FLOWSERVE CORP
Form 10-Q
September 29, 2006

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

**FORM 10-Q**

(Mark One)

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

**FOR THE QUARTERLY PERIOD ENDED June 30, 2006**

**OR**

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**FOR THE TRANSITION PERIOD FROM _________ to _________.**

**Commission File 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. o Yes þ 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 þ Accelerated filer o Non-accelerated filer o

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

As of September 25, 2006, there were 56,532,358 shares of the issuer s common stock outstanding.

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## EXPLANATORY NOTE

As a result of the significant delay in completing our Annual Report on Form 10-K for the year ended December 31, 2005 ( 2005 Annual Report ) , which was filed on June 30, 2006, and the obligations regarding internal control certification under Section 404 of the Sarbanes-Oxley Act of 2002 ( Section 404 ), we were unable to timely file with the Securities and Exchange Commission ( SEC ), this Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2006 ( Quarterly Report ).

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**PART I FINANCIAL INFORMATION**
**Item 1. Financial Statements.**

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

| | Three Months Ended June 30, | |
|---|---|---|
| (Amounts in thousands, except per share data) | **2006** | **2005** |
| Sales | $ 752,859 | $ 691,165 |
| Cost of sales | 501,140 | 468,463 |
| Gross profit | 251,719 | 222,702 |
| Selling, general and administrative expense | 179,241 | 166,399 |
| Operating income | 72,478 | 56,303 |
| Interest expense | (16,260) | (19,861) |
| Interest income | 1,070 | 618 |
| Other income (expense), net | 4,392 | (5,866) |
| Earnings before income taxes | 61,680 | 31,194 |
| Provision for income taxes | 28,609 | 12,633 |
| Income from continuing operations | 33,071 | 18,561 |
| Discontinued operations, net of tax | | (611) |
| Net earnings | $ 33,071 | $ 17,950 |
| Earnings (loss) per share: | | |
| Basic: | | |
| Continuing operations | $ 0.59 | $ 0.33 |
| Discontinued operations | | (0.01) |
| Net earnings | $ 0.59 | $ 0.32 |
| Diluted: | | |
| Continuing operations | $ 0.57 | $ 0.33 |
| Discontinued operations | | (0.01) |
| Net earnings | $ 0.57 | $ 0.32 |

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

| | Three Months Ended June 30, | |
|---|---|---|
| (Amounts in thousands) | **2006** | **2005** |

| | | |
|---|---|---|
| Net earnings | $ 33,071 | $ 17,950 |
| Other comprehensive income (expense) : | | |
| Foreign currency translation adjustments, net of tax | 17,568 | (16,438) |
| Cash flow hedging activity, net of tax | 944 | (142) |
| Other comprehensive income (loss) | 18,512 | (16,580) |
| Comprehensive income | $ 51,583 | $ 1,370 |

See accompanying notes to condensed consolidated financial statements.

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

| (Amounts in thousands, except per share data) | Six Months Ended June 30, 2006 | 2005 |
|---|---|---|
| Sales | $ 1,406,716 | $ 1,307,283 |
| Cost of sales | 940,605 | 893,438 |
| Gross profit | 466,111 | 413,845 |
| Selling, general and administrative expense | 356,113 | 331,715 |
| Operating income | 109,998 | 82,130 |
| Interest expense | (31,941) | (39,896) |
| Interest income | 2,153 | 1,462 |
| Other income (expense), net | 5,524 | (8,579) |
| Earnings before income taxes | 85,734 | 35,117 |
| Provision for income taxes | 38,771 | 13,658 |
| Income from continuing operations | 46,963 | 21,459 |
| Discontinued operations, net of tax | | (7,523) |
| Net earnings | $ 46,963 | $ 13,936 |
| Earnings (loss) per share: | | |
| Basic: | | |
| Continuing operations | $ 0.84 | $ 0.39 |
| Discontinued operations | | (0.14) |
| Net earnings | $ 0.84 | $ 0.25 |
| Diluted: | | |
| Continuing operations | $ 0.81 | $ 0.38 |
| Discontinued operations | | (0.13) |
| Net earnings | $ 0.81 | $ 0.25 |

**CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

| (Amounts in thousands) | Six Months Ended June 30, 2006 | 2005 |
|---|---|---|
| Net earnings | $ 46,963 | $ 13,936 |
| Other comprehensive income (expense) : | | |

| | | |
|---|---|---|
| Foreign currency translation adjustments, net of tax | 22,961 | (25,146) |
| Cash flow hedging activity, net of tax | 2,361 | 818 |
| Other comprehensive income (loss) | 25,322 | (24,328) |
| Comprehensive income (loss) | $ 72,285 | $ (10,392) |

See accompanying notes to condensed consolidated financial statements.

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

| (Amounts in thousands, except per share data) | June 30, 2006 | December 31, 2005 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 58,247 | $ 92,864 |
| Restricted cash | 2,436 | 3,628 |
| Accounts receivable, net of allowance for doubtful accounts of $15,614 and $14,271, respectively | 506,107 | 472,946 |
| Inventories, net | 429,407 | 361,770 |
| Deferred taxes | 121,596 | 113,957 |
| Prepaid expenses and other | 37,160 | 26,034 |
| Total current assets | 1,154,953 | 1,071,199 |
| Property, plant and equipment, net of accumulated depreciation of $484,868 and $444,701, respectively | 421,893 | 397,622 |
| Goodwill | 844,870 | 834,863 |
| Deferred taxes | 17,462 | 34,261 |
| Other intangible assets, net | 146,576 | 146,251 |
| Other assets, net | 93,392 | 91,342 |
| Total assets | $ 2,679,146 | $ 2,575,538 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 321,143 | $ 316,713 |
| Accrued liabilities | 354,865 | 360,798 |
| Debt due within one year | 10,731 | 12,367 |
| Deferred taxes | 5,322 | 5,044 |
| Total current liabilities | 692,061 | 694,922 |
| Long-term debt due after one year | 644,875 | 652,769 |
| Retirement obligations and other liabilities | 429,555 | 396,013 |
| Shareholders equity: | | |
| Series A 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 | 479,541 | 477,201 |
| Retained earnings | 493,126 | 446,163 |
| | 1,044,685 | 995,382 |

| | | |
|---|---|---|
| Treasury shares, at cost 1,346 and 1,640 shares, respectively | (31,655) | (37,547) |
| Deferred compensation obligation | 4,960 | 4,656 |
| Accumulated other comprehensive loss | (105,335) | (130,657) |
| Total shareholders equity | 912,655 | 831,834 |
| Total liabilities and shareholders equity | $ 2,679,146 | $ 2,575,538 |

See accompanying notes to condensed consolidated financial statements.

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

| (Amounts in thousands) | Six Months Ended June 30, 2006 | 2005 |
|---|---|---|
| **Cash flows Operating activities:** | | |
| Net earnings | $ 46,963 | $ 13,936 |
| Adjustments to reconcile net earnings to net cash provided (used) by operating activities: | | |
| Depreciation | 29,291 | 31,395 |
| Amortization | 5,130 | 5,245 |
| Amortization of deferred loan costs and discount | 1,001 | 2,424 |
| Net (gain) loss on the disposition of assets | (503) | 396 |
| Equity based compensation expense | 9,321 | 9,568 |
| Equity income in unconsolidated subsidiaries, net of dividends received | (1,737) | (3,435) |
| Impairment of assets | | 5,905 |
| Change in assets and liabilities: | | |
| Accounts receivable, net | (14,841) | 1,643 |
| Inventories, net | (52,155) | (35,112) |
| Prepaid expenses and other | (3,651) | (12,531) |
| Other assets, net | (10,569) | 2,981 |
| Accounts payable | (15,340) | (4,389) |
| Accrued liabilities and income taxes payable | (18,471) | 3,025 |
| Retirement obligations and other liabilities | 22,377 | (5,927) |
| Net deferred taxes | 11,126 | (17,724) |
| Net cash flows provided (used) by operating activities | 7,942 | (2,600) |
| **Cash flows Investing activities:** | | |
| Capital expenditures | (29,458) | (17,885) |
| Change in restricted cash | 1,192 | (1,736) |
| Net cash flows used by investing activities | (28,266) | (19,621) |
| **Cash flows Financing activities:** | | |
| Net borrowings under lines of credit | | 1,070 |
| Payments on long-term debt | (15,856) | |
| Proceeds from stock option activity | | 1,111 |
| Net cash flows (used) provided by financing activities | (15,856) | 2,181 |
| Effect of exchange rate changes on cash | 1,563 | (2,528) |
| Net change in cash and cash equivalents | (34,617) | (22,568) |
| Cash and cash equivalents at beginning of year | 92,864 | 63,759 |

| | | |
|---|---|---|
| Cash and cash equivalents at end of period | $ 58,247 | $ 41,191 |

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 June 30, 2006, and the related condensed consolidated statements of income and comprehensive income (loss) for the three and six months ended June 30, 2006 and 2005, and the condensed consolidated statements of cash flows for the six months ended June 30, 2006 and 2005, are unaudited. In management s opinion, all adjustments comprising normal recurring adjustments necessary for a fair presentation of such condensed consolidated financial statements have been made.

The accompanying condensed consolidated financial statements and notes in this Quarterly Report are presented as permitted by Regulation S-X and do not contain certain information included in our annual financial statements and notes to the financial statements. Accordingly, the accompanying condensed consolidated financial information should be read in conjunction with the consolidated financial statements for the year ended December 31, 2005 presented in our 2005 Annual Report.

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

**Stock-Based Compensation**

Effective January 1, 2006, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards ( SFAS ) No. 123(R), Share Based Payment using the modified prospective application method, and therefore, have not restated results for prior periods. Under this method, stock based compensation expense for the first quarter of 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested at the date of adoption, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation. Stock-based compensation expense for all stock-based compensation awards granted after the date of adoption is based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R).

In conjunction with the adoption of SFAS No. 123(R), we selected the alternative transition method to determine the net excess tax benefits that would have qualified as such as of January 1, 2006. See Note 3 for further discussion on stock-based compensation.

**Other Accounting Policies**

Other significant accounting policies, for which no significant changes have occurred in the quarter ended June 30, 2006, are detailed in Note 1 of our 2005 Annual Report.

**Accounting Developments**

***Pronouncements Implemented***

In December 2004, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 123(R). We adopted SFAS No. 123(R) on January 1, 2006 utilizing the modified prospective application method. See Note 3 for additional information regarding the adoption of SFAS No. 123(R).

In November 2004, the FASB issued SFAS No. 151, Inventory Costs, an amendment of Accounting Research Bulletin No. 43, Chapter 4. SFAS No. 151 amends Accounting Research Bulletin No. 43, Chapter 4 and seeks to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted materials by requiring those items to be recognized as current period charges. Additionally, SFAS No. 151 requires that fixed production overheads be allocated to conversion costs based on the normal capacity of the production facilities. SFAS No. 151 is effective prospectively for inventory costs incurred in fiscal years beginning after June 15, 2005. Our adoption of SFAS No. 151, effective beginning in the first quarter of 2006, did not have a material impact on our consolidated financial condition or results of operation.

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections. SFAS No. 154 establishes new standards on accounting for changes in accounting principles. All such changes must be accounted for by retrospective application to the financial statements of prior periods unless it is impracticable to do so. SFAS No. 154 replaces APB No. 20, Accounting Changes, and SFAS No. 3, Reporting Accounting Changes in Interim Periods. However, it carries forward the guidance in those pronouncements with respect to accounting for changes in estimates, changes in the reporting entity and the correction of errors. Our adoption of SFAS No. 154 in the first quarter of 2006 had no impact on our consolidated financial condition or results of operations.

***Pronouncements Not Yet Implemented***

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments, which amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. SFAS No. 155 improves the financial reporting of certain hybrid financial instruments and simplifies the accounting for these instruments. In particular, SFAS No. 155:

- permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation;
- clarifies which interest-only and principal-only strips are not subject to the requirements of SFAS No. 133;
- establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation;
- clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and
- amends SFAS No. 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument.

SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity s fiscal year that begins after September 15, 2006. We do not expect the adoption of SFAS No. 155 to have a material impact on our consolidated financial condition and results of operations.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of Statement No. 140. SFAS No. 156 clarifies when an obligation to service financial assets should be separately recognized as a servicing asset or a servicing liability, requires that a separately recognized servicing asset or servicing liability be initially measured at fair value and permits an entity with a separately recognized servicing asset or servicing liability to choose either the amortization method or fair value method for subsequent measurement. SFAS No. 156 is effective for all separately recognized servicing assets and liabilities acquired or issued after the beginning of an entity s fiscal year that begins after September 15, 2006. We do not expect the adoption of SFAS No. 156 to have a material impact on our financial condition and results of operations.

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

Although there are no other final pronouncements recently issued that we have not adopted and that we expect to impact reported financial information or disclosures, accounting promulgating bodies have a number of pending projects 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.

