DONALDSON CO INC
Form 10-K
September 28, 2007

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

x **Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934** for the fiscal year ended July 31, 2007 or

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
for the transition period from __________ to __________

Commission File Number: 1-7891

DONALDSON COMPANY, INC.

(Exact name of registrant as specified in its charter)

Delaware	**41-0222640**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1400 West 94th Street, Minneapolis, Minnesota	**55431**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: (952) 887-3131
Securities registered pursuant to Section 12(b) of the Act:

Title of each class	**Name of each exchange on which registered**
Common Stock, $5 Par Value	New York Stock Exchange
Preferred Stock Purchase Rights	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the

Act. Yes o No x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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 x 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).
Yes o No x

As of January 31, 2007, the last business day of the registrant s most recently completed second fiscal quarter, the aggregate market value of voting and non-voting common stock held by non-affiliates of the registrant was $2,764,315,979 (based on the closing price of $35.22 as reported on the New York Stock Exchange as of that date).

As of August 31, 2007, there were approximately 79,173,622 shares of the registrant s common stock outstanding.

Documents Incorporated by Reference

Portions of the registrant s Proxy Statement for its 2007 annual meeting of shareholders are incorporated by reference in Part III, as specifically set forth in Part III.

DONALDSON COMPANY, INC.

ANNUAL REPORT ON FORM 10-K

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PART I

Item 1. BUSINESS

General

Donaldson Company, Inc. (Donaldson or the Company) was founded in 1915 and organized in its present corporate form under the laws of the State of Delaware in 1936.

The Company is a worldwide manufacturer of filtration systems and replacement parts. The Company s product mix includes air and liquid filters and exhaust and emission control products for mobile equipment; in-plant air cleaning systems; compressed air purification systems; air intake systems for industrial gas turbines and specialized filters for such diverse applications as computer disk drives and semi-conductor processing. Products are manufactured at more than 35 plants around the world and through three of our joint ventures. The Company has two reporting segments engaged in the design, manufacture and sale of systems to filter air and liquid and other complementary products. The two segments are Engine Products and Industrial Products. Products in the Engine Products segment consist of air intake systems, exhaust and emissions systems, liquid filtration systems and replacement parts. The Engine Products segment sells to original equipment manufacturers (OEM) in the construction, mining, agriculture and transportation markets and to independent distributors, OEM dealer networks, private label accounts and large equipment fleets. Products in the Industrial Products segment consist of dust, fume and mist collectors, compressed air purification systems, liquid filters and parts, static and pulse-clean air filter systems for gas turbines, and specialized air filtration systems for diverse applications including computer disk drives. The Industrial Products segment sells to various industrial end-users, OEMs of gas-fired turbines and OEMs and end-users requiring highly purified air.

The table below shows the percentage of total net sales contributed by the principal classes of similar products for each of the last three fiscal years:

	Year Ended July 31		
	2007	**2006**	**2005**
Engine Products segment			
Off-road Equipment Products (including defense products)	18%	18%	18%
Truck Products	9%	11%	11%
Aftermarket Products (including replacement part sales to our OEMs)	30%	29%	29%
Industrial Products segment			
Industrial Filtration Solutions Products	27%	26%	27%
Gas Turbine Systems Products	8%	8%	7%
Special Applications Products	8%	8%	8%

Financial information about segment operations appears in Note J in the Notes to Consolidated Financial Statements on page 47.

The Company makes its annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments to those reports, available free of charge through its website, at www.donaldson.com, as soon as reasonably practicable after it electronically files such material with (or furnishes such material to) the Securities and Exchange Commission. Also available on the Company s website are corporate governance documents, including the Company s code of business conduct and ethics, corporate governance guidelines, Audit Committee charter, Human Resources Committee charter, and Corporate Governance Committee charter. These documents are available in print free of charge to any shareholder who requests them. The information contained on the Company s website is not incorporated by reference into this Annual Report on Form 10-K and should not be considered to be part of this Form 10-K.

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Seasonality

In general, the Company s Engine Products and Industrial Products segments are not considered to be seasonal. However, a number of our end markets are dependent on the construction and agricultural industries, which are generally stronger in the second half of our fiscal year.

Competition

Principal methods of competition in both the Engine Products and Industrial Products segments are price, geographic coverage, service and product performance. The Company competes in a number of highly competitive filtration markets in both the Engine Products and Industrial Products segments. The Company believes it is a market leader in many of its primary product lines. The Industrial Products segment s principal competitors vary from country to country and include several large regional or global competitors and a significant number of small competitors who compete in a limited geographical region or in a limited number of product applications. The Company believes within the Engine Products segment it is a market leader in its Off-road Equipment and Truck Products lines for OEMs and is a significant participant in the aftermarket for replacement filters and hard parts. The Engine Products segment s principal competitors vary from country to country and include several large regional or global competitors, and small regional competitors, especially in the Engine Aftermarket Products business.

Raw Materials

The principal raw materials that we use are steel and filter media. We purchase a variety of types of steel for various applications. During fiscal 2007 commodity prices were relatively stable after experiencing increases in fiscal 2006 primarily related to the cost of steel. The Company experienced no significant or unusual problems in the purchase of raw materials or commodities. The Company has more than one source of raw materials essential to its business. The Company is not required to carry significant amounts of inventory to meet rapid delivery demands or secure supplier allotments. However, the Company does stock inventory at its regional distribution centers around the world in order to meet anticipated Customer demand.

