterly Report.

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

| (Amounts in millions)                           | Quarter Ended March 31,<br><b>2004</b> | 2003          |
|---|--|---------------|
|   | (As<br>restated)                       | (As restated) |
| Net cash flows provided by operating activities | \$ 7.9                                 | \$ 12.3       |
| Net cash flows used by investing activities     | (12.7)                                 | (5.5)         |
| Net cash flows used by financing activities     | (8.7)                                  | (18.5)        |

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 March 31, 2004 was \$39.7 million, as compared with \$53.5 million at December 31, 2003.

Cash flows provided by operating activities in the first three months of 2004 were \$7.9 million, compared with \$12.3 million in the first three months of 2003. Working capital, excluding cash, was a source of operating cash flow of \$5.1 million in the first three months of 2004, compared with a use of \$17.3 million in the prior year period. The reduction in working capital for the current quarter reflects an increase of \$6.0 million in accrued liabilities versus the prior year, which primarily reflects an increase in accrued vacation.

Accounts receivable for the first three months generated \$0.8 million of cash flow compared with \$1.6 million in the prior year, however, days sales outstanding improved to 74 days from 81 days at March 31, 2003 due to the higher sales level. Inventory was a \$1.4 million use of cash flow for the first three months of 2004, compared with a \$3.6 million source of cash in the prior year. The increase in inventory was generally due to the higher backlog. Inventory turns improved to 4.1 times at March 31, 2004 compared with 3.8 times at March 31, 2003.

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

| Quarter ending: | 2004                  | 2003    |
|-----------------|-----------------------|---------|
|                 | (Amounts in millions) |         |
| March 31        | \$ 0.2                | \$ 0.1  |
| June 30         | 8.1                   | 2.9     |
| September 30    | 5.3                   | 23.9    |
| December 31     | 1.7                   | 0.1     |
|                 | \$ 15.3               | \$ 27.0 |

Cash flows used by investing activities in the first three months of 2004 were \$12.7 million, compared with \$5.5 million in the first three months of 2003. Cash outflows in 2004 were primarily due to capital expenditures and the acquisition of TKL in March 2004 (described below). Cash outflows in 2003 were due to capital expenditures.

Cash flows used by financing activities in the first three months of 2004 were \$8.7 million, compared with \$18.5 million in the first three months of 2003. Cash outflows in both periods were due to 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.

**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 \$6.9 million for the first quarter of 2004, compared with \$5.5 million for the same period in 2003. Capital expenditures were funded primarily by operating cash flows. For each period, capital expenditures were invested in new and replacement machinery and equipment, information technology and acquisition integration activities, including structures and equipment required at receiving facilities. For the full year 2004, our capital expenditures were approximately \$45 million, including approximately \$5 million in July 2004 for the purchase of a building we previously leased for the manufacture of valves. 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****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 IFC 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.





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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.

During the three months ended March 31, 2004, we made scheduled debt payments of \$8.0 million. During the remainder of 2004, we made scheduled, mandatory and optional principal payments of \$19.5 million, \$167.9 million and \$160.0 million, respectively.

***Senior Subordinated Notes***

At March 31, 2004, we had \$188.5 million and 65 million (equivalent to \$80.0 million at March 31, 2004) face value of Senior Subordinated Notes outstanding. 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.

***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 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.

***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 prepayment, 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.



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In August 2004, we borrowed \$85 million at a floating interest rate based on 3-month U.S. LIBOR that resets quarterly. As of December 31, 2004, the interest rate was 2.39%. 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 our 2000 Credit Facilities, New Credit Facilities, and EIB credit facility is included in Note 7 to our condensed consolidated financial statements, included in this Amended 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.

***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. See additional discussion of our accounts receivable factoring program in Note 8 to our condensed consolidated financial statements included in this Amended Quarterly Report.

***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 2004 Restatement 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 the quarterly periods ended June 30, 2004, September 30, 2004, March 31, 2005, June 30, 2005 and September 30, 2005, 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 such waivers, were not in default due to 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. However, our debt is properly classified as non-current in our balance sheet as we have demonstrated our ability and intent to obtain new long-term credit facilities in August 2005.

We have determined, utilizing our restated financial information, that on multiple occasions we did not comply with some of the financial covenants in our 2000 Credit Facilities, which are no longer in effect. We believe that we could have undertaken readily available actions to maintain compliance or obtained a waiver or amendment to the 2000 Credit Facilities had the new restated results then been known. We have complied with all other non-financial covenants under our 2000 Credit Facilities. We believe that these covenant violations have no impact on our New Credit Facilities and that the amounts outstanding under the 2000 Credit Facilities are properly classified in our consolidated balance sheet.



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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. Delivery of the December 31, 2005 audited financial statements is required by May 30, 2006. 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. We are currently in compliance with all debt covenants under the New Credit Facilities.

**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 2004 Annual Report. These critical policies, for which no significant changes have occurred in the first three months of 2004, include:

Revenue Recognition;

Accounts Receivable and Related Allowance for Doubtful Accounts;

Inventories and Related Reserves;

Deferred Tax Asset Valuation;

Tax Reserves;

Restructuring and Integration Expense;

Legal and Environmental Accruals;

Warranty Accruals;

Pension and Postretirement Benefits Obligations; and

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

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 Amended Quarterly Report.