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**2. Discontinued Operations**

*General Services Group* During the first quarter of 2005 we made a definitive decision to divest certain non-core service operations, collectively called the General Services Group ( GSG ), and accordingly, evaluated impairment pursuant to a held for sale concept as opposed to the previously held and used concept. As part of our decision to sell, we allocated $12.3 million of goodwill to GSG based on its relative fair value to the total reporting unit s estimated fair value. We recognized impairment charges aggregating $30.1 million during 2005 relating to GSG as the number of potential buyers diminished to one purchaser during the bidding process, and the business underperformed during the year due to the pending sale. Of the $30.1 million impairment, $0 and $5.9 million was recorded during the three and six months ended June 30, 2005, respectively. Effective December 31, 2005, we sold GSG to Furmanite, a unit of Dallas-based Xanser Corporation for approximately $16 million in gross cash proceeds, including $2 million held in escrow pending final settlement, subject to final working capital adjustments. The sale excluded approximately $12 million of net accounts receivable and resulted in a pre-tax loss of $3.8 million, which was recognized in the fourth quarter of 2005. The ultimate purchase price of GSG is subject to final working capital adjustments, which remain under negotiation, and is expected to be resolved in the fourth quarter of 2006. The outcome of such negotiations could result in a change in the ultimate loss on sale in the period of resolution. We used approximately $11 million of the net cash proceeds to reduce our indebtedness in January 2006. We have allocated estimated interest expense related to this repayment to each period presented based upon then prevailing interest rates. As a result of this sale, we have presented the results of operations of GSG as discontinued operations for all periods presented.

GSG generated the following results of operations for the three months ended June 30, 2005 (in millions):

| | |
|---|---|
| Sales | $ 27.3 |
| Cost of sales | 21.2 |
| Selling, general and administrative expense | 7.1 |
| Interest expense | 0.2 |
| Earnings before income taxes | (1.2) |
| Income tax benefit | (0.6) |
| Results for discontinued operations, net of tax | (0.6) |

GSG generated the following results of operations for the six months ended June 30, 2005 (in millions):

| | |
|---|---|
| Sales | $ 54.7 |
| Cost of sales | 43.6 |
| Selling, general and administrative expense | 20.0 |
| Interest expense | 0.4 |
| Other income, net | (0.1) |
| Earnings before income taxes | (9.4) |
| Income tax benefit | (1.9) |
| Results for discontinued operations, net of tax | $ (7.5) |

**3. Stock-Based Compensation Plans**

We adopted SFAS No. 123(R) on January 1, 2006. Prior to January 1, 2006, we accounted for stock-based compensation using the intrinsic value method as set forth in Accounting Principles Board Opinion ( APB ) No. 25, Accounting for Stock Issued to Employees , and related interpretations as permitted by SFAS No. 123. Accordingly, we recognized compensation expense for restricted stock and other equity awards over the applicable vesting period, however we did not recognize compensation expense for stock options for the three or six months ended June 30, 2005, because the options were granted at market value on the date of grant.

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The following tables illustrate the effect of stock-based compensation on net earnings and earnings per share for the three and six months ended June 30, 2005, if we had applied the fair value recognition provisions of SFAS No. 123 to all stock-based employee compensation, calculated using the Black-Scholes option-pricing model.

| (Amounts in thousands, except per share data) | | Three Months Ended June 30, 2005 |
|---|---|---|
| Net earnings, as reported | $ | 17,950 |
| Restricted stock compensation expense included in net earnings, net of tax | | 1,685 |
| Less: Stock-based employee compensation expense determined under fair value method for all awards, net of tax | | (2,522) |
| Pro forma net earnings | $ | 17,113 |
| Net earnings per share basic: | | |
| As reported | $ | 0.32 |
| Pro forma | | 0.31 |
| Net earnings per share diluted: | | |
| As reported | $ | 0.32 |
| Pro forma | | 0.30 |

| (Amounts in thousands, except per share amounts) | | Six Months Ended June 30, 2005 |
|---|---|---|
| Net earnings, as reported | $ | 13,936 |
| Restricted stock compensation expense included in net earnings, net of tax | | 2,426 |
| Less: Stock-based employee compensation expense determined under fair value method for all awards, net of tax | | (3,720) |
| Pro forma net earnings | $ | 12,642 |
| Net earnings per share basic: | | |
| As reported | $ | 0.25 |
| Pro forma | | 0.23 |
| Net earnings per share diluted: | | |
| As reported | $ | 0.25 |
| Pro forma | | 0.22 |

We adopted SFAS No. 123(R) under the modified prospective application method. Under this method, we recorded stock-based compensation expense of $3.9 million ($5.4 million pre-tax) and $6.7 million ($9.3 million pre-tax) for the three and six months ended June 30, 2006, respectively, for all awards granted on or after the date of adoption and for the portion of previously granted awards that remain unvested at the date of adoption over the remaining vesting period. Accordingly, prior period amounts have not been restated. In accordance with SFAS No. 123(R), we adjust share-based compensation on a quarterly basis for changes to the estimate of expected equity award forfeitures based on actual forfeiture experience. Currently, our stock-based compensation relates to stock options, restricted stock and other equity-based awards. It is our policy to set the exercise price of stock options at the closing price of our common stock on the New York Stock Exchange on the date such grants are authorized by our Board of Directors. Options granted to officers, other employees and directors allow for the purchase of common shares at or above the fair market value of our stock on the date the options are granted, although no options have been granted above fair market value. Generally, options become exercisable over a staggered period ranging from one to five years (most typically from one to three years). Options generally expire ten years from the date of the grant or within a short period of time following the termination of employment or cessation of services by an option holder; however, as described in greater detail under Modifications below, the expiration provisions relating to certain outstanding option awards that have been modified.

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*Stock Options* Information related to stock options issued to officers, other employees and directors under all plans is presented in the following table:

| | Six Months Ended June 30, 2006 | | | |
|---|---|---|---|---|
| | Shares | Weighted Average Exercise Price | Remaining Contractual Life (in years) | Aggregate Intrinsic Value (in millions) |
| Number of shares under option: | | | | |
| Outstanding beginning of year | 2,966,326 | $ 23.00 | | |
| Granted | 270,350 | 49.28 | | |
| Exercised | | | | |
| Cancelled | (5,573) | 37.26 | | |
| Modified (1) | 89,404 | 24.55 | | |
| Outstanding end of period | 3,320,507 | $ 25.16 | 4.1 | $ 105.4 |
| Exercisable end of period | 2,473,120 | $ 22.04 | 2.4 | $ 86.2 |

(1) Options expiring in 2005 that had their expiration dates extended contingent upon shareholder approval, which was obtained on August 24, 2006, as discussed below in Modifications .

The weighted average fair value per share of options granted was $27.61 and $13.15 for the three months ended June 30, 2006 and 2005, respectively, and $24.77 and $12.13 for the six months ended June 30, 2006 and 2005, respectively. For purposes of pro forma disclosure, the estimated fair value of the options is amortized to expense over the options vesting periods. The fair value for these options at the date of grant was estimated using the Black-Scholes option pricing model.

The assumptions used in calculating the expense for stock option awards are as follows:

| | Six Months Ended June 30, | |
|---|---|---|
| | 2006 | 2005 |
| Risk-free interest rate | 5.1% | 4.2% |
| Dividend yield | | |
| Stock volatility | 42.1% | 43.9% |
| Average expected life (years) | 6.5 | 6.7 |

| | | |
|---|---|---|
| Forfeiture rate | 9.3% | 9.7% |

As of June 30, 2006, we have $8.3 million of unrecognized compensation cost related to outstanding unvested stock option awards, which is expected to be recognized over a weighted-average period of approximately 1.9 years. The total intrinsic value of stock options exercised during the three months ended June 30, 2006 and 2005 was $0 and $0.1 million, respectively, and $0 and $0.3 million exercised during the six months ended June 30, 2006 and 2005, respectively.

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Incremental stock-based compensation expense related solely to stock options recognized for the three and six months ended June 30, 2006 as a result of adoption of SFAS No. 123(R) was as follows:

| (Amounts in thousands, except per share data) | Three Months Ended June 30, 2006 | |
|---|---|---|
| Stock-based compensation expense, before taxes | $ | 1,975 |
| Related income tax benefit | | (482) |
| Stock-based compensation expense, net of tax | $ | 1,493 |
| Earnings per share basic: | $ | 0.03 |
| Earnings per share diluted: | | 0.03 |

| (Amounts in thousands, except per share data) | Six Months Ended June 30, 2006 | |
|---|---|---|
| Stock-based compensation expense, before taxes | $ | 3,547 |
| Related income tax benefit | | (866) |
| Stock-based compensation expense, net of tax | $ | 2,681 |
| Earnings per share basic: | $ | 0.05 |
| Earnings per share diluted: | | 0.05 |

*Restricted Stock* Awards of restricted stock are valued at the closing market price of our common stock on the grant date and recorded as unearned compensation within shareholders equity. The unearned compensation is amortized to compensation expense over the vesting period of the restricted stock. We have unearned compensation of $19.2 million and $9.1 million at June 30, 2006 and December 31, 2005, respectively. These amounts will be recognized into net earnings in prospective periods as the awards vest.

Stock-based compensation expense related to restricted stock recognized was $2.4 million ($3.5 million pre-tax) and $4.0 million ($5.8 million pre-tax) for the three and six months ended June 30, 2006, respectively. Stock-based compensation expense related to restricted stock recognized was $1.5 million ($2.1 million pre-tax) and $2.3 million ($3.3 million pre-tax) for the three and six months ended June 30, 2005, respectively.

The following tables summarize information regarding the restricted stock plans:

| | Six Months Ended June 30, 2006 | | |
|---|---|---|---|
| | Shares | Weighted Average Grant-Date Fair Value | |
| Number of unvested shares: | | | |
| Outstanding beginning of year | 583,455 | $ | 25.65 |
| Granted | 332,990 | | 48.26 |
| Lapsed | (93,144) | | 49.02 |
| Cancelled | (10,543) | | 47.50 |

| | | | |
|---|---|---|---|
| Unvested restricted stock | 812,758 | $ | 31.95 |

*Modifications* During 2005, we made a number of modifications to our stock plans, including the acceleration of vesting of certain restricted stock grants and outstanding options, as well as the extension of the exercise period associated with certain outstanding options. These modifications resulted from severance agreements with former executives and from our decision to temporarily suspend option exercises. As a result of the modifications primarily associated with the severance agreements with former executives, we recorded additional stock-based compensation expense in 2005 of $7.2 million based upon the intrinsic values of the awards on the dates the modifications were made of which $0 and $6.2 million was recorded during the three and six months ended June 30, 2005, respectively.

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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 further extend the exercise date of these options, and options expiring in 2006, to January 1, 2009. We thereafter concluded, however, that recent regulatory guidance issued under Section 409A of the Internal Revenue Code might cause the recipients of these extended options to become subject to unintended adverse tax consequences under Section 409A. Accordingly, effective December 14, 2005, the Organization and Compensation Committee of the Board of Directors partially rescinded, in accordance with the regulations, the extensions of the regular term of these options, to provide as follows:

(i) the regular term of options otherwise expiring in 2005 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 were subject to shareholder approval of applicable plan amendments, which was obtained at our annual shareholders meeting, held in August 2006. The approval of such plan amendments is considered a stock modification for financial reporting purposes subject to the recognition of a non-cash compensation charge in accordance with SFAS No. 123(R) and we recorded a charge of approximately $6 million, which will be recognized in the third quarter of 2006.

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 charge in accordance with APB No. 25, of $1.0 million in 2005, none of which was recorded in the six months ended June 30, 2005. The extension of the exercise period following separation from employment does not apply to option exercise periods governed by a separate separation contract or agreement.

**4. 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 specifies the conditions in which we enter into derivative contracts. As of June 30, 2006, we had approximately $295 million of notional amount in outstanding contracts with third parties. As of June 30, 2006, the maximum length of any forward contract in place was 23 months.

The fair market value adjustments of certain of our forward contracts are recognized directly in our results of operations. The fair value of these outstanding forward contracts at June 30, 2006 was a net asset of $4.0 million and a net liability of $2.3 million at December 31, 2005. Unrealized gains (losses) from the changes in the fair value of these forward contracts of $6.2 million and $(3.8) million for the three months ended June 30, 2006 and 2005, respectively, and $6.4 million and $(5.6) million for the six months ended June 30, 2006 and 2005, respectively, are included in other income (expense), net in the consolidated statements of income. The fair value of outstanding forward contracts qualifying for hedge accounting at June 30, 2006 was a net asset of $0.2 million and a net liability of $7,000 at December 31, 2005. Unrealized gains (losses) from the changes in the fair value of qualifying forward contracts and the associated underlying exposures of $0.2 million and $(0.3) million, net of tax, for the three months ended June 30, 2006 and 2005, respectively, and $0.2 million and $(0.1) million, net of tax, for the six months ended June 30, 2006 and 2005, 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 June 30, 2006, we had $385.0 million of notional amount in outstanding interest rate swaps with third parties. As of June 30, 2006, the maximum remaining length of any interest rate contract in place was approximately 30 months. The fair value of the interest rate swap agreements was a net asset of $4.4 million and $0.9 million at June 30, 2006 and December 31, 2005, respectively. Unrealized gains from the changes in fair value of our interest rate swap agreements, net of reclassifications, of $0.8 million and $0.2 million, net of tax, for the three months ended June 30, 2006 and 2005, respectively, and $2.2 million and $0.9 million, net of tax, for the six months ended June 30, 2006 and 2005, respectively, are included in other comprehensive income (loss).