Patents and Trademarks

The Company owns various patents and trademarks, which it considers in the aggregate to constitute a valuable asset, including patents and trademarks for products and filtration systems sold under the Ultra-Web®, PowerCore® and Donaldson® trademarks. However, it does not regard the validity of any one patent or trademark as being of material importance.

Major Customers

Sales to Caterpillar Inc. and its subsidiaries (Caterpillar) accounted for 10 percent of net sales in 2007 and 12 percent of net sales in both 2006 and 2005. Caterpillar has been a customer of the Company for many years and it purchases many models and types of products for a variety of applications. Sales to the U.S. Government do not constitute a material portion of the Company s business. There were no Customers over 10 percent of gross accounts receivable in 2007 or 2006.

Backlog

At August 31, 2007, the backlog of orders expected to be delivered within 90 days was $328,939,000. The 90-day backlog at August 31, 2006 was $291,011,000. Backlog is one of many indicators of business conditions in our market. However, it is not always indicative of future results for a number of reasons, including short lead times in our aftermarket and the timing of receipt of orders in many of our original equipment and industrial markets.

Research and Development

During 2007, the Company spent $36,458,000 on research and development activities relating to the development of new products or improvements of existing products or manufacturing processes. The Company spent $33,887,000 in 2006 and $32,234,000 in 2005 on research and development activities. Substantially all commercial research and development is performed in-house.

Environmental Matters

The Company does not anticipate any material effect on its capital expenditures, earnings or competitive position during fiscal 2008 due to compliance with government regulations regulating the discharge of materials into the environment or otherwise relating to the protection of the environment.

Employees

The Company employed over 12,000 persons in worldwide operations as of August 31, 2007.

Geographic Areas

Financial information about geographic areas appears in Note J of the Notes to Consolidated Financial Statements on page 47.

Item 1A. RISK FACTORS

There are inherent risks and uncertainties associated with our global operations that involve manufacturing and sale of products for highly demanding Customer applications throughout the world. The risks and uncertainties associated with our business could adversely affect our operating performance and financial condition. The following discussion along with discussions elsewhere in this report outlines the risks and uncertainties that we believe are the most material to our business. However, these are not the only risks or uncertainties that could affect our business. Therefore, the following is not intended to be a complete discussion of all potential risks or uncertainties.

Operating internationally carries risks which could negatively effect our financial performance.

We have sales and manufacturing operations throughout the world, with the heaviest concentrations in North America, Europe and Asia. Our stability, growth and profitability are subject to a number of risks of doing business internationally that could harm our business, including:

- political and military events,

legal and regulatory requirements, including import, export and defense regulations,

tariffs and trade barriers,

potential difficulties in staffing and managing local operations,

credit risk of local Customers and distributors,

difficulties in protecting intellectual property, and

local economic, political and social conditions, specifically in China where we have significant investments in both our Engine and Industrial Products segments.

Maintaining a competitive advantage requires continuing investment with uncertain returns.

We operate in highly competitive markets and have numerous competitors who may already be well established in those markets. We experience price pressures from these competitors in certain product lines and geographic markets. We expect our competitors to continue improving the design and performance of their products and to introduce new products that are competitive in both price and performance. We believe that we have certain technological advantages over our competitors but maintaining these advantages requires us to continually invest in research and development, sales and marketing and Customer service and support. There is no guarantee that we will be successful in maintaining these advantages. We are currently making investments in emissions technology development and potential new emission systems products to meet the changing regulatory requirements worldwide. There is no guarantee that we will be successful in completing development or achieving sales of these products or that the margins on such products will be acceptable. Our financial performance may be negatively impacted if a competitor s successful product innovation reaches the market before ours or gains broader market acceptance.

A number of our major OEM Customers manufacture component products for their own use. Although these OEM Customers rely on us and other suppliers for other of their component products,

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they sometimes choose to manufacture additional component products for their own use. There is also a risk that a Customer could acquire one or more of our competitors.

We may be adversely impacted by changes in technology that could reduce or eliminate the demand for our products. We are at risk with respect to:

Breakthroughs in technology which provide a viable alternative to diesel engines.

Reduced demand for disk drive products if our Customers further develop flash memory or a similar technology which would eliminate the need for filtration solutions.

We participate in highly competitive markets with pricing pressure. If we are not able to compete effectively our margins and results of operations could be adversely affected.

The businesses and product lines in which we participate are very competitive and we risk losing business based on a wide range of factors, including price, delivery, service, product performance and Customer satisfaction. Large Customers continue to seek productivity gains and lower prices from their suppliers. We may lose business or negatively impact our margins if we are unable to deliver value to our Customers through our technology and innovation and our product cost reduction and lean improvement efforts in manufacturing and throughout the Company.

Demand for our products relies on economic and industrial conditions worldwide.

Demand for certain of our products tends to be cyclical and responds to varying levels of construction, agricultural, mining and industrial activity in the United States and in other industrialized nations.

Sales to Caterpillar, Inc. and its subsidiaries accounted for 10 percent of our net sales in the most recent year and greater than 10 percent in the previous three fiscal years. An adverse change in Caterpillar s financial performance or a material reduction in our sales to it could negatively impact our operating results.

Changes in our product mix impacts our financial performance.

We sell products in various product lines that have varying profit margins. Our financial performance can be impacted positively or negatively depending on the mix of products we sell during a given period as compared to a previous period.

Unavailable or higher cost materials could result in our Customers being dissatisfied.

We obtain raw material, including a significant amount of various grades and types of steel, and certain manufactured components from third-party suppliers and tend to carry limited raw material inventories. Even a brief unanticipated delay in delivery or increases in prices by our suppliers could result in the inability to satisfy our Customers on delivery and pricing. This could negatively affect our financial performance.