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**Forward-Looking Information is Subject to Risk and Uncertainty**

This Amended 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, 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 granted in past years to employees under the Company's 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 include 809,667 options held by our former Chairman, President and Chief Executive Officer, C. Scott Greer. Given the significant increase in the Company's share price during this exercise unavailability period, it is possible that many holders may want to exercise promptly when first able to do so. Once we regain both a current SEC financial report filing status and the ability to once again register our stock option shares with the SEC, we will reopen the stock option exercise program. We currently expect this reopening to occur in 2006. If the holders of a large number of these shares do then promptly exercise at this reopening, 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;

our ability to convert bookings, which are not subject to nor computed in accordance with generally accepted accounting principles, 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;



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;

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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;

the health of the petroleum, chemical, power and water industries;

adverse movement in currency exchange rates;

unanticipated difficulties or costs associated with the implementation of systems, including software;

our relative geographical profitability and its impact on our ability to utilize foreign tax credits;

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 Amended Quarterly Report are based on information available to us on the date of this Amended Quarterly Report. We undertake no obligation to revise our 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.

**Table of Contents****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 March 31, 2004, after the effect of interest rate swaps, we have approximately \$494.5 million of variable rate debt obligations outstanding with a weighted average interest rate of 3.82%. 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 \$1.2 million for the quarter ended March 31, 2004.

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 March 31, 2004, we have \$175 million of notional amount in outstanding interest rate swaps with third parties with maturities through November 2006 compared to \$165 million as of the same period in 2003.

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 March 31, 2004, a 10% adverse change in the foreign currency exchange rates could impact our results of operations by \$2.8 million as shown below:

(Amounts in millions)

|                  |            |
|------------------|------------|
| Euro             | \$ 1.3     |
| Swiss franc      | 0.3        |
| British pound    | 0.2        |
| Canadian dollar  | 0.2        |
| Indian rupee     | 0.2        |
| Singapore dollar | 0.2        |
| Brazil real      | 0.1        |
| All other        | 0.3        |
| <br>Total        | <br>\$ 2.8 |

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 March 31, 2004, we have a U.S. dollar equivalent of \$119.2 million in outstanding forward contracts with third parties compared with \$39.7 million at March 31, 2003.

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 \$(6.7) million and \$14.8 million for the quarters ended March 31, 2004 and 2003, respectively, which is 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 \$4.3 million and \$1.4 million for the quarters ended March 31, 2004 and 2003, respectively, which is included in other (expense) income, net in the accompanying consolidated statements of operations, which primarily relate to changes in the fair values of forward contracts.



**Table of Contents****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 Amended 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 March 31, 2004. In making this evaluation, our management considered the matters relating to our recently completed restatement of our financial statements and the material weaknesses described in our 2004 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 March 31, 2004.

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 March 31, 2004:

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.

In light of the material weaknesses described in our 2004 Annual Report, we performed additional analyses and other procedures to ensure that our unaudited restated condensed consolidated financial statements included in this Amended Quarterly Report were prepared in accordance with GAAP. As a result of these procedures, we believe that the unaudited restated condensed consolidated financial statements included in this Amended 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.

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**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 have improved and 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 and in our 2004 Annual Report will be remediated by December 31, 2005, our next reporting as of date under Sarbanes-Oxley Section 404. Accordingly, we expect to report that our internal control over financial reporting and our disclosure controls and procedures remain ineffective as of December 31, 2005.

**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 March 31, 2004 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****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. We continue to cooperate with the SEC in this matter.

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 (Complaint). The Complaint alleges that federal securities violations occurred between February 6, 2001 and September 27, 2002 and names as defendants Mr. C. Scott Greer, our former Chairman, President and Chief Executive Officer, Ms. Renee J. Hornbaker, our former Vice President and Chief Financial Officer, PricewaterhouseCoopers LLP, our independent registered public accounting firm, and Banc of America Securities LLC and Credit Suisse First Boston LLC, which served as underwriters for two of our public stock offerings during the relevant period. The Complaint asserts claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, and Sections 11 and 15 of the Securities Act of 1933. The lead plaintiff seeks unspecified compensatory damages, forfeiture by Mr. Greer and Ms. Hornbaker of unspecified incentive-based or equity-based compensation and profits from any stock sales, and recovery of costs. On November 22, 2005, the Court entered an order denying the defendants' motions to dismiss the Complaint on the pleadings in their entirety. 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. Hornbaker, 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 we delivered to Iraq from 1996 through 2003 during the United Nations Oil-for-Food Program. We are in the process of reviewing and responding to the subpoena and intend to cooperate with the SEC. We believe that other companies in our industry (as well as in other industries) have received similar subpoenas and requests for information.

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. Hornbaker, and current board members Hugh K. Coble, George T. Haymaker, Jr., Lewis M. Kling, 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 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.

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Greer and Ms. Hornbaker 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 intend to file a motion seeking dismissal of the case.

Since we manufacture and sell our products globally, we are subject to risks associated with doing business internationally. 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 require further research to determine compliance with U.S. export control laws and regulations. With assistance from outside counsel, we are currently involved in a systematic process to conduct further research. 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 suspension of the privilege to engage in export transactions or to have our foreign affiliates receive U.S.-origin goods, software or technology. Because our research into this issue is ongoing, we are unable to determine the extent of any violations or the nature or amount of any potential penalties to which we might be subject to in the future. As a result, we cannot currently predict whether the resolution of this matter will materially adversely affect our financial position or results of operations. At this time, we have not made any provision in our consolidated financial statements for any fines or penalties that might be incurred relating to this matter.

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, 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.

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**Item 6. Exhibits.**

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

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 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.  |
| 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.   |

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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.

FLOWSERVE CORPORATION  
(Registrant)

Date: April 26, 2006

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

Date: April 26, 2006

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