During the third quarter of 2004, we entered into a compound derivative contract to hedge exposure to both currency translation and interest rate risks associated with our European Investment Bank ( EIB ) loan. The notional amount of the derivative was $85.0 million, and it served to convert floating rate interest rate risk to a fixed rate, as well as United States ( U.S. ) dollar currency risk to Euros. The derivative matures in 2011. At June 30, 2006 and December 31, 2005, the fair value of this derivative was a net liability of $6.3 million and $2.8 million, respectively. This derivative did not qualify for hedge accounting. The unrealized gain (loss) on the derivative, offset with the foreign currency translation effect on the underlying loan aggregates to $1.4 million and $(2.5) million for the three months ended June 30, 2006 and 2005, respectively, and $3.6 million and $(2.7) million for the six months ended June 30, 2006 and 2005, respectively, and is included in other income (expense), net in the consolidated statements of income.

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

**5. Debt**

Debt, including capital lease obligations, consisted of:

| (Amounts in thousands) | June 30, 2006 | December 31, 2005 |
|---|---|---|
| Term Loan, interest rate of 7.23% in 2006 and 6.36% in 2005 | $ 562,644 | $ 578,500 |
| EIB loan, interest rate of 5.26% in 2006 and 4.42% in 2005 | 85,000 | 85,000 |
| Capital lease obligations and other | 7,962 | 1,636 |
| Debt and capital lease obligations | 655,606 | 665,136 |
| Less amounts due within one year | 10,731 | 12,367 |
| Total debt due after one year | $ 644,875 | $ 652,769 |

**New Credit Facilities**

On August 12, 2005, we entered into credit facilities comprised of a $600.0 million term loan expiring on August 10, 2012 and a $400.0 million revolving line of credit, which can be utilized to provide up to $300.0 million in letters of credit, expiring on August 12, 2010. We refer to these credit facilities collectively as our New Credit Facilities. We also replaced the letter of credit agreement guaranteeing our obligations under the EIB credit facility (described below) with a letter of credit issued under the new revolving line of credit. We had outstanding letters of credit of $180.7 million at June 30, 2006 under the revolving line of credit, which reduced borrowing capacity to $219.3 million, compared with a borrowing capacity of $234.2 million at December 31, 2005. During the three and six months ended June 30, 2006, we made mandatory repayments of $0 and $10.9 million, respectively, using the net proceeds from the sale of GSG, and optional prepayments of $5.0 million and $5.0 million, respectively. In addition, we made a mandatory repayment of $0.9 million in July 2006 using excess cash flows. We have no scheduled repayments due in 2006.

Borrowings under our New Credit Facilities bear interest at a rate equal to, at our option, either (1) the base rate (which is based on the greater of the prime rate most recently announced by the administrative agent under our New Credit Facilities or the Federal Funds rate plus 0.50%) or (2) London Interbank Offered Rate ( LIBOR ) plus an applicable margin determined by reference to the ratio of our total debt to consolidated Earnings Before Interest, Taxes, Depreciation and Amortization ( EBITDA ), which at June 30, 2006 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.

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

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

- 100% of the net cash proceeds of asset sales; and

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

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

Our New Credit Facilities contain covenants requiring us to deliver to lenders leverage and interest coverage financial covenants and our audited annual and unaudited quarterly financial statements. Under the leverage covenant, the maximum permitted leverage ratio steps down beginning with the fourth quarter of 2006, with a further step-down beginning with the fourth quarter of 2007. Under the interest coverage covenant, the minimum required interest coverage ratio steps up beginning with the fourth quarter of 2006, with a further step-up beginning with the fourth quarter of 2007. Compliance with these financial covenants under our New Credit Facilities is tested quarterly, and we were in compliance with the financial covenants as of June 30, 2006.

We are required to furnish to our lenders within 50 days of the end of each of the first three quarters of each year our consolidated balance sheet, and related statements of operations, shareholders equity and cash flows. Our New Credit Facilities also contain covenants restricting our and our subsidiaries ability to dispose of assets, merge, pay dividends, repurchase or redeem capital stock and indebtedness, incur indebtedness and guarantees, create liens, enter into agreements with negative pledge clauses, make certain investments or acquisitions, enter into sale and leaseback transactions, enter into transactions with affiliates, make capital expenditures, engage in any business activity other than our existing business or any business activities reasonably incidental thereto. We were in compliance with all debt covenants under the New Credit Facilities as of June 30, 2006.

**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 70.0 million, with the ability to draw funds in multiple currencies, to finance in part specified research and development projects undertaken by us in Europe. Borrowings under the EIB credit facility bear interest at a fixed or floating rate of interest agreed to by us and EIB with respect to each borrowing under the facility. Loans under the EIB credit facility are subject to mandatory repayment, at EIB s discretion, upon the occurrence of certain events, including a change of control or prepayment of certain other indebtedness. In addition, the EIB credit facility contains covenants that, among other things, limit our ability to dispose of assets related to the financed project and require us to deliver to EIB our audited annual financial statements within 30 days of publication. In August 2004, we borrowed $85.0 million at a floating interest rate based on 3-month U.S. LIBOR that resets quarterly. As of June 30, 2006, the interest rate was 5.26%. The maturity of the amount drawn is June 15, 2011, but may be repaid at any time without penalty. Our obligations under the EIB credit facility are guaranteed by a letter of credit outstanding under our New Credit Facilities, which costs 1.75% per annum.

**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 New Credit Facilities, such factoring is generally limited to $75.0 million, based on due date of the factored receivables.

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**6. Inventories**

Inventories are stated at lower of cost or market. Cost is determined for principally all U.S. inventories by the last-in, first-out method and for non-U.S. inventories by the first-in, first-out method. Inventories, net consisted of the following:

| (Amounts in thousands) | June 30, 2006 | December 31, 2005 |
|---|---|---|
| Raw materials | $ 134,466 | $ 114,636 |
| Work in process | 269,668 | 195,585 |
| Finished goods | 247,141 | 219,610 |
| Less: Progress billings | (116,398) | (71,065) |
| Less: Excess and obsolete reserve | (60,744) | (57,106) |
| | 474,133 | 401,660 |
| LIFO reserve | (44,726) | (39,890) |
| Inventories, net | $ 429,407 | $ 361,770 |
| Percent of inventory accounted for by: | | |
| LIFO | 44% | 49% |
| FIFO | 56% | 51% |

**7. Earnings Per Share**

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

| | Three Months Ended June 30, | |
|---|---|---|
| (Amounts in thousands, except per share amounts) | 2006 | 2005 |
| Income from continuing operations | $ 33,071 | $ 18,561 |
| Net earnings | $ 33,071 | $ 17,950 |
| Denominator for basic earnings per share weighted average shares | 55,699 | 55,610 |
| Effect of potentially dilutive securities | 2,188 | 1,027 |
| Denominator for diluted earnings per share weighted average shares | 57,887 | 56,637 |
| Net earnings per share: | | |
| Basic: | | |
| Continuing operations | $ 0.59 | $ 0.33 |
| Net earnings | 0.59 | 0.32 |
| Diluted: | | |
| Continuing operations | $ 0.57 | $ 0.33 |
| Net earnings | 0.57 | 0.32 |

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| (Amounts in thousands, except per share amounts) | Six Months Ended June 30, 2006 | 2005 |
|---|---|---|
| Income from continuing operations | $ 46,963 | $ 21,459 |
| Net earnings | $ 46,963 | $ 13,936 |
| Denominator for basic earnings per share weighted average shares | 55,593 | 55,478 |
| Effect of potentially dilutive securities | 2,137 | 942 |
| Denominator for diluted earnings per share weighted average shares | 57,730 | 56,420 |
| Net earnings per share: | | |
| Basic: | | |
| Continuing operations | $ 0.84 | $ 0.39 |
| Net earnings | 0.84 | 0.25 |
| Diluted: | | |
| Continuing operations | $ 0.81 | $ 0.38 |
| Net earnings | 0.81 | 0.25 |

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:

| | Three Months Ended June 30, 2006 | 2005 |
|---|---|---|
| Total number excluded | 26,000 | 305,458 |

| | Six Months Ended June 30, 2006 | 2005 |
|---|---|---|
| Total number excluded | 33,000 | 586,029 |

**8. Legal Matters and Contingencies**

We are a defendant in a large number of pending lawsuits (which include, in many cases, multiple claimants and multiple defendants) 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. The asbestos-containing parts we used 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 available insurance or indemnities from other companies.

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

During the quarter ended September 30, 2003, related lawsuits were filed in federal court in the Northern District of Texas (the Court ), alleging that we violated federal securities laws. Since the filing of these cases, which have been consolidated, the lead plaintiff has amended its complaint several times. The lead plaintiff s current pleading is the fifth consolidated amended complaint (the Complaint ). The Complaint alleges that federal securities violations occurred between February 6, 2001 and September 27, 2002 and names as defendants our company, C. Scott Greer, our former Chairman, President and Chief Executive Officer, Renée J. Hornbaker, our former Vice President and Chief Financial Officer, PricewaterhouseCoopers LLP, our independent registered public accounting firm, and Banc of America Securities LLC and Credit Suisse First Boston LLC, which served as underwriters for our two public stock offerings during the relevant period. The Complaint asserts claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, and Sections 11 and 15 of the Securities Act of 1933. The lead plaintiff seeks unspecified compensatory damages, forfeiture by Mr. Greer and Ms. Hornbaker of unspecified incentive-based or equity-based compensation and profits from any stock sales, and recovery of costs. On November 22, 2005, the Court entered an order denying the defendants motions to dismiss the Complaint. The case is currently set for trial on June 11, 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 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 Mr. Coble, Mr. Haymaker, Jr., Lewis M. Kling, Mr. Rusnack, Mr. Johnston, Mr. Rampacek, Mr. Sheehan, Ms. Harris, Mr. Rollans and Mr. Bartlett. We are named as a nominal defendant. Based primarily on certain of the purported misstatements alleged in the above-described federal securities case, the plaintiff asserts claims against the defendants for breaches of fiduciary duty. The plaintiff alleges that the purported breaches of fiduciary duty occurred between 2000 and 2004. The plaintiff seeks on our behalf an unspecified amount of damages, disgorgement by Mr. Greer and Ms. 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 have filed a motion seeking dismissal of the case.

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

On February 7, 2006, we received a subpoena from the SEC regarding goods and services that certain foreign subsidiaries delivered to Iraq from 1996 through 2003 during the United Nations Oil-for-Food program. This investigation includes a review of whether any inappropriate payments were made to Iraqi officials in violation of the Foreign Corrupt Practices Act. The investigation includes periods prior to, as well as subsequent to our acquisition of the foreign operations involved in the investigation. We may be subject to liabilities if violations are found regardless of whether they relate to periods before or subsequent to our acquisition. In addition, one of our foreign subsidiary s operations is cooperating with a foreign governmental investigation of that site s involvement in the United Nations Oil-for-Food program. This cooperation has included responding to an investigative trip by foreign authorities to the foreign subsidiary s site, providing relevant documentation to these authorities and answering their questions. We are unable to predict how or if the foreign authorities will pursue this matter in the future. We believe that both the SEC and foreign authorities are investigating other companies from their actions arising from the United Nations Oil-for-Food program. We also understand that the U.S. Department of Justice is conducting its own investigation of the same events underlying the SEC inquiry. We are in the process of reviewing and responding to the SEC subpoena and assessing the implications of the foreign investigation, including the continuation of a thorough internal investigation. Our investigation remains ongoing. The investigation has included and will include a detailed review of contracts with the Iraqi government during the period in question and certain payments associated therewith, as well as other documents and information that might relate to Oil-for-Food transactions. Additionally, we have and will continue to conduct interviews with employees with knowledge of the contracts and payments in question. While we have made substantial progress in our internal investigation, we are still unable to make any definitive determination whether any inappropriate payments were made and accordingly are unable to predict the ultimate outcome of this matter. We will continue to fully cooperate in both the SEC and the foreign investigations. Both investigations are in progress but, at this point, are incomplete. Accordingly, if the SEC and/or the foreign authorities take enforcement action with regard to these investigations, we may be required to pay fines, take remedial compliance measures, further improve our existing compliance program, consent to injunctions against future conduct or suffer other penalties which could potentially materially impact our business financial statements and cash flows.

In March 2006, we initiated a process to determine our compliance posture with respect to U.S. export control laws and regulations. Upon initial investigation, it appears that some product transactions and technology transfers may technically not be in compliance with U.S. export control laws and regulations and require further review. With assistance from outside counsel, we are currently involved in a systematic process to conduct further review, which we believe will take about 15 months to complete given the complexity of the export laws and the comprehensive scope of our investigation. Any potential violations of U.S. export control laws and regulations that are identified may result in civil or criminal penalties, including fines and/or other penalties. Because our review into this issue is ongoing, we are currently unable to determine the full extent of potential violations or the nature or amount of potential penalties to which we might be subject to in the future. Given that the resolution of this matter is uncertain at this time, we are not able to reasonably estimate the maximum amount of liability that could result from final resolution of this matter. We cannot currently predict whether the ultimate resolution of this matter will have a material adverse effect on our business, including our ability to do business outside the U.S, or on our financial condition.

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. We believe that 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. 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.

Although none of the aforementioned potential liabilities can be quantified with absolute certainty except as otherwise indicated above, we have established reserves covering exposures relating to contingencies, to the extent believed to be reasonably estimable and which we believe to be probable of loss 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, will recognize expense as soon as such losses become probable and can be reasonably estimated.