Unfavorable fluctuations in foreign currency exchange rates could negatively impact our results of operations and financial position.

We have operations in many countries. Each of our subsidiaries reports its results of operations and financial position in its relevant foreign currency, which is then translated into United States dollars. The translated financial information is included in our consolidated financial statements. The strengthening of the United States dollar in comparison to the foreign currencies of our subsidiaries could have a negative impact on our results of operations or financial position.

Acquisitions may not necessarily have a positive impact on our results.

We have made and continue to pursue acquisitions of complementary product lines, technologies and businesses. We cannot guarantee that these acquisitions will have a positive impact on our results. These acquisitions could negatively impact our profitability due to operating and integration inefficiencies, the incurrence of debt, contingent liabilities and amortization expenses related to intangible assets. There are also a number of risks involved in acquisitions. For example, we could lose key existing or

potential Customers, have difficulties in assimilating the acquired operations, assume unanticipated legal liabilities or lose key employees of the acquired company.

Compliance with environmental laws and regulations can be costly.

We are subject to many environmental laws and regulations in the jurisdictions in which we operate. We incur product development capital and operating costs in order to comply with these laws and regulations. We may be adversely impacted by new or changing environmental laws and regulations that affect both our operations and our ability to develop and sell products that meet our Customers product and performance requirements.

Item 1B. UNRESOLVED STAFF COMMENTS

None.

Item 2. PROPERTIES

The Company s principal office and research facilities are located in Bloomington, Minnesota, a suburb of Minneapolis, Minnesota. The principal European administrative and engineering offices are located in Leuven, Belgium. The Company also has extensive operations in the Asia-Pacific region.

The Company s principal plant activities are carried out in the United States and internationally. Following is a summary of the principal plants and other materially important physical properties owned or leased by the Company.

U.S. Facilities
Auburn, Alabama (E)
Dixon, Illinois
Frankfort, Indiana
Cresco, Iowa
Grinnell, Iowa (E)
Nicholasville, Kentucky
Bloomington, Minnesota
Chillicothe, Missouri (E)
St. Charles, Missouri* (E)
Philadelphia, Pennsylvania (I)
Maryville, Tennessee (I)
Greeneville, Tennessee
Baldwin, Wisconsin
Stevens Point, Wisconsin

Joint Venture Facilities
Champaign, Illinois (E)
Jakarta, Indonesia
Dammam, Saudi Arabia (I)

Distribution Centers
Ontario, California*
Rensselaer, Indiana
Singapore*
Aguascalientes, Mexico
Brugge, Belgium
Johannesburg, South Africa

International Facilities
Wyong, Australia
Athens, Canada (I)
Hong Kong, China*
Wuxi, China
Kadan, Czech Republic (I)
Klasterec, Czech Republic (E)
Domjean, France (E)
Carrieres Sur Seine, France (E)
Dulmen, Germany (E)
Flensburg, Germany (I)
Haan, Germany (I)
New Delhi, India
Ostiglia, Italy
Gunma, Japan
Aguascalientes, Mexico
Monterrey, Mexico
Cape Town, South Africa
Johannesburg, South Africa*
Barcelona, Spain (I)
Rayong, Thailand (I)
Hull, United Kingdom
Leicester, United Kingdom (I)

The Company s properties are utilized for both the Engine and Industrial Product segments except as indicated with an (E) for Engine or (I) for Industrial. The Company also leases certain of its facilities, primarily under long-term leases.

The denoted facilities (*) are leased facilities. In Wuxi, China, a portion of the operations are conducted in leased facilities. The Company s properties are considered to be suitable for their present purposes, well-maintained and in good operating condition.

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Item 3. LEGAL PROCEEDINGS

The Company is not currently subject to any pending litigation other than litigation which arises out of and is incidental to the conduct of the Company s business. All such matters are subject to many uncertainties and outcomes that are not predictable with assurance. The Company does not consider any of such proceedings that are currently pending to be likely to result in a material adverse effect on the Company s consolidated financial position or results of operation.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders of the Company during the quarter ended July 31, 2007.

Executive Officers of the Registrant

Current information regarding executive officers is presented below. All terms of office are for one year. There are no arrangements or understandings between individual officers and any other person pursuant to which the officer was selected as an executive officer.

Name	**Age**	**Positions and Offices Held**	**First Year Elected or Appointed as an Executive Officer**
William M. Cook	54	Chairman, President and Chief Executive Officer	1994
Sandra N. Joppa	42	Vice President, Human Resources, Communications and Facilities	2005
Norman C. Linnell	48	Vice President, General Counsel and Secretary	1996
Charles J. McMurray	53	Senior Vice President, Industrial Products and South Africa	2003
Mary Lynne Perushek	49	Vice President and Chief Information Officer	2006
Lowell F. Schwab	59	Senior Vice President, Engine Systems and Parts	1994
David W. Timm	54	Vice President, Asia-Pacific	2007
William I. Vann	62	Vice President, NAFTA Operations and Mexico	2004

Name	Age	Positions and Offices Held	First Year Elected or Appointed as an Executive Officer
Thomas R. VerHage	54	Vice President and Chief Financial Officer	2004
Jay L. Ward	43	Vice President, Europe and Middle East	2006
Debra L. Wilfong	52	Vice President and Chief Technology Officer	2007

Mr. Cook joined Donaldson Company, Inc. in 1980 and has held various positions, including CFO and Senior Vice President, International from 2001 to 2004 and President and CEO from 2004 to 2005. Mr. Cook was appointed Chairman, President and CEO in July 2005.