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**9. Retirement and Postretirement Benefits**

Components of the net periodic cost for the three months ended June 30, 2006 and 2005 were as follows:

| | U.S. Defined Benefit Plans | | Non-U.S. Defined Benefit Plans | | Postretirement Medical Benefits | |
|---|---|---|---|---|---|---|
| (Amounts in millions) | 2006 | 2005 | 2006 | 2005 | 2006 | 2005 |
| Net periodic cost | | | | | | |
| Service cost | $ 3.7 | $ 3.7 | $ 0.9 | $ 0.8 | $ | $ |
| Interest cost | 3.8 | 3.9 | 2.5 | 2.6 | 1.0 | 1.0 |
| Expected return on plan assets | (3.9) | (4.1) | (1.4) | (1.4) | | |
| Curtailments/settlements | | (0.1) | | | | |
| Amortization of unrecognized net loss | 1.6 | 1.3 | 0.6 | 0.3 | 0.3 | 0.2 |
| Amortization of prior service cost (benefit) | (0.3) | (0.4) | | | (1.1) | (1.0) |
| Net cost recognized | $ 4.9 | $ 4.3 | $ 2.6 | $ 2.3 | $ 0.2 | $ 0.2 |

Components of the net periodic cost for the six months ended June 30, 2006 and 2005 were as follows:

| | U.S. Defined Benefit Plans | | Non-U.S. Defined Benefit Plans | | Postretirement Medical Benefits | |
|---|---|---|---|---|---|---|
| (Amounts in millions) | 2006 | 2005 | 2006 | 2005 | 2006 | 2005 |
| Net periodic cost | | | | | | |
| Service cost | $ 7.4 | $ 7.4 | $ 1.8 | $ 1.7 | $ | $ 0.1 |
| Interest cost | 7.6 | 7.8 | 5.0 | 5.1 | 2.0 | 2.1 |
| Expected return on plan assets | (7.8) | (8.2) | (2.8) | (2.9) | | |
| Curtailments/settlements | | (0.2) | | | | |
| Amortization of unrecognized net loss | 3.2 | 2.5 | 1.2 | 0.7 | 0.6 | 0.3 |
| Amortization of prior service costs (benefit) | (0.6) | (0.7) | | | (2.2) | (2.1) |
| Net cost recognized | $ 9.8 | $ 8.6 | $ 5.2 | $ 4.6 | $ 0.4 | $ 0.4 |

**10. Income Taxes**

For the three months ended June 30, 2006, we earned $61.7 million before taxes and provided for income taxes of $28.6 million, resulting in an effective tax rate of 46.4%. For the six months ended June 30, 2006, we earned $85.7 million before taxes and provided for income taxes of $38.8 million, resulting in an effective tax rate of 45.2%. The effective tax rate varied from the U.S. federal statutory rate for the three and six months ended June 30, 2006 primarily due to the tax impact of operating activities in certain non-U.S. jurisdictions, including higher losses incurred in the second quarter of 2006 as compared with the same period in 2005, for which a tax benefit has not been recognized.

For the three months ended June 30, 2005, we earned $31.2 million before taxes and provided for income taxes of $12.6 million, resulting in an effective tax rate of 40.5%. For the six months ended June 30, 2005, we earned $35.1 million before taxes and provided for income taxes of $13.7 million, resulting in an effective tax rate of 38.9%. The effective tax rate varied from the U.S. federal statutory rate for the three and six months ended June 30, 2005 primarily due to the net impact of foreign operations.

The Internal Revenue Service ( IRS ) substantially concluded its audit of our U.S. federal income tax returns for the years 1999 through 2001 during December 2005. Based on its audit work, the IRS has issued proposed adjustments to increase taxable income during 1999 through 2001 by $12.8 million, and to deny foreign tax credits of $2.4 million in the aggregate. The tax liability resulting from these proposed adjustments will be offset with foreign tax credit carryovers and other refund claims, which was approved by the Joint Committee on Taxation on July 24, 2006, and therefore should not result in a material future cash payment. We anticipate the final cash settlement of this examination will be completed by December 31, 2006. The effect of the adjustments to current and deferred taxes has been reflected in previously filed consolidated financial statements for the applicable periods.

During the third quarter of 2006, the IRS commenced an audit of our U.S. federal income tax returns for the years 2002 through 2004. While we expect that the upcoming IRS audit will be similar in scope to the recently completed examination, the upcoming audit may be broader. Furthermore, the preliminary results from the audit of 1999 through 2001 are not indicative of the future result of the audit of 2002 through 2004. The audit of 2002 through 2004 may result in additional tax payments by us, the amount of which may be material, but will not be known until that IRS audit is finalized.

In the course of the tax audit for the years 1999 through 2001, we identified record keeping issues that existed during the periods, which caused us to incur significant expense to substantiate our tax return items and address information and document requests made by the IRS. We expect to incur similar expenses in future periods with respect to the upcoming IRS audit of the years 2002 through 2004.

Due to the record keeping issues referred to above, the IRS has issued a Notice of Inadequate Records for the years 1999 through 2001 and may issue a similar notice for the years 2002 through 2004. While the IRS has agreed not to assess penalties for inadequacy of records with respect to the years 1999 through 2001, no assurances can be made that the IRS will not seek to assess such penalties or other types of penalties with respect to the years 2002 through 2004. Such penalties could result in a material impact to the consolidated results of operations. Additionally, the record keeping issues noted above may result in future U.S. state and local, as well as non-U.S., tax assessments of tax, penalties and interest which could have a material impact to the consolidated results of operations.

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

We evaluate segment performance and allocate resources based on each segment s operating income. Amounts classified as All Other include 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.

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

**Three Months Ended June 30, 2006**

| (Amounts in thousands) | Flowserve Pump | Flow Control | Flow Solutions | Subtotal Reportable Segments | All Other | Consolidated Total |
|---|---|---|---|---|---|---|
| Sales to external customers | $385,516 | $251,715 | $114,158 | $751,389 | $ 1,470 | $ 752,859 |
| Intersegment sales | 1,442 | 635 | 10,818 | 12,895 | (12,895) | |
| Segment operating income | 46,929 | 29,310 | 27,346 | 103,585 | (31,107) | 72,478 |

**Three Months Ended June 30, 2005**

| (Amounts in thousands) | Flowserve Pump | Flow Control | Flow Solutions | Subtotal Reportable Segments | All Other | Consolidated Total |
|---|---|---|---|---|---|---|
| Sales to external customers | $359,099 | $227,674 | $103,126 | 689,899 | $ 1,266 | $ 691,165 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Intersegment sales | 1,140 | 1,177 | 8,775 | 11,092 | (11,092) | |
| Segment operating income | 37,749 | 26,171 | 24,234 | 88,154 | (31,851) | 56,303 |

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**Six Months Ended June 30, 2006**

| (Amounts in thousands) | Flowserve Pump | Flow Control | Flow Solutions | Subtotal Reportable Segments | All Other | Consolidated Total |
|---|---|---|---|---|---|---|
| Sales to external customers | $712,952 | $468,758 | $222,374 | $1,404,084 | $ 2,632 | $ 1,406,716 |
| Intersegment sales | 2,066 | 1,390 | 20,813 | 24,269 | (24,269) | |
| Segment operating income | 71,384 | 53,389 | 50,642 | 175,415 | (65,417) | 109,998 |

**Six Months Ended June 30, 2005**

| (Amounts in thousands) | Flowserve Pump | Flow Control | Flow Solutions | Subtotal Reportable Segments | All Other | Consolidated Total |
|---|---|---|---|---|---|---|
| Sales to external customers | $670,905 | $436,407 | $197,654 | $1,304,966 | $ 2,317 | $ 1,307,283 |
| Intersegment sales | 2,230 | 1,974 | 17,098 | 21,302 | (21,302) | |
| Segment operating income | 55,384 | 46,175 | 42,885 | 144,444 | (62,314) | 82,130 |

**12. Subsequent Events**

Our Shareholder Rights Plan and Series A Preferred Stock expired in August 2006. As a result of the expiration, we amended our Certificate of Incorporation and the New York Stock Exchange delisted the Series A Preferred Stock.

On September 29, 2006, the Board of Directors authorized a program to repurchase up to two million shares of our outstanding common stock. Shares will be repurchased to offset potentially dilutive effects of stock options issued under our stock-based compensation programs. We expect to commence the program after our planned November filing of our third quarter 2006 Form 10-Q.

At our annual shareholders meeting on August 24, 2006, our shareholders approved certain applicable amendments to our stock option and incentive plans. See Note 3 for further discussion of this matter.

Updates to legal matters in existence at June 30, 2006, and new legal matters that have arisen since June 30, 2006 are discussed in Note 8.

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements, and notes thereto, and the other financial data included elsewhere in this Quarterly Report. The following discussion should also be read in conjunction with our audited consolidated financial statements, and notes thereto, and Management s Discussion and Analysis of Financial Condition and Results of Operations included in our 2005 Annual Report.

**EXECUTIVE OVERVIEW**

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

We have experienced steadily improving conditions in 2005 and 2006 in several core markets, including oil and gas, chemical, power and general industries. The rise of the price of crude oil and natural gas in particular has spurred capital investment in the oil and gas market, resulting in many new projects and expansion opportunities. Although feedstock costs have been rising in the chemical market, greater global demand is allowing companies to pass through pricing and strengthen the global market. We have also seen a resurgence of nuclear power, particularly in the Asian market and an increase in coal-fired power plants across the globe. The opportunity to increase our installed base of new products and drive recurring aftermarket business in future years is a critical by-product of these favorable market conditions.

We currently have approximately 13,000 employees in more than 56 countries. We continue to implement new Quick Response Centers ( QRCs ) to be better positioned as near to our customers as possible for service and support, as a means to capture the important aftermarket business. Our markets have improved and we see corresponding growth in our business, much of which is in non-traditional areas of the world where new oil and gas reserves have been discovered. While we have experienced increased demand for our products and services in recent periods, we continue to monitor our core industries for changes and track global issues that could impact our performance. We and our customers are seeing rapid growth in Asia and the Middle East, with China providing a source of significant project growth. We have a strategy in place to increase our presence in China to capture the aftermarket business with our current installed base as well as to support new plant construction and expansions. In 2006, we expanded our presence in China through two new QRCs in Shenzhen and Shanghai, as well as a new greenfield manufacturing operation in Suzhou to support local service and low cost sourcing.

Along with ensuring that we have the local capability to sell, install and service our equipment in remote regions, it becomes more imperative to continuously improve our global operations. Our global supply chain capability is being expanded to meet the global customer demands and ensure the quality and timely delivery of our products while minimizing our input costs. Significant efforts are underway to reduce the supply base and drive processes across the business to find areas of synergy and cost reduction. In addition, we are improving our supply chain management capability to ensure we meet global customer demands. We continue to focus on improving on-time delivery and quality, while reducing warranty costs across our global operations through a focused Continuous Improvement Process ( CIP ) initiative. The goal of the CIP initiative is to maximize service fulfillment to our customers (such as on-time delivery, reduced cycle time and quality) at the highest internal productivity. This program is a key factor in our margin expansion plans.

**RECENT DEVELOPMENTS**

The IRS substantially concluded its audit of our U.S. federal income tax returns for the years 1999 through 2001 during December 2005. Based on its audit work, the IRS issued proposed adjustments to increase taxable income during 1999 through 2001 by $12.8 million, and to deny foreign tax credits of $2.4 million in the aggregate. The tax liability resulting from these proposed adjustments will be offset with foreign tax credit carryovers and other refund claims, which were approved by the Joint Committee on Taxation on July 24, 2006, and therefore should not result in a material future cash payment. We anticipate the final cash settlement of this examination will be completed by December 31, 2006. The effect of the adjustments to current and deferred taxes has been reflected in previously filed consolidated financial statements for the applicable periods.

During the third quarter of 2006, the IRS commenced an audit of our U.S. federal income tax returns for the years 2002 through 2004. While we expect that the upcoming IRS audit will be similar in scope to the recently completed examination, the upcoming audit may be broader. Furthermore, the preliminary results from the audit of 1999 through 2001 are not indicative of the future result of the audit of 2002 through 2004. The audit of 2002 through 2004 may result in additional tax payments by us, the amount of which may be material, but will not be known until that IRS audit is finalized.

In the course of the tax audit for the years 1999 through 2001, we identified record keeping issues that existed during the periods, which caused us to incur significant expense to substantiate our tax return items and address information and document requests made by the IRS. We expect to incur similar expenses in future periods with respect to the upcoming IRS audit of the years 2002 through 2004.

Due to the record keeping issues referred to above, the IRS has issued a Notice of Inadequate Records for the years 1999 through 2001 and may issue a similar notice for the years 2002 through 2004. While the IRS has agreed not to assess penalties for inadequacy of records with respect to the years 1999 through 2001, no assurances can be made that the IRS will not seek to assess such penalties or other types of penalties with respect to the years 2002 through 2004. Such penalties could result in a material impact to the consolidated results of operations. Additionally, the record keeping issues noted above may result in future U.S. state and local, as well as non-U.S., tax assessments of tax, penalties and interest which could have a material impact to the consolidated results of operations.