Ms. Joppa was appointed Vice President, Human Resources and Communications in November 2005 and added responsibility for Facilities in May 2007. Prior to that time Ms. Joppa held various positions at General Mills, a consumer food products company, from 1989 to 2005, including service as Director of Human Resources for several different operating divisions from 1999 to 2005.

Mr. Linnell joined Donaldson Company, Inc. in 1996 as General Counsel and Secretary and was appointed Vice President, General Counsel and Secretary in 2000.

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Mr. McMurray joined Donaldson Company, Inc. in 1980 and has held various positions, including Director, Global Information Technology from 2001 to 2003; Vice President, Human Resources & Communication, Information Technology and Logistics from 2004 to 2005; and Vice President, Information Technology, Europe, South Africa and Mexico from 2005 to 2006. Mr. McMurray became Senior Vice President, Industrial Products, Technology, and South Africa in September 2006 and transferred responsibility for Information Technology upon the hiring of Ms. Perushek in November 2006.

Ms. Perushek was appointed Vice President and Chief Information Officer in November 2006. Prior to that time Ms. Perushek was Vice President of Global Information Technology at H.B. Fuller Company, a worldwide manufacturer of adhesive products, from 2005 to 2006 and Chief Information Officer for Young America Corporation, a marketing company, from 1999 to 2004.

Mr. Schwab joined Donaldson Company, Inc. in 1977 and has held various positions, including Senior Vice President, Operations from 1994 to 2004 and was promoted to Senior Vice President, Engine Systems and Parts in 2004.

Mr. Timm joined Donaldson Company, Inc. in 1983 and has held various positions, including General Manager, Disk Drive from 1995 to 2004; General Manager, Disk Drive and New Business Development from 2004 to 2005; and General Manager, Gas Turbine Systems Products from 2005 to 2006. Mr. Timm was appointed Vice President, Asia-Pacific in March 2007.

Mr. Vann joined Donaldson Company, Inc. in 1967 and has held various positions, including General Manager of Industrial Air Filtration from 2000 to 2004; Vice President, NAFTA Operations in 2005; and Vice President, NAFTA

Operations and Mexico since 2006.

Mr. VerHage was appointed Vice President and Chief Financial Officer in March 2004. Prior to that time Mr. VerHage was a partner for Deloitte & Touche, LLP, an international accounting firm, from 2002 to 2004.

Mr. Ward joined Donaldson Company, Inc. in 1998 and has held various positions, including Director, Operations from 2001 to 2003; Director, Product and Business Development, Industrial Filtration Solutions Group from 2003 to 2004; and Managing Director, Europe from 2004 to 2006. Mr. Ward was appointed Vice President, Europe and Middle East in December 2006.

Ms. Wilfong was appointed Vice President and Chief Technology Officer in May 2007. Prior to that time, Ms. Wilfong held various director positions in research and development at 3M Company, an international consumer products company, from 2000 to 2007, most recently as Director, Research and Development for the 3M Automotive Division from 2006 to 2007.

Effective August 3, 2007, Mr Geert Henk Touw retired as Senior Vice President, Asia-Pacific.

PART II

Item 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The common shares of the Company are traded on the New York Stock Exchange under the symbol DCI. The amount and frequency of all cash dividends declared on the Company s common stock for 2007 and 2006 appear in Note L of the Notes to Consolidated Financial Statements on page 51. As of September 21, 2007, there were 1,836 shareholders of record of common stock.

The low and high sales prices for the Company s common stock for each full quarterly period during 2007 and 2006 were as follows:

	First Quarter		Second Quarter		Third Quarter		Fourth Quarter	
2006	$28.60	32.88	$29.91	34.64	$32.08	36.00	$30.16	33.99
2007	$31.83	38.97	$33.60	38.74	$34.38	38.89	$34.11	38.40

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The following table sets forth information in connection with purchases made by, or on behalf of, the Company or any affiliated purchaser of the Company, of shares of the Company s common stock during the quarterly period ended July 31, 2007.

Period	Total Number of Shares Purchased(1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly	Maximum Number of Shares that May Yet Be Purchased

			Announced Plans or Programs	Under the Plans or Programs
May 1-May 31, 2007				4,402,200
June 1-June 30, 2007	204,400	$ 35.15	204,400	4,197,800
July 1-July 31, 2007	219,989	$ 35.59	219,800	3,978,000
Total	424,389	$ 35.38	424,200	3,978,000

(1) On March 31, 2006, the Company announced that the Board of Directors authorized the repurchase of up to 8.0 million shares of common stock. This repurchase authorization, which is effective until terminated by the Board of Directors, replaced the existing authority that was authorized on January 17, 2003. There were no repurchases of common stock made outside of the Company s current repurchase authorization during the quarter ended July 31, 2007. However, the table above includes 189 previously owned shares tendered by option holders in payment of the exercise price of options. While not considered repurchases of shares, the Company does at times withhold shares that would otherwise be issued under equity-based awards to cover the withholding taxes due as a result of exercising stock options or payment of equity-based awards.

The graphs below compare the cumulative total stockholder return on the Company s Common Stock for the last five fiscal years with the cumulative total return of the Standard & Poor s 500 Stock Index and the Standard & Poor s Index of Industrial Machinery Companies. The graph and table assume the investment of $100 in each of Donaldson s Common Stock and the specified indexes at the beginning of the applicable period, and assume the reinvestment of all dividends.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN

	Year ended July 31,					
	2007	**2006**	**2005**	**2004**	**2003**	**2002**
Donaldson Company, Inc.	$ 227.06	$ 203.15	$ 199.28	$ 161.65	$ 146.84	$ 100.00
S&P 500	174.78	150.50	142.81	125.22	110.64	100.00
S&P Industrial Machinery	223.02	172.58	164.80	152.07	117.32	100.00

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Item 6. SELECTED FINANCIAL DATA

The following table sets fourth selected financial data for each of the fiscal years in the five-year period ended July 31, 2007 (in millions, except per share data):

	Year ended July 31,				
	2007	**2006**	**2005**	**2004**	**2003**

	Year ended July 31,				
Net Sales	$ 1,918.8	$ 1,694.3	$ 1,595.7	$ 1,415.0	$ 1,218.3
Income from continuing operations	150.7	132.3	110.6	106.3	95.3
Diluted earnings per share	1.83	1.55	1.27	1.18	1.05
Total assets	1,319.0	1,124.1	1,111.8	1,001.6	882.0
Long-term obligations	129.0	100.5	103.3	70.9	105.2
Cash dividends declared per share	0.370	0.410	0.180	0.213	0.180
Cash dividends paid per share	0.360	0.320	0.235	0.205	0.175

Item 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

Results of Operation

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

Executive Overview The Company manufactures filtration systems and replacement parts. The Company s core strengths are leading filtration technology, strong Customer relationships and global presence. The Company operates through two reporting segments, Engine Products and Industrial Products, and has a product mix including air and liquid filters and exhaust and emission control products. As a worldwide business, the Company s results of operations are affected by global industrial and economic factors. The Company s diversity between its original equipment and replacement parts Customers, its diesel engine and industrial end markets, and its North American and international end markets has helped to limit the impact of any one of these factors and markets on the consolidated results of the Company. The continued strong demand in most of the Company s end markets combined with strong international growth in both our Engine Product and Industrial Product segments drove record earnings in fiscal 2007.

The Company reported record sales in 2007 of $1.919 billion, up 13.3 percent from $1.694 billion in the prior year. The Company s results were positively impacted by foreign currency translation for the year. The impact of foreign currency translation during the year increased sales by $47.2 million. Excluding the current year impact of foreign currency translation, worldwide sales increased 10.5 percent during the year.

Although net sales excluding foreign currency translation is not a measure of financial performance under GAAP, the Company believes it is useful in understanding its financial results and provides a comparable measure for understanding the operating results of the Company s foreign entities between different fiscal periods excluding the impact of foreign currency translation. Following is a reconciliation to the most comparable GAAP financial measure of this non-GAAP financial measure (in millions):

	July 31, 2007	July 31, 2006
Net sales, excluding foreign currency translation	$ 1,871.6	$ 1,719.6
Current year foreign currency translation impact	47.2	(25.3)
Net sales	$ 1,918.8	$ 1,694.3

Gross margin of 31.5 percent was down from the gross margin of 32.9 percent in the prior year. A number of factors combined to lower the gross margin for the year, including higher than expected global distribution costs due to increased Customer demand, some lower margin Gas Turbine System and Industrial Filtration Solutions sales as well as some process inefficiencies. Gross margin was

negatively impacted by higher than expected distribution costs associated with implementing the investments made to increase the Company s distribution capacity and capabilities.

Although not as large as the impact on net sales, the Company s net earnings were also positively impacted by foreign currency translation for the year. The impact of foreign currency translation during the year increased net earnings by $5.1 million. Excluding the current year impact of foreign currency translation, net earnings increased 10.1 percent during the year.

Although net earnings excluding foreign currency translation is not a measure of financial performance under GAAP, the Company believes it is useful in understanding its financial results and provides a comparable measure for understanding the operating results of the Company s foreign entities between different fiscal periods excluding the impact of foreign currency translation. Following is a reconciliation to the most comparable GAAP financial measure of this non-GAAP financial measure (in millions):

	July 31, 2007	**July 31, 2006**
Net earnings, excluding foreign currency translation	$ 145.6	$ 133.1
Current year foreign currency translation impact, net of tax	5.1	(0.8)
Net earnings	$ 150.7	$ 132.3

The Company reported record diluted earnings per share of $1.83, an 18.1 percent increase from $1.55 in the prior year.

Following is financial information for the Company s Engine Products and Industrial Products segments. Corporate and Unallocated includes corporate expenses determined to be non-allocable to the segments, interest income and expense, non-operating income and expense and expenses not allocated to the business segments in the same period. During the first quarter of 2006, the Company adjusted its basis of measurement for earnings before income taxes such that certain expenses, such as amortization of intangibles, which were previously considered to be Corporate and Unallocated, are now included in the Engine and Industrial Products segment results. The impact of the change in the basis of measurement resulted in approximately $16.0 million of Corporate and Unallocated expenses being charged to the Engine and Industrial Products segments aggregate earnings before income taxes in fiscal 2006 as compared to fiscal 2005. This change resulted in approximately $8.0 million of additional expense to each of the Engine and Industrial Products segments during fiscal 2006 when compared to 2005. This adjustment to the basis of measurement of segment earnings did not change the business components included in each of the Company s reportable segments.

See further discussion of segment information in Note J of the Company s Notes to Consolidated Financial Statements.