**RESULTS OF OPERATIONS Three and Six Months ended June 30, 2006 and 2005**

**Consolidated Results**

**Bookings, Sales and Backlog**

| (Amounts in millions) | **Three Months Ended June 30, 2006** | **2005** |
|---|---|---|
| Bookings continuing operations | $ 912.0 | $ 696.1 |
| Bookings discontinued operations | | 27.2 |
| Total bookings | 912.0 | 723.3 |
| Sales | 752.9 | 691.2 |

| (Amounts in millions) | **Six Months Ended June 30, 2006** | **2005** |
|---|---|---|
| Bookings continuing operations | $ 1,790.6 | $ 1,381.7 |
| Bookings discontinued operations | | 54.1 |
| Total bookings | 1,790.6 | 1,435.8 |
| Sales | 1,406.7 | 1,307.3 |

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. Total bookings for the three months ended June 30, 2006 increased by $188.7 million, or 26.1%, as compared with the same period in 2005. The increase includes currency benefits of approximately $2 million. Total bookings for the six months ended June 30, 2006 increased by $354.8 million, or 24.7%, as compared with the same period in 2005. The increase includes negative currency effects of approximately $36 million. Total bookings for the three and six months ended June 30, 2005 include $27.2 million and $54.1 million, respectively, of bookings for GSG, our discontinued operations. Bookings for continuing operations for the three months ended June 30, 2006 increased by $215.9 million, or 31.0%, as compared with the same period in 2005. Bookings for continuing operations for the six months ended June 30, 2006 increased by $408.9 million, or 29.6%, as compared with the same period in 2005. The increases are primarily attributable to the strong oil and gas industry, particularly in our Flowserve Pump and Flow Control Divisions.

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Sales for the three months ended June 30, 2006 increased by $61.7 million, or 8.9%, as compared with the same period in 2005. The increase includes currency benefits of approximately $4 million. Sales for the six months ended June 30, 2006 increased by $99.4 million, or 7.6%, as compared with the same period in 2005. The increase includes negative currency effects of approximately $19 million. The increases are primarily attributable to the strength in the engineered pump products and services market, particularly in the Middle East, improved valve markets and expansion into the Asia Pacific region.

Net sales to international customers, including export sales from the U.S., were approximately 65% and 64% of sales for the three and six months ended June 30, 2006, respectively, compared with 64% for each of the same periods in 2005. The increase in 2006 is due primarily to a growth in sales to the Middle East and expansion in the Asia Pacific region.

Backlog represents the accumulation of uncompleted customer orders. Backlog of $1.4 billion at June 30, 2006 increased by $402.5 million, or 40.5%, as compared with December 31, 2005. The increase includes currency benefits of approximately $55 million. The backlog increase compared with the prior year resulted from increased bookings during the six months ended June 30, 2006 as discussed above. The increase in total bookings reflects an increase in orders of engineered products, which naturally have longer lead times, as well as expanded lead times at the request of certain customers.

**Gross Profit and Operating Margin**

| | Three Months Ended June 30, | |
|---|---|---|
| (Amounts in millions) | **2006** | **2005** |
| Gross profit | $ 251.7 | $ 222.7 |
| Gross profit margin | 33.4% | 32.2% |

| | Six Months Ended June 30, | |
|---|---|---|
| (Amounts in millions) | **2006** | **2005** |
| Gross profit | $466.1 | $413.8 |
| Gross profit margin | 33.1% | 31.7% |

Gross profit margin of 33.4% for the three months ending June 30, 2006 increased from 32.2% for the same period in 2005. The increase is a result of increased sales, which favorably impacts our absorption of fixed costs, and cost savings achieved through our CIP initiative, both of which have positively impacted each of our divisions.

Gross profit margin of 33.1% for the six months ending June 30, 2006 increased from 31.7% for the same period in 2005. The increase is a result of increased sales, which favorably impacts our absorption of fixed costs, and cost savings achieved through our CIP initiative, both of which have positively impacted each of our divisions. The increase is also attributable to increased sales of aftermarket products, which generally have a higher margin, by our Flowserve Pump Division.

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

| | Three Months Ended June 30, | |
|---|---|---|
| (Amounts in millions) | **2006** | **2005** |
| SG&A expense | $ 179.2 | $ 166.4 |
| SG&A expense as a percentage of sales | 23.8% | 24.1% |

| | Six Months Ended June 30, | |
|---|---|---|
| (Amounts in millions) | **2006** | **2005** |

| | | |
|---|---|---|
| SG&A expense | $356.1 | $331.7 |
| SG&A expense as a percentage of sales | 25.3% | 25.4% |

SG&A for the three months ended June 30, 2006 increased by $12.8 million, or 7.7%, as compared with the same period in 2005. The increase includes negative currency effects of less than $1 million. The increase in SG&A is attributable to an increase in employee-related costs of $7.7 million, which includes increased incentive compensation and equity incentive programs arising from improved performance and higher stock price and development of in-house capabilities for: tax, Section 404 compliance, internal

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audit, and financial planning and analysis, as well as expansion in Asia. The increase is also due to an increase in travel expenses of $3.4 million, due to increased global marketing activity and expansion in Asia.

SG&A for the six months ended June 30, 2006 increased by $24.4 million, or 7.4%, as compared with the same period in 2005. SG&A for the three months ended June 30, 2006 reflects a reduction of approximately $4 million resulting from currency effects. The increase is due to an increase in employee-related costs of $14.4 million, which includes increased incentive compensation and equity incentive programs arising from improved performance and higher stock price and development of in-house capabilities for: tax, Section 404 compliance, internal audit, and financial planning and analysis, as well as expansion in Asia. The increase is also due to an increase in audit fees of $7.0 million, primarily related to the 2004 and 2005 audits, which were completed in February 2006 and June 2006, respectively, and an increase in travel expenses of $5.3 million, due to increased global marketing activity and expansion in Asia. These increases are partially offset by a decrease of $2.6 million in legal fees and expenses.

**Operating Income**

| | **Three Months Ended June 30,** | |
|---|---|---|
| (Amounts in millions) | **2006** | **2005** |
| Operating income | $ 72.5 | $ 56.3 |
| Operating income as a percentage of sales | 9.6% | 8.1% |

| | **Six Months Ended June 30,** | |
|---|---|---|
| (Amounts in millions) | **2006** | **2005** |
| Operating income | $110.0 | $82.1 |
| Operating income as a percentage of sales | 7.8% | 6.3% |

Operating income for the three months ended June 30, 2006 increased by $16.2 million, or 28.8%, as compared with the same period in 2005. The increase includes currency benefits of approximately $1 million. Operating income for the six months ended June 30, 2006 increased by $27.9 million, or 34.0%, as compared with the same period in 2005. The increase includes negative currency effects of approximately $2 million. The increases are primarily a result of the increases in gross profit, partially offset by the increases in SG&A discussed above.

**Interest Expense and Interest Income**

| | **Three Months Ended June 30,** | |
|---|---|---|
| (Amounts in millions) | **2006** | **2005** |
| Interest expense | $ (16.3) | $ (19.9) |
| Interest income | 1.1 | 0.6 |

| | **Six Months Ended June 30,** | |
|---|---|---|
| (Amounts in millions) | **2006** | **2005** |
| Interest expense | $(31.9) | $(39.9) |
| Interest income | 2.2 | 1.5 |

Interest expense for the three months ended June 30, 2006 decreased by $3.6 million, as compared with the same period in 2005. Interest expense for the six months ended June 30, 2006 decreased by $8.0 million, as compared with the same period in 2005. The decreases are primarily attributable to the refinancing in August 2005 of our 12.25% Senior Subordinated Notes with the proceeds of borrowings under our New Credit Facilities. Approximately 72% of our debt was at fixed rates at June 30, 2006, including the effects of $470.0 million notional interest rate swaps.

Interest income was higher for both the three and six months ended June 30, 2006, as compared with the same periods in 2005, due to a higher average cash balance in 2006, as well as increased interest rates.

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**Other Income (Expense), net**

| (Amounts in millions) | Three Months Ended June 30, 2006 | Three Months Ended June 30, 2005 |
|---|---|---|
| Other income (expense), net | $ 4.4 | $ (5.9) |

| (Amounts in millions) | Six Months Ended June 30, 2006 | Six Months Ended June 30, 2005 |
|---|---|---|
| Other income (expense), net | $ 5.5 | $ (8.6) |

Other income (expense), net for the three months ended June 30, 2006 increased by $10.3 million, to income of $4.4 million, as compared with the same period in 2005, primarily due to an increase in unrealized gains on forward exchange contracts, slightly offset by an increase in foreign currency transaction losses.

Other income (expense), net for the six months ended June 30, 2006 increased by $14.1 million, to income of $5.5 million, as compared with the same period in 2005, primarily due to an increase in unrealized gains on forward exchange contracts, slightly offset by an increase in foreign currency transaction losses.

**Tax Expense and Tax Rate**

| (Amounts in millions) | Three Months Ended June 30, 2006 | Three Months Ended June 30, 2005 |
|---|---|---|
| Provision for income tax | $ 28.6 | $ 12.6 |
| Effective tax rate | 46.4% | 40.5% |

| (Amounts in millions) | Six Months Ended June 30, 2006 | Six Months Ended June 30, 2005 |
|---|---|---|
| Provision for income tax | $ 38.8 | $ 13.7 |
| Effective tax rate | 45.2% | 38.9% |

Our effective tax rate of 46.4% for the three months ended June 30, 2006 increased from 40.5% for the same period in 2005. Our effective tax rate of 45.2% for the six months ended June 30, 2006 increased from 38.9% for the same period in 2005. The increases are due primarily to the tax impact of operating activities in certain non-U.S. jurisdictions, including higher losses incurred in the second quarter of 2006 as compared with the same period in 2005, for which a tax benefit has not been recognized.

**Net Earnings and Earnings Per Share**

| (Amounts in millions, except per share data) | Three Months Ended June 30, 2006 | Three Months Ended June 30, 2005 |
|---|---|---|
| Income from continuing operations | $ 33.1 | $ 18.6 |
| Net earnings | 33.1 | 18.0 |
| Net earnings per share from continuing operations diluted | 0.57 | 0.33 |
| Net earnings per share diluted | 0.57 | 0.32 |

| | | |
|---|---|---|
| Average diluted shares | 57.9 | 56.6 |

| | Six Months Ended June 30, | |
|---|---|---|
| (Amounts in millions, except per share data) | **2006** | **2005** |
| Income from continuing operations | $ 47.0 | $ 21.5 |
| Net earnings | 47.0 | 13.9 |
| Net earnings per share from continuing operations diluted | 0.81 | 0.38 |
| Net earnings per share diluted | 0.81 | 0.25 |
| Average diluted shares | 57.7 | 56.4 |

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Income from continuing operations for the three and six months ended June 30, 2006 increased by $14.5 million and $25.5 million, respectively, as compared with the same periods in 2005. The increases are a result of the increases in operating income, decreases in interest expense and increases in other income (expense), net discussed above, partially offset by the increase in tax expense.

Net income for the six months ended June 30, 2005 was lower than income from continuing operations due to the loss from discontinued operations. This is primarily attributable to a $5.9 million impairment recorded in the first quarter of 2005 for assets held for sale.

**Other Comprehensive Income (Loss)**

| | **Three Months Ended June 30,** | |
|---|---|---|
| (Amounts in millions) | **2006** | **2005** |
| Other comprehensive income (loss) | $ 18.5 | $ (16.6) |

| | **Six Months Ended June 30,** | |
|---|---|---|
| (Amounts in millions) | **2006** | **2005** |
| Other comprehensive income (loss) | $25.3 | $(24.3) |

Other comprehensive income (loss) for the three months ended June 30, 2005 increased by $35.1 million to income of $18.5 million as compared with the same period in 2005. Other comprehensive income (loss) for the six months ended June 30, 2005 increased by $49.6 million to income of $25.3 million as compared with the same period in 2005. The increases primarily reflect a strengthening of the Euro and British pound during the three and six months ended June 30, 2006, as compared with a weakening during the same periods in 2005.

**Business Segments**

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

- Flowserve Pump Division ( FPD ) for engineered pumps, industrial pumps and related services;

- Flow Control Division ( FCD ) for industrial valves, manual valves, control valves, nuclear valves, valve actuators and related services; and

- Flow Solutions Division ( FSD ) for precision mechanical seals and related services.

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

***Flowserve Pump Division***

Through FPD, we design, manufacture, distribute and service engineered and industrial pumps and pump systems, replacement parts and related equipment, principally to industrial markets. FPD has 27 manufacturing facilities worldwide, of which nine are located in North America, 11 in Europe, four in South America and three in Asia. FPD also has more than 50 service centers, which are either free standing or co-located in a manufacturing facility.

| | **Three Months Ended June 30,** | |
|---|---|---|
| (Amounts in millions) | **2006** | **2005** |
| Bookings | $ 529.6 | $ 342.8 |
| Sales | 387.0 | 360.2 |
| Gross profit | 109.4 | 98.9 |

| | | |
|---|---|---|
| Gross profit margin | 28.3% | 27.5% |
| Operating income | 46.9 | 37.7 |
| Operating income as a percentage of sales | 12.1% | 10.5% |

| (Amounts in millions) | Six Months Ended June 30, 2006 | 2005 |
|---|---|---|
| Bookings | $1,025.2 | $702.1 |
| Sales | 715.0 | 673.1 |
| Gross profit | 201.2 | 178.2 |
| Gross profit margin | 28.1% | 26.5% |
| Operating income | 71.4 | 55.4 |
| Operating income as a percentage of sales | 10.0% | 8.2% |

Bookings for the three months ended June 30, 2006, increased by $186.8 million, or 54.5%, as compared with the same period in 2005. The increase includes currency benefits of approximately $1 million. The increase is primarily attributable to Europe, the Middle East and Africa ( EMA ), which increased by $152.7 million due to the continued strength in the oil and gas industry.