	Engine Products	Industrial Products	Corporate & Unallocated	Total Company
		(thousands of dollars)		
2007				
Net sales	$ 1,084,262	$ 834,566	$	$ 1,918,828
Earnings before income taxes	140,762	80,321	(16,222)	204,861
2006				
Net sales	$ 991,554	$ 702,773	$	$ 1,694,327
Earnings before income taxes	135,994	65,550	(12,377)	189,167
2005				
Net sales	$ 923,840	$ 671,893	$	$ 1,595,733
Earnings before income taxes	125,454	53,709	(24,430)	154,733

During fiscal 2007, the Company s Engine Products segment decreased from the prior year as a percent of total net sales at 56.5 percent compared to 58.5 percent in the prior year. For the Company s Industrial Products segment, percent of total net sales increased to 43.5 percent from 41.5 percent in the prior year.

Factors within the Company s reporting segments that contributed to the Company s results for fiscal 2007 included strong business conditions within the Engine Products segment in Europe and Asia,

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partially offset by weaker Truck Products sales in the United States, Mexico and Canada. Specifically, strength in new construction and mining equipment spurred Off-road Equipment Products sales worldwide. Additionally, equipment utilization rates remained strong driving Aftermarket Products sales growth. In the Industrial Products segment, demand increases in Europe and Asia drove sales growth in the Company s Industrial Filtration Solutions Products. Worldwide sales in Gas Turbine Products were higher than the prior year primarily due to high demand for power generation capacity as well as strength in the oil and gas industry internationally. Sales of Special Applications Products were strong with continued strong demand for membrane products.

Following are net sales by product within the Engine Products segment and Industrial Products segment:

	2007	2006	2005
		(thousands of dollars)	
Engine Products segment:			
Off-road Products	$ 352,065	$ 308,175	$ 286,230
Truck Products	166,370	184,303	175,048
Aftermarket Products*	565,827	499,076	462,562
Total Engine Products segment	1,084,262	991,554	923,840

	2007	2006	2005
Industrial Products segment:			
Industrial Filtration Solutions Products	515,022	440,230	424,727
Gas Turbine Products	158,025	121,194	112,872
Special Applications Products	161,519	141,349	134,294
Total Industrial Products segment	834,566	702,773	671,893
Total Company	$ 1,918,828	$ 1,694,327	$ 1,595,733

* Includes replacement part sales to our original equipment manufacturers.

Outlook The Company expects five to seven percent sales growth in fiscal 2008 for sales in its Engine Products segment. Due to the continued impact of the EPA diesel emissions standards, the Company expects its United States, Mexico and Canada Truck Products sales to decrease $30 to $40 million in the first three quarters of 2008 before growth returns in the fourth quarter. Production of new heavy construction and mining equipment by international OEM Customers is forecasted to remain healthy. The Company expects non-residential and public construction markets to benefit from continued infrastructure investment in the United States. Production of new agriculture equipment by Customers is expected to remain strong globally. Aftermarket Products sales are expected to grow with continued strong equipment utilization in the field, and the increasing amount of equipment with the Company s PowerCore filtration systems.

The Company expects eight to ten percent sales growth in fiscal 2008 for its Industrial Products segment. Industrial Filtration Solutions Products sales are expected to grow 10 percent due to continued strong global manufacturing investment and production utilization conditions. The Company expects full-year gas turbine sales growth in the high-single digits over last year s 30 percent growth, with continued strength in the international power generation and oil and gas market segments. Special Applications Products sales are expected to grow in the mid-single digit percent.

Fiscal 2007 Compared to Fiscal 2006

Engine Products Segment The Engine Products segment sells to OEMs in the construction, mining, agriculture and transportation markets and to independent distributors, OEM dealer networks, private label accounts and large equipment fleets. Products include air intake systems, exhaust and emissions systems, liquid filtration systems and replacement filters.

Sales for the Engine Products segment were $1.084 billion, an increase of 9.3 percent from $991.6 million in the prior year, reflecting increases in the worldwide Off-road and Aftermarket Products businesses partially offset by decreased Truck Products sales in the United States.

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Within the Engine Products segment, worldwide sales of Off-road Products were $352.1 million, an increase of 14.2 percent from $308.2 million in the prior year. Sales in the United States showed an increase of 7.6 percent due to continued improvements in new construction and agricultural equipment demand. Internationally, sales of Off-road Products were up 21.9 percent from the prior year with sales increasing in both Europe and Asia by 24.3 percent and

16.9 percent, respectively, reflecting strength in the new construction and mining equipment demand internationally.

Worldwide sales of Truck Products were $166.4 million, a decrease of 9.7 percent from $184.3 million in the prior year. Truck Products sales in the United States decreased 14.9 percent from the prior year as a result of the new EPA emissions standards which resulted in lower new truck build rates at our Customers. International Truck Products sales increased 5.3 percent from the prior year. Strong sales in Europe resulted in an increase of 9.9 percent from stronger build rates due to economic growth and increased market share.

Worldwide Aftermarket Products sales of $565.8 million increased 13.4 percent from $499.1 million in the prior year. Sales in the United States increased 6.8 percent over the prior year while international sales increased 21.3 percent with sales increasing in Europe, Asia and Mexico by 28.2 percent, 13.7 percent and 29.9 percent, respectively. Equipment utilization remained high in all regions driving demand for replacement filters. Geographic expansion also contributed to the increases internationally.

Industrial Products Segment The Industrial Products segment sells to various industrial end-users, OEMs of gas-fired turbines, and OEMs and end-users requiring highly purified air. Products include dust, fume and mist collectors, compressed air purification systems, liquid filters and parts, static and pulse-clean air filter systems, specialized air filtration systems for diverse applications including computer disk drives and PTFE membrane and laminates.

Sales for the Industrial Products segment were $834.6 million, an increase of 18.8 percent from $702.8 million in the prior year resulting from stronger sales of all products across all regions.

Within the Industrial Products segment, worldwide sales of Industrial Filtration Solutions Products of $515.0 million increased 17.0 percent from $440.2 million in the prior year. Sales in the United States, Europe, Asia, South Africa and Mexico increased 7.2 percent, 24.9 percent, 18.8 percent, 27.7 percent and 25.5 percent, respectively. Demand has been strong worldwide but specifically in Europe where manufacturing investment conditions have been good.

Worldwide sales of Gas Turbine Products were $158.0 million, an increase of 30.4 percent from $121.2 million in the prior year as the demand for power generation remained strong internationally where there is a deficit of power generation capacity. High levels of activity in the oil and gas industry generated increased demand for small turbines and replacement filters.

Worldwide sales of Special Applications Products were $161.5 million, a 14.3 percent increase from $141.3 million in the prior year. Sales in the United States, Europe, and Asia increased 30.3 percent, 17.1 percent, and 11.4 percent from the prior year due primarily to strength in the end markets served by our membrane product line.

Consolidated Results The Company reported record net earnings for 2007 of $150.7 million compared to $132.3 million in 2006, an increase of 13.9 percent. Diluted net earnings per share was a record $1.83, up 18.1 percent from $1.55 in the prior year. The Company s operating income of $211.1 million increased from prior year operating income of $192.8 million by 9.5 percent. Operating income in the Engine Products segment as a percent of total operating income decreased to 62.9 percent from 67.7 percent in the prior year. Operating income in the Industrial Products segment as a percent of total operating income of 37.8 percent increased from the prior year of 33.6 percent. International operating income, prior to corporate expense allocations, totaled 77.7 percent of consolidated operating income in 2007 as compared to 77.2 percent in 2006. Of the 2007 international operating income, prior to corporate expense allocations, Europe contributed 44.8 percent while Asia contributed 49.7 percent. Total international operating income increased 10.2 percent from the prior year. This increase is attributable to strong sales of Special Applications Products and Gas Turbine Systems Products.

Gross margin for 2007 was 31.5 percent, a decrease from 32.9 percent in the prior year. A number of factors combined to lower the gross margin for the year, including higher than expected global

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distribution costs due to increased Customer demand, some lower margin Gas Turbine System Products and Industrial Filtration Solutions Products sales as well as some process inefficiencies. Gross margin was negatively impacted by higher than expected distribution costs associated with implementing the investments made to increase the Company s distribution capacity and capabilities. Plant rationalization and start-up costs for new facilities were $5.3 million in 2007, down from $5.4 million in the prior year. Operating expenses for 2007 were $393.8 million or 20.5 percent of sales, up from $363.8 million or 21.5 percent in the prior year. While operating expenses were up in total dollars, the amount as a percent of sales was down due to a gain in operating leverage with revenue increases and continued cost containment efforts.

Interest expense of $14.6 million increased $4.7 million from $9.9 million in the prior year as a result of investments in working capital, the Aerospace Filtration Systems, Inc. acquisition in March, and continued capital investments. Net other income totaled $8.3 million in 2007 compared to $6.3 million in the prior year. Components of other income for 2007 were as follows: interest income of $1.1 million, earnings from non-consolidated joint ventures of $5.9 million, charitable donations of $0.4 million, foreign exchange gains of $0.2 million and other miscellaneous income and expense items resulting in income of $1.5 million.

The effective income tax rate for fiscal 2007 was 26.4 percent. The effective income tax rate for fiscal 2006 was 30.1 percent. In the fourth quarter of fiscal 2006, the Company recognized a $3.6 million tax charge for the additional $80.0 million foreign earnings repatriation plan approved pursuant to the American Jobs Creation Act of 2004. The favorable comparison for 2007 is primarily due to the tax charge mentioned above plus an additional $3.1 million of discrete items in 2007 compared to 2006 related to the reinstatement of the Research and Experimentation Tax Credit, the favorable resolution of some open foreign and state tax positions, the expiration of the statute of limitations on certain matters previously reserved, and the tax benefit from dividends received from foreign subsidiaries. The tax rate going forward is dependent upon the applicable tax rates, the geographic mix of profits, and resolution of tax audits. The Company expects that the tax rate will be between 29 and 32 percent in fiscal 2008.

Total backlog at July 31, 2007 was $616.1 million, up 19.2 percent from the same period in the prior year. Backlog is one of many indicators of business conditions in our market. However, it is not always indicative of future results for a number of reasons, including short lead times in our aftermarket and the timing of receipt of orders in many of our original equipment and industrial markets. In the Engine Products segment, total open order backlog increased 9.3 percent from the prior year. In the Industrial Products segment, total open order backlog increased 38.0 percent from the prior year. Because some of the change in backlog can be attributed to a change in the ordering patterns of our Customers, it may not necessarily correspond to higher future sales.

Fiscal 2006 Compared to Fiscal 2005

Engine Products Segment Sales for the Engine Products segment were $991.6 million, an increase of 7.3 percent from $923.8 million in the prior year, reflecting increased sales across all products within this segment both in the United States and internationally.