Bookings for the six months ended June 30, 2006 increased by $323.1 million, or 46.0%, as compared with the same period in 2005. The increase includes negative currency effects of approximately $22 million. The increase is primarily attributable to EMA, which increased by $238.5 million, including negative currency effects of approximately $23 million, due to strength in the oil and gas, power and water markets.

Sales for the three months ended June 30, 2006 increased by $26.8 million, or 7.4%, as compared with the same period in 2005. The increase includes currency benefits of approximately $2 million. The increase is primarily attributable to EMA, which increased by $22.2 million due to the continued strength in the oil and gas industry. The Middle East has contributed the most significant growth to EMA.

Sales for the six months ended June 30, 2006 increased by $41.9 million, or 6.2%, as compared with the same period in 2005. The increase includes negative currency effects of approximately $10 million. The increase is primarily attributable to EMA, which increased by $19.7 million, including negative currency effects of approximately $11 million. The Middle East has contributed the most significant growth to EMA. North America increased by $20.6 million. The increases in EMA and North America are due to strength in the oil and gas industry.

Gross profit margin of 28.3% for the three months ended June 30, 2006 increased from 27.5% for the same period in 2005. The increase is primarily attributable to increased sales, which favorably impacts our absorption of fixed costs.

Gross profit margin of 28.1% for the six months ended June 30, 2006 increased from 26.5% for the same period in 2005. The increase is attributable to increased sales, which favorably impacts our absorption of fixed costs. The improvement is also attributable to a product and services mix that resulted in the aftermarket business increasing from 46.6% of sales for the six months ended June 30, 2006 as compared with 45.9% for the same period in 2005. The aftermarket business consistently provides more favorable gross margins than original equipment sales.

Operating income for the three months ended June 30, 2006 increased by $9.2 million, or 24.4%, as compared with the same period in 2005. The increase includes currency benefits of less than $1 million. The increase is primarily attributable to the $10.5 million improvement in gross profit.

Operating income for the six months ended June 30, 2006 increased by $16.0 million, or 28.9%, as compared with the same period in 2005. The increase includes negative currency effects of less than $1 million. The increase is primarily attributable to the $23.0 million improvement in gross profit, partially offset by an increase in SG&A, which is due primarily to an increase in employee-related costs and information technology costs.

Backlog of $1.0 billion at June 30, 2006 increased by $317.1 million, or 45.1%, as compared with December 31, 2005. The increase includes currency benefits of approximately $42 million. Backlog growth is primarily a result of the growth in bookings. The increase in bookings reflects an increase in orders of engineered products, which naturally have longer lead times, as well as expanded lead times at the request of certain customers.

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***Flow Control Division***

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

| | Three Months Ended June 30, | |
|---|---|---|
| (Amounts in millions) | 2006 | 2005 |
| Bookings continuing operations | $ 273.9 | $ 240.9 |
| Bookings discontinued operations | | 27.2 |
| Total bookings | 273.9 | 268.1 |
| Sales | 252.3 | 228.9 |
| Gross profit | 86.0 | 74.0 |
| Gross profit margin | 34.1% | 32.3% |
| Operating income | 29.3 | 26.2 |
| Operating income as a percentage of sales | 11.6% | 11.4% |

| | Six Months Ended June 30, | |
|---|---|---|
| (Amounts in millions) | 2006 | 2005 |
| Bookings continuing operations | $ 541.6 | $ 465.6 |
| Bookings discontinued operations | | 54.1 |
| Total bookings | 541.6 | 519.7 |
| Sales | 470.1 | 438.4 |
| Gross profit | 160.2 | 143.9 |
| Gross profit margin | 34.1% | 32.8% |
| Operating income | 53.4 | 46.2 |
| Operating income as a percentage of sales | 11.4% | 10.5% |

Total bookings for the three months ended June 30, 2006 increased by $5.8 million, or 2.2%, as compared with the same period in 2005. Currency had a negligible impact on bookings for the quarter. Total bookings for the three months ended June 30, 2005 includes $27.2 million of bookings for GSG, our discontinued operations. Bookings for continuing operations for the three months ended June 30, 2006 increased by $33.0 million, or 13.7%, as compared with the same period in 2005. The increase in bookings is primarily attributable to the process valve market, which realized continued success in the coal degasification business in China, as well as improved delivery performance in the North American oil and gas market. We also experienced increased activity in the control valve QRC and aftermarket businesses, and continued strength in the power business, particularly with Russian district heating.

Total bookings for the six months ended June 30, 2006 increased by $21.9 million, or 4.2%, as compared with the same period in 2005. The increase includes negative currency effects of approximately $12 million. Total bookings for the six months ended June 30, 2005 includes $54.1 million of bookings for GSG, our discontinued operations. Bookings for continuing operations for the six months ended June 30, 2006 increased by $76.0 million, or 16.3%, as compared with the same period in 2005. The increase in bookings is primarily attributable to the continued strengthening of several of the division s key end markets, such as oil and gas and coal degasification, as well as increased project sales in all of our markets.

Sales for the three months ended June 30, 2006 increased by $23.4 million, or 10.2%, as compared with the same period in 2005. The increase includes currency benefits of less than $1 million. The increase is principally a result of stronger performance in all of our primary markets. We realized notable improvements in both the North American and European control valve markets for petroleum products, increased process valve Maintenance/Repairs/Operation activity in the chemical and general industries, and improvements in the parts and service business related to power valves.

Sales for the six months ended June 30, 2006 increased by $31.7 million, or 7.2%, as compared with the same period in 2006. The increase includes negative currency effects of approximately $8 million. This increase is principally attributable to the

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aforementioned improved economic conditions in several of our key markets, most notably North American petroleum markets and Asian chemical and general industries.

Gross profit margin of 34.1% for the three months ended June 30, 2006 increased from 32.3% for the same period in 2005. This increase results from the aforementioned improvement in sales causing an improved absorption of fixed manufacturing cost, strong focus on capturing the aftermarket of our installed base and our successful implementation of various CIP and supply chain initiatives.

Gross profit margin of 34.1% for the six months ended June 30, 2006 increased from 32.8% for the same period in 2005. The increase in gross profit margin is primarily the result of the aforementioned increase in sales causing an improved absorption of fixed manufacturing cost, as well as the realization of higher margins on control valve projects, and the impact of broad-based price increases implemented in the latter half of 2005.

Operating income for the three months ended June 30, 2006 increased by $3.1 million, or 11.8%, as compared with the same period in 2005. Currency had a negligible impact on operating income for the period. This increase is driven by the $12.0 million improvement in gross profit, mostly offset by higher SG&A costs primarily associated with bad debt for a single customer, increased headcount and equity incentive compensation and increased sales commissions resulting from increased bookings.

Operating income for the six months ended June 30, 2006 increased by $7.2 million, or 15.6%, as compared with the same period in 2005. The increase includes negative currency effects of approximately $1 million. This increase is driven by the $16.3 million improvement in gross profit, partially offset by the aforementioned higher SG&A costs primarily associated with bad debt for a single customer, increased headcount and equity incentive compensation and increased sales commissions resulting from increased bookings.

Backlog of $318.7 million at June 30, 2006 increased by $78.8 million, or 32.8%, as compared with backlog at December 31, 2005. The increase includes currency benefits of approximately $11 million. This increase is attributable to the impact of increased bookings during the first half of 2006, which should yield increased sales in the coming months, as well as expanded lead times at the request of certain customers.

***Flow Solutions Division***

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

| | **Three Months Ended June 30,** | |
|---|---|---|
| (Amounts in millions) | **2006** | **2005** |
| Bookings | $ 122.7 | $ 124.2 |
| Sales | 125.0 | 111.9 |
| Gross profit | 56.7 | 49.9 |
| Gross profit margin | 45.4% | 44.6% |
| Operating income | 27.3 | 24.2 |
| Operating income as a percentage of sales | 21.8% | 21.6% |

| | **Six Months Ended June 30,** | |
|---|---|---|
| (Amounts in millions) | **2006** | **2005** |
| Bookings | $250.6 | $236.6 |
| Sales | 243.2 | 214.8 |

| | | |
|---|---|---|
| Gross profit | 108.2 | 94.4 |
| Gross profit margin | 44.5% | 43.9% |
| Operating income | 50.6 | 42.9 |
| Operating income as a percentage of sales | 20.8% | 20.0% |

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Bookings for the three months ended June 30, 2006 decreased by $1.5 million, or 1.2%, as compared with the same period in 2005. The decrease includes currency benefits of less than $1 million. The decrease is due primarily to a $5.3 million decrease in customer bookings, which is attributable to all regions, partially offset by an increase of $3.8 million in intersegment bookings (which are eliminated and are not included in consolidated bookings as disclosed above).

Bookings for the six months ended June 30, 2006 increased by $14.0 million, or 5.9%, as compared with the same period in 2005. The increase includes negative currency effects of approximately $2 million. The increase is primarily attributable to increased demand from oil and gas and chemical markets, primarily in North America, Latin America and Europe.

Sales for the three months ended June 30, 2006 increased by $13.1 million, or 11.7%, as compared with the same period in 2005. The increase includes currency benefits of approximately $1 million. Sales for the six months ended June 30, 2006 increased by $28.4 million, or 13.2%, as compared with the same period in 2005. The increase includes negative currency effects of approximately $1 million. The increases are attributable to all regions, and are primarily a result of increased bookings during the first three months of 2006.

Gross profit margin of 45.4% for the three months ending June 30, 2006, increased from 44.6% for the same period in 2005. Gross profit margin of 44.5% for the six months ending June 30, 2006, increased from 43.9% for the same period in 2005. The increases are attributable to increased sales, which favorably impacts our absorption of fixed costs.

Operating income for the three months ended June 30, 2006 increased by $3.1 million, or 12.8%, as compared with the same period in 2005. Currency had a negligible impact on operating income for the period. The increase is primarily attributable to the $6.8 million increase in gross profit, partially offset by an increase in marketing, information technology and research and development costs.

Operating income for the six months ended June 30, 2006 increased by $7.7 million, or 17.9%, as compared with the same period in 2005. Currency had a negligible impact on operating income for the first six months of 2006. The increase is primarily attributable to the $13.8 million increase in gross profit, partially offset by an increase in marketing, information technology and research and development costs.

Backlog of $71.7 million at June 30, 2006 increased by $10.5 million, or 17.2%, as compared with December 31, 2005. The increase includes currency benefits of approximately $2 million. Backlog growth is primarily a result of the growth in bookings discussed above. Capacity expansions that began during the quarter helped to significantly increase shipments, primarily in North America, and have helped to begin a reduction in backlog. Additional capacity expansion in all regions for the remainder of the year is anticipated to continue in order to support our sales growth and reduce the backlog to prior year levels.

## LIQUIDITY AND CAPITAL RESOURCES

### *Cash Flow Analysis*

| | **Six Months Ended June 30,** | |
|---|---|---|
| (Amounts in millions) | **2006** | **2005** |
| Net cash flows provided (used) by operating activities | $ 7.9 | $ (2.6) |
| Net cash flows used by investing activities | (28.3) | (19.6) |
| Net cash flows (used) provided by financing activities | (15.9) | 2.2 |

Cash generated by operations and borrowings available under our existing revolving credit facility are our primary sources of short-term liquidity. Our cash balance at June 30, 2006 was $58.2 million, as compared with $92.9 million at December 31, 2005.

Cash flows provided by operating activities during the six months ended June 30, 2006 was $7.9 million, as compared with a use of $2.6 million for the same period in 2005. Net income growth of $33.0 million was offset by an unfavorable working capital impact of $57.1 million. The increase in working capital during the first six months of 2006 was due primarily to increases in inventory and accounts receivable, which corresponds to record demand levels for our products and the increase in business volume and sales activity during the period. We have made no material contributions to our U.S. pension plans during the six months ended June 30, 2006. However, we contributed approximately $36 million to our U.S. pension plans during September 2006.

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During the first half of the year, increases in working capital reduce cash flow. We have historically derived a greater portion of our operating profit during the second half of the year, which is consistent with our customers buying patterns. Costs are incurred evenly throughout the year. As a result, our operating cash flows generally increase as the year progresses. Therefore, we do not expect operating cash flows for the six months ended June 30 to be indicative of full year results.

Cash flows used by investing activities during the six months ended June 30, 2006 were $28.3 million, as compared with $19.6 million for the same period in 2005. Capital expenditures during the six months ended June 30, 2006 were $29.5 million, an increase of $11.6 million as compared with the same period in 2005, which reflects increased spending to support capacity expansion, enterprise resource planning application upgrades and information technology infrastructure.

Cash flows used by financing activities during the six months ended June 30, 2006 were $15.9 million, as compared with a source of $2.2 million for the same period in 2005. Cash outflows in 2006 were primarily due to net payments on 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. See Cautionary Note Regarding Forward-Looking Statements.

We have a substantial number of outstanding stock options granted in past years to employees under our stock option plans which have been unexercisable for an extended period due to our non-current filing status of all our required SEC public filings. These outstanding options include options for 809,667 shares held by our former Chairman, President and Chief Executive Officer, C. Scott Greer. Given the significant increase in our share price during the period in which optionees have been unable to exercise their options, it is possible that many holders may want to exercise soon after they are first able to do so. We will reopen our stock option exercise program and allow optionees to exercise their options once we become current with our SEC reporting obligations and have registered with the SEC the common shares to be issued upon exercise of such stock options. We currently expect this to occur in the fourth quarter of 2006. If the holders of a large number of these options promptly exercise following such reopening, there would be some dilutive impact on our earnings per share. We anticipate that a significant number of stock option exercises at one time would positively impact our cash flow, however the impacts on our cash flow and earnings per share are dependent upon share price, the number of shares exercised and strike price of shares exercised.

On September 29, 2006, our Board of Directors authorized a program to repurchase up to two million shares of our outstanding common stock. Shares will be repurchased to offset potentially dilutive effects of stock options issued under our stock-based compensation programs. We expect to commence the program after our planned November filing of our third quarter 2006 Form 10-Q. We expect to fund the program using existing cash and cash provided by operations, borrowings and stock option exercises.

**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.

**Capital Expenditures**

Capital expenditures were $29.5 million for the six months ended June 30, 2006 compared with $17.9 million for the same period in 2005. Capital expenditures were funded primarily by operating cash flows. Capital expenditures in 2006 are focused on capacity expansion, enterprise resource planning application upgrades (Project STAR: Simplification and Teamwork Accelerates Results), information technology infrastructure and cost reduction opportunities. Capital expenditures in 2005 were focused on new product development, information technology infrastructure and cost reduction opportunities. For the full year 2006, our capital expenditures are expected to be approximately $75 million. Certain of our facilities may face capacity constraints in the foreseeable future, which may lead to higher capital expenditure levels.

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## Financing

***New Credit Facilities***

On August 12, 2005, we entered into New Credit Facilities comprised of a $600.0 million term loan maturing on August 10, 2012 and a $400.0 million revolving line of credit, which can be utilized to provide up to $300.0 million in letters of credit, expiring on August 12, 2010. Further, we replaced the letter of credit agreement that guaranteed our EIB credit facility (described below) with a letter of credit issued as part of the New Credit Facilities.

Borrowings under our New Credit Facilities bear interest at a rate equal to, at our option, either (1) the base rate (which is based on the greater of the prime rate most recently announced by the administrative agent under our New Credit Facilities or the Federal Funds rate plus 0.50%) or (2) LIBOR plus an applicable margin determined by reference to the ratio of our total debt to consolidated EBITDA, which as of June 30, 2006 was 1.75% for LIBOR borrowings.

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

- 100% of the net cash proceeds of asset sales; and

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

We may prepay loans under our New Credit Facilities in whole or in part, without premium or penalty. During the three and six months ended June 30, 2006, we made mandatory repayments of $0 and $10.9 million, respectively, using the net proceeds from the sale of GSG and optional prepayments of $5.0 million and $5.0 million, respectively. In addition we made a mandatory repayment of $0.9 million in July 2006 using excess cash flows. We have no scheduled repayments due in 2006.

***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 70.0 million, with the ability to draw funds in multiple currencies, to finance in part specified research and development projects undertaken by us in Europe. Borrowings under the EIB credit facility bear interest at a fixed or floating rate of interest agreed to by us and EIB with respect to each borrowing under the facility. Loans under the EIB credit facility are subject to mandatory repayment, at EIB s discretion, upon the occurrence of certain events, including a change of control or prepayment of certain other indebtedness. In addition, the EIB credit facility contains covenants that, among other things, limit our ability to dispose of assets related to the financed project and require us to deliver to EIB our audited annual financial statements within 30 days of publication. Our obligations under the EIB credit facility are guaranteed by a letter of credit outstanding under our New Credit Facilities, which costs 1.75% per annum.

In August 2004, we borrowed $85.0 million at a floating interest rate based on 3-month U.S. LIBOR that resets quarterly. As of June 30, 2006, the interest rate was 5.26%. The maturity of the amount drawn is June 15, 2011, but may be repaid at any time without penalty. Concurrent with borrowing the $85.0 million we entered into a derivative contract with a third party financial institution, swapped this principal amount to 70.6 million and fixed the LIBOR portion of the interest rate to a fixed interest rate of 4.19% through the scheduled repayment date. Additional discussion of the derivative is included in Note 4 to our condensed consolidated financial statements, included in this Quarterly Report.

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

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

***Debt Covenants and Other Matters***

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 June 30, 2006.

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 Quarterly Report. Our more critical accounting policies used in the preparation of the consolidated financial statements were discussed in our 2005 Annual Report. These critical policies, for which no significant changes have occurred in the first six months of 2006, include:

Revenue Recognition;

Allowance for Doubtful Accounts;

Inventories and Related Reserves;

Deferred Taxes and Tax Valuation Allowances;

Tax Reserves;

Legal and Environmental Accruals;

Warranty Accruals;

Retirement and Postretirement Benefits; 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 condition and results of operations. This is not to suggest that other general risk factors, such as changes in worldwide demand, changes in material costs, performance of acquired businesses and others, could not adversely impact our consolidated financial condition, results of operations and cash flows in future periods.

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

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## ACCOUNTING DEVELOPMENTS

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

**Cautionary Note Regarding Forward-Looking Statements**

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

The forward-looking statements included in this Quarterly Report are based on our current expectations, plans, estimates, assumptions and beliefs that involve numerous risks and uncertainties. Assumptions relating to the foregoing involve judgments with respect to, among other things, future economic, competitive and market conditions and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Any of the assumptions underlying forward-looking statements could be inaccurate. To the extent that our assumptions differ from actual results, our ability to meet such forward-looking statements may be significantly hindered.

The following are some of the risks and uncertainties, although not all of the risks and uncertainties, which could cause actual results to differ materially from those presented in certain forward-looking statements:

- material weaknesses in our internal control over financial reporting that could adversely affect our ability to report our financial condition and results of operations accurately and on a timely basis;

- our failure to comply with the requirements of Section 404 of the Sarbanes-Oxley Act;

- potential adverse consequences resulting from securities class action litigation and other litigation to which we are a party, such as litigation involving asbestos-containing material claims;

- SEC and foreign government investigations regarding our participation in the United Nations Oil-for-Food Program;

- our potential non-compliance with U.S. export control, economic sanctions and import laws and regulations;

- our risk associated with certain of our foreign subsidiaries autonomously conducting, under their own local authority, business operations and sales, which have recently generated between 1-2% of our consolidated global revenue in certain countries that have been identified by the U.S. State Department as state sponsors of terrorism. Although these foreign subsidiaries are planning to voluntarily withdraw from conducting new business in these countries in the near future, they will continue to honor existing contracts and warranty obligations that are in compliance with U.S. laws and regulations;

- increased tax liabilities resulting from a recent audit of our tax returns by the U.S. Internal Revenue Service, as well as potential costs and liabilities that may be associated with likely future audits;

- a portion of our bookings may not lead to completed sales, and we may not be able to convert bookings into revenues at acceptable profit margins, since such profit margins cannot be assured nor can they be necessarily assumed to follow historical trends;

the recording of increased deferred tax asset valuation allowances in the future;

- an impairment in the carrying value of goodwill or other intangibles could adversely impact our consolidated financial condition and results of operations;
- economic, political and other risks associated with our international operations, including military actions or trade embargoes that could affect customer markets, including the continuing conflict in Iraq and its potential impact on Middle Eastern markets and global petroleum producers;
- our sales are substantially dependent upon the petroleum, chemical, power and water industries and any significant down turn in any one of these industries could adversely impact such sales;
- our operations are dependent upon third-party suppliers whose failure to perform timely could adversely affect our business operations;
- our dependence on our customers ability to make required capital investment and maintenance expenditures;
- risks associated with cost overruns on fixed-fee projects;
- the highly competitive markets in which we operate;
- environmental compliance costs and liabilities;
- work stoppages and other labor matters;
- our inability to protect our intellectual property in the U.S., as well as in foreign countries;
- the loss of senior executives and other key personnel;
- difficulties in obtaining raw materials at favorable prices;
- obligations under our defined benefit pension plans;
- liabilities, including rescission rights, potentially resulting from issuances of interests in our Flowserve Corporation Retirement Savings Plan;
- the impact of a significant number of stock option exercises following the removal of the current suspension on the exercise of outstanding stock options that is somewhat mitigated by the stock repurchase program that was approved by the Board of Directors, which will be implemented during the fourth quarter of 2006;
- liabilities that result from product liability and warranty claims;
- our outstanding indebtedness and the restrictive covenants in the agreements governing our indebtedness limit our operating and financial flexibility; and
- our inability to continue to expand our market presence through acquisitions, and unforeseen integration difficulties or costs resulting from acquisitions we do complete.

These risks are more fully discussed in, and all forward-looking statements should be read in light of, all of the factors discussed in Part I. Item 1A. Risk Factors included in this Quarterly Report and in our 2005 Annual Report. The updated risk factors included in this Quarterly Report are presented in addition to the risk factors disclosed in the 2005 Annual Report.

You are cautioned not to place undue reliance on any forward-looking statements included in this Quarterly Report. All forward-looking statements are made as of the date of this Quarterly Report and the risk that actual results will differ materially from the expectations expressed in this Quarterly Report may increase with the passage of time. In light of the significant uncertainties inherent in the forward-looking statements included in this Quarterly Report, the inclusion of such forward-looking statements should not be regarded as a representation by us or any other person that the objectives and plans set forth in this Quarterly Report will be achieved.

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All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by reference to these risks and uncertainties. Each forward-looking statement speaks only as of the date of the particular statement, and we do not undertake to update any forward-looking statement.

**Item 3. Quantitative and Qualitative Disclosures about Market Risk.**

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

Our earnings are impacted by changes in short-term interest rates as a result of borrowings under our New Credit Facilities, which bear interest based on floating rates. At June 30, 2006, after the effect of interest rate swaps, we have approximately $177.6 million of variable rate debt obligations outstanding with a weighted average interest rate of 7.23%. 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 $0.9 million for the six months ended June 30, 2006.

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 will continue to meet their obligations given their creditworthiness. As of June 30, 2006, we had $470.0 million of notional amount in outstanding interest rate swaps with third parties with maturities through June 2011 compared to $160.0 million as of June 30, 2005.

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 June 30, 2006, a 10% adverse change in the foreign currency exchange rates could impact our results of operations for the six months ended June 30, 2006 by $5.9 million as shown below:

(Amounts in millions)

| | |
|---|---|
| Swiss franc | $ 1.6 |
| British pound | 0.9 |
| Euro | 0.9 |
| Indian rupee | 0.6 |
| Canadian dollar | 0.4 |
| Singapore dollar | 0.4 |
| Mexican peso | 0.3 |
| Australian dollar | 0.2 |
| Argentina peso | 0.1 |
| All other | 0.5 |
| Total | $ 5.9 |

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 June 30, 2006, we had a U.S. dollar equivalent of $295.2 million in outstanding forward contracts with third parties compared with $236.0 million at December 31, 2005.

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 $17.6 million and $(16.4) million for the three months ended June 30, 2006 and 2005, respectively, and $23.0 million and $(25.1) million for the six months ended June 30, 2006 and 2005, respectively, which are included in other comprehensive income (loss). Transactional currency gains and losses arising from transactions outside of our sites functional currencies and changes in fair value of certain forward contracts are included in our consolidated results of operations. We realized foreign currency gains (losses) of $4.8 million and $(6.7) million for the three months ended June 30, 2006 and 2005, respectively, and $6.8 million and $(9.2) million for the six months ended June 30, 2006 and 2005, respectively, which is included in other income (expense), net in the accompanying consolidated statements of income.

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**Item 4. Controls and Procedures.**

**Disclosure Controls and Procedures**

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

In connection with the preparation of this Quarterly Report, our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as of June 30, 2006. In making this evaluation, our management considered the material weaknesses described in our 2005 Annual Report, which was filed with the SEC on June 30, 2006. 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 June 30, 2006.

A material weakness is a control deficiency, or combination of control deficiencies, that results 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 2005 Annual Report, management identified the following material weaknesses in our internal control over financial reporting as of December 31, 2005, which also existed as of June 30, 2006:

We did not maintain: (1) effective controls over our period-end financial reporting processes, including monitoring; (2) effective segregation of duties over automated and manual transaction processes; (3) effective controls over the completeness, accuracy and validity of revenue; (4) effective controls over the completeness, accuracy, validity and valuation of our inventory and related cost of sales transactions; (5) effective controls over the completeness, accuracy and validity of our accounts payable and related disbursements; (6) effective controls over accounting for certain derivative transactions; and (7) effective controls over the completeness, accuracy and valuation of stock-based employee compensation expense, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

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

**Remediation of Material Weaknesses**

In response to the identified material weaknesses, we, with oversight from our audit committee, have dedicated significant resources to support management in its efforts to remedy the identified material weaknesses. As more fully described in the *Completed Remediation* section of Item 9A of our 2005 Annual Report, the remediation that occurred prior to December 31, 2005 focused on: (i) appointed a chief compliance officer; (ii) expanded and strengthened our finance organization by creating and filling new positions in the areas of financial reporting, controls compliance, accounting policies, financial planning and analysis, and tax; (iii) expanded and strengthened our internal audit organization; (iv) enhanced our accounting policy program; (v) strengthened our centrally managed internal controls and financial review program; (vi) improved our communication of accounting policy and control requirements; (vii) expanded and enhanced our financial disclosure control and certification process; (viii) enhanced our anti-fraud program; and (ix) improved our information technology general controls.

As more fully described in the *Continuing Remediation* section of Item 9A of our 2005 Annual Report, the ongoing remediation efforts subsequent to December 31, 2005 have been focused on: (i) implementing or upgrading ERP systems to increase the level of automated controls; (ii) implementing a global web-based financial controls management solution to facilitate the documentation and assessment of accounting and financial reporting controls; (iii) strengthening our segregation of duties and application security policy, and updating our spreadsheet controls policy; (iv) updating our account reconciliation policy, issuing training materials defining the specific requirements regarding account reconciliation preparation, review and approval, and further communicating the requirements of account reconciliations as part of our regional accounting and finance organization training sessions; (v) designing and implementing additional revenue cycle, inventory cycle and accounts payable process controls, including the establishment of additional review and verification procedures, updating policies as necessary, and providing training to our global finance organization; (vi) implementing new procedures and controls to ensure technical compliance with derivative accounting provisions; and (vii) designing and implementing enhanced controls to ensure proper accounting for stock-based employee compensation transactions.

We believe that the *Completed Remediation* actions described above have further improved our internal control over financial reporting, as well as our disclosure controls and procedures. We also believe that the *Continuing Remediation* actions described above will continue to improve our internal control over financial reporting, as well as our disclosure controls and procedures. Our management, with the oversight of our Audit Committee, will continue to take steps to remedy known material weaknesses as expeditiously as possible.

**Changes in Internal Control over Financial Reporting**

There have been no material changes in our internal control over financial reporting during the three months ended June 30, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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## 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 and multiple defendants) 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. The asbestos-containing parts we used 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 available insurance or indemnities from other companies.

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

During the quarter ended September 30, 2003, related lawsuits were filed in federal court in the Northern District of Texas (the Court ), alleging that we violated federal securities laws. Since the filing of these cases, which have been consolidated, the lead plaintiff has amended its complaint several times. The lead plaintiff s current pleading is the fifth consolidated amended complaint (the Complaint ). The Complaint alleges that federal securities violations occurred between February 6, 2001 and September 27, 2002 and names as defendants our company, C. Scott Greer, our former Chairman, President and Chief Executive Officer, Renee J. Hornbaker, our former Vice President and Chief Financial Officer, PricewaterhouseCoopers LLP, our independent registered public accounting firm, and Banc of America Securities LLC and Credit Suisse First Boston LLC, which served as underwriters for our two public stock offerings during the relevant period. The Complaint asserts claims under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder, and Sections 11 and 15 of the Securities Act of 1933. The lead plaintiff seeks unspecified compensatory damages, forfeiture by Mr. Greer and Ms. Hornbaker of unspecified incentive-based or equity-based compensation and profits from any stock sales, and recovery of costs. On November 22, 2005, the Court entered an order denying the defendants motions to dismiss the Complaint. The case is currently set for trial on June 11, 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 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 Mr. Coble, Mr. Haymaker, Jr., Lewis M. Kling, Mr. Rusnack, Mr. Johnston, Mr. Rampacek, Mr. Sheehan, Ms. Harris, Mr. Rollans and Mr. Bartlett. We are named as a nominal defendant. Based primarily on certain of the purported misstatements alleged in the above-described federal securities case, the plaintiff asserts claims against the defendants for breaches of fiduciary duty. The plaintiff alleges that the purported breaches of fiduciary duty occurred between 2000 and 2004. The plaintiff seeks on our behalf an unspecified amount of damages, disgorgement by Mr. Greer and Ms. 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 have filed a motion seeking dismissal of the case.

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

On February 7, 2006, we received a subpoena from the SEC regarding goods and services that certain foreign subsidiaries delivered to Iraq from 1996 through 2003 during the United Nations Oil-for-Food program. This investigation includes a review of whether any inappropriate payments were made to Iraqi officials in violation of the Foreign Corrupt Practices Act. The investigation includes periods prior, to as well as subsequent to our acquisition of the foreign operations involved in the investigation. We may be subject to liabilities if violations are found regardless of whether they relate to periods before or subsequent to our acquisition. In addition, one of our foreign subsidiary s operations is cooperating with a foreign governmental investigation of that site s involvement in the United Nations Oil-for-Food program. This cooperation has included responding to an investigative trip by foreign authorities to the foreign subsidiary s site, providing relevant documentation to these authorities and answering their questions. We are unable to predict how or if the foreign authorities will pursue this matter in the future. We believe that both the SEC and foreign authorities are investigating other companies from their actions arising from the United Nations Oil-for-Food program. We also understand that the U.S. Department of Justice is conducting its own investigation of the same events underlying the SEC inquiry. We are in the process of reviewing and responding to the SEC subpoena and assessing the implications of the foreign investigation, including the continuation of a thorough internal investigation. Our investigation remains ongoing. The investigation has included and will include a detailed review of contracts with the Iraqi government during the period in question and certain payments associated therewith, as well as other documents and information that might relate to Oil-for-Food transactions. Additionally, we have and will continue to conduct interviews with employees with knowledge of the contracts and payments in question. While we have made substantial progress in our internal investigation, we are still unable to make any definitive determination whether any inappropriate payments were made and accordingly are unable to predict the ultimate outcome of this matter. We will continue to fully cooperate in both the SEC and the foreign investigations. Both investigations are in progress but, at this point, are incomplete. Accordingly, if the SEC and/or the foreign authorities take enforcement action with regard to these investigations, we may be required to pay fines, take remedial compliance measures, further improve our existing compliance program, consent to injunctions against future conduct or suffer other penalties which could potentially materially impact our business financial statements and cash flows.

In March 2006, we initiated a process to determine our compliance posture with respect to U.S. export control laws and regulations. Upon initial investigation, it appears that some product transactions and technology transfers may not technically been in compliance with U.S. export control laws and regulations and require further review. With assistance from outside counsel, we are currently involved in a systematic process to conduct further review which we believe will take about 15 months to complete given the complexity of the export laws and the comprehensive scope of the investigation. Any potential violations of U.S. export control laws and regulations that are identified may result in civil or criminal penalties, including fines and/or other penalties. Because our review into this issue is ongoing, we are currently unable to determine the full extent of potential violations or the nature or amount of potential penalties to which we might be subject to in the future. Given that the resolution of this matter is uncertain at this time, we are not able to reasonably estimate the maximum amount of liability that could result from final resolution of this matter. We cannot currently predict whether the ultimate resolution of this matter will have a material adverse effect on our business, including our ability to do business outside the United States, or on our financial condition.

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. We believe that 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. 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.

Although none of the aforementioned potential liabilities can be quantified with absolute certainty except as otherwise indicated above, we have established reserves covering exposures relating to contingencies, to the extent believed to be reasonably estimable and which we believe to be probable of loss 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.

**Item 1A. Risk Factors.**

This Quarterly Report provides updates on two previously disclosed risk factors that were presented in our Annual Report on Form 10-K for the year ended December 31, 2005, which was filed with the SEC on June 30, 2006. The updated risk factors noted below are presented in addition to the other risk factors disclosed in the 2005 Annual Report. All of our disclosed risk factors could materially affect our business, financial condition or future results. The risks described in our Quarterly Report and 2005 Annual Report are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

**We are currently subject to securities class action litigation, the unfavorable outcome of which might have a material adverse effect on our financial condition, results of operations and cash flows.**

A number of putative class action lawsuits have been filed against us, certain of our former officers, our independent auditors and the lead underwriters of our most recent public stock offerings, alleging securities laws violations. We believe that these lawsuits, which have been consolidated, are without merit and are vigorously defending them and have notified our applicable insurers. We cannot, however, determine with certainty the outcome or resolution of these claims or the timing for their resolution. The consolidated securities case is currently set for trial on June 11, 2007. In addition to the expense and burden incurred in defending this litigation and any damages that we may suffer, our management s efforts and attention may be diverted from the ordinary business operations in order to address these claims. If the final resolution of this litigation is unfavorable to us, our financial condition, results of operations and cash flows might be materially adversely affected if our existing insurance coverage is unavailable or inadequate to resolve the matter.

**The ongoing SEC and foreign government investigation regarding our participation in the United Nations Oil-for-Food Program could materially adversely affect our Company.**

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

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

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

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

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

**Potential noncompliance with U.S. export control laws could materially adversely affect our business.**

We have notified applicable U.S. governmental authorities of our plans to investigate, analyze and, if applicable, disclose past potential violations of the U.S. export control laws through, in general, the export of products, services and technologies without the licenses possibly required by such authorities. If and to the extent violations are identified, confirmed and so disclosed, we could be subject to substantial fines and other penalties affecting our ability to do business outside the United States.

Our risks involved in conducting our international business operations include, without limitation, the risks associated with certain of our foreign subsidiaries autonomously conducting, under their own local authority and consistent with U.S. export laws, business operations and sales, which constitute approximately 1-2% of our consolidated global revenue, in countries that have been designated by the U.S. State Department as state sponsors of terrorism. Due to the growing political uncertainties associated with these countries, we have been planning to voluntarily withdraw, on a phased basis, from conducting new business in these countries since early in 2006. However, these subsidiaries will continue to honor existing contracts and warranty obligations that are in compliance with U.S. laws and regulations.

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

As of May 1, 2005, due to the non-current status of our filings with the SEC in accordance with the Securities Exchange Act of 1934, our Registration Statements on Form S-8 were no longer available to cover offers and sales of securities to our employees and other persons. Since that date, the acquisition of interests in our common stock fund under our 401(k) Plan by plan participants may have been subject to the registration requirements of the Securities Act of 1933 or applicable state securities laws and may not have qualified for an available exemption from such requirements. Federal securities laws generally provide for a one-year rescission right for an investor who acquires unregistered securities in a transaction that is subject to registration and for which no exemption was available. As such, an investor successfully asserting a rescission right during the one-year time period has the right to require an issuer to repurchase the securities acquired by the investor at the price paid by the investor for the securities (or if such security has been disposed of, to receive damages with respect to any loss on such disposition), plus interest from the date of acquisition. The remedies and statute of limitations under state securities laws vary and depend upon the state in which the shares were purchased. These rights may apply to affected participants who acquired an interest in our common stock fund in our 401(k) Plan and their affected interest in this plan may involve up to 270,000 shares of our common stock acquired pursuant to the 401(k) Plan during 2005 and an additional 75,000 shares acquired during the three months ended June 30, 2006. Based on our current stock price, we believe that our current potential liability for rescission claims is not material to our financial condition, results of operations or cash flows; however, our potential liability could become material in the future if our stock price were to fall below participants acquisition prices for their interest in our common stock fund during the one-year period following the unregistered acquisitions. We are currently exploring various options to limit this potential liability.

During the second quarter of 2006, we issued an aggregate of 3,900 shares of restricted stock to employees pursuant to the 2004 Stock Compensation Plan. We believe these securities are not subject to registration under the no sale principle or were otherwise issued pursuant to exemptions from registration under Section 4(2) of the Securities

Act of 1933 as transactions by an issuer not involving a public offering.

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**Issuer Purchases of Equity Securities**

| Period | Total Number of Shares Purchased (1) | Weighted Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plan (2) | Maximum Number of Shares That May Yet Be Purchased Under the Plan (2) |
|---|---|---|---|---|
| April 1-30, 2006 | 4,631 | $ 56.31 | N/A | N/A |
| May 1-31, 2006 | 3,301 | 53.80 | N/A | N/A |
| June 1-30, 2006 | 265 | 49.47 | N/A | N/A |
| Total | 8,197 | $ 55.08 | N/A | N/A |

(1) Represents 5,425 shares that were tendered by employees to satisfy minimum tax withholding amounts for restricted stock awards and 2,772 shares of common stock purchased by a rabbi trust that we established in connection with our director deferral plans pursuant to which non-employee directors may elect to defer directors cash compensation to be paid at a later date in the form of common stock.

(2) Our Board of Directors has approved a program to repurchase up to two million shares of our outstanding common stock; however, such plan will not be implemented until after our planned November filing of our third quarter 2006 Form 10-Q.

**Item 3. Defaults Upon Senior Securities.**

None.

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

None.

**Item 5. Other Information.**

None.

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**Item 6. Exhibits.**

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

| Exhibit No. | Description |
|---|---|
| 3.1 | Restated Certificate of Incorporation of Flowserve Corporation, filed as Exhibit 3(i) to the Company s Current Report on Form 8-K/A, dated August 16, 2006. |
| 3.6 | Amended and Restated By-Laws of Flowserve Corporation, as amended, filed as Exhibit 3.9 to Flowserve Corporation s Annual Report on Form 10-K for the year ended December 31, 2003. |
| 10.1 | Second Amendment dated as of May 8, 2006 and effective as of May 16, 2006 to that certain Credit Agreement, dated as of August 12, 2005, by and among the Company, the financial institutions from time to time party thereto (collectively, the Lenders ), and Bank of America, N.A., as Swingline Lender, Administrative Agent and Collateral Agent for the Lenders, filed as Exhibit 10.1 to the Company s Current Report on Form 8-k, dated May 16, 2006. |
| 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<br>(Registrant) |
| Date: September 29, 2006 | /s/ Lewis M. Kling<br>Lewis M. Kling<br>President and Chief Executive Officer |
| Date: September 29, 2006 | /s/ Mark A. Blinn<br>Mark A. Blinn<br>Vice President and Chief Financial Officer |

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## Exhibits Index

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