Within the Engine Products segment, worldwide sales of Off-road Products were $308.2 million, an increase of 7.7 percent from $286.2 million in the prior year. Sales in the United States showed an increase of 5.8 percent due to continued improvements in new construction and mining equipment demand. Internationally, sales of Off-road Products were up 9.9 percent from the prior year with sales increasing in both Asia and Europe by 14.0 percent and

8.4 percent, respectively, reflecting the strength in the off-road equipment market internationally.

Worldwide sales of Truck Products were $184.3 million, an increase of 5.3 percent from $175.0 million in the prior year. Truck Products sales in the United States increased 6.9 percent from the prior year due to record heavy truck build rates and strong diesel emission sales. International Truck Products sales increased 0.9 percent from the prior year. Strong sales in Europe resulted in an increase of 10.4 percent from stronger build rates and increased market share. Offsetting Europe s increase was a decrease in sales in Asia of 5.9 percent primarily as a result of the weaker Japanese yen.

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Worldwide Aftermarket Products sales of $499.1 million increased 7.9 percent from $462.6 million in the prior year as equipment utilization rates remained high spurring demand for replacement filters. Sales in the United States increased 9.1 percent over the prior year while international sales increased 6.5 percent with sales increasing in Europe, Asia and Mexico by 6.1 percent, 5.4 percent and 25.7 percent, respectively.

Industrial Products Segment Sales for the Industrial Products segment were $702.8 million, an increase of 4.6 percent from $671.9 million in the prior year resulting from stronger sales of Industrial Filtration Solutions Products, Gas Turbine Systems Products and Special Applications Products.

Within the Industrial Products segment, worldwide sales of Industrial Filtration Solutions Products of $440.2 million increased 3.6 percent from $424.7 million in the prior year. Sales in the United States, Asia, South Africa and Mexico increased 5.8 percent, 2.7 percent, 33.6 percent and 45.1 percent, respectively. Sales in Europe decreased 0.9 percent from the prior year reflecting stability in the market despite the negative impact of foreign currency translation.

Worldwide sales of Gas Turbine Products were $121.2 million, an increase of 7.4 percent from $112.9 million in the prior year as business conditions strengthened primarily toward the end of fiscal 2006.

Worldwide sales of Special Applications Products were $141.3 million, a 5.3 percent increase from $134.3 million in the prior year. Sales in the United States decreased 16.9 percent from the prior year due primarily to softness in the end markets served by our membrane product line while sales in Europe and Asia increased 13.4 percent and 8.5 percent from the prior year, respectively, due to strong demand for computer hard drives and other consumer electronics.

Consolidated Results The Company reported record net earnings for 2006 of $132.3 million compared to $110.6 million in 2005, an increase of 19.7 percent. Diluted net earnings per share was a record $1.55, up 22.1 percent from $1.27 in the prior year. The Company s operating income of $192.8 million increased from prior year operating income of $156.5 million by 23.2 percent. Operating income in the Engine Products segment as a percent of total operating income decreased to 67.7 percent from 77.4 percent in the prior year. Operating income in the Industrial Products segment as a percent of total operating income of 33.6 percent decreased from the prior year of 34.2 percent. This change is primarily attributable to the Company s decision to adjust its basis of measurement for earnings before income taxes such that certain expenses, such as amortization of intangibles, which were previously considered to be Corporate and Unallocated, are now included in the Engine and Industrial Products segment results. This adjustment is discussed further in Note J. International operating income, prior to corporate expense allocations, totaled 77.2 percent of consolidated operating income in 2006 as compared to 82.7 percent in 2005. Of the 2006 international operating income, prior to corporate expense allocations, Europe contributed 42.4 percent while Asia contributed

48.5 percent. Total international operating income increased 15.0 percent from the prior year. This increase is attributable to strong sales of Special Applications Products and Gas Turbine Systems Products.

Gross margin for 2006 was 32.9 percent, an increase from 31.7 percent in the prior year. The margin benefited from the Company s focus on cost reduction efforts, production efficiencies and some selective price increases. The Company continued its efforts to improve manufacturing infrastructure and reduce product costs through plant rationalization. Plant rationalization and start-up costs for new facilities were $5.4 million in 2006, up from the $4.0 million in the prior year.

Operating expenses for 2006 were $363.8 million or 21.5 percent of sales, up from $349.1 million or 21.9 percent in the prior year. Operating expenses in fiscal 2006 included $2.8 million of stock option expense that was not included in fiscal 2005. Operating expenses in fiscal 2005 included a $6.4 million increase to the Company s legal reserve for the EPC patent infringement judgment. The Company continued to focus on operating expense controls in 2006.

Interest expense of $9.9 million increased $0.5 million from $9.4 million in the prior year. Net other income totaled $6.3 million in 2006 compared to $7.7 million in the prior year. Components of other income for 2006 were as follows: interest income of $1.7 million, earnings from non-consolidated joint

ventures of $5.0 million, charitable donations of $2.1 million, foreign exchange gains of $0.3 million and other miscellaneous income and expense items resulting in income of $1.4 million.

The effective income tax rate for fiscal 2006 was 30.1 percent. In the fourth quarter of fiscal 2006, the Company recognized a $3.6 million tax charge for the additional $80.0 million foreign earnings repatriation plan approved pursuant to the American Jobs Creation Act of 2004. The effective income tax rate for fiscal 2005 was 28.6 percent and also included a $4.0 million tax charge for a previous $80.0 million foreign earnings repatriation plan approved pursuant to the American Jobs Creation Act of 2004. The higher fiscal 2006 effective tax rate as compared to the prior year is primarily a result of the mix of earnings in our various jurisdictions. Higher tax jurisdictions such as Japan, Germany and the United States contributed a higher proportion of our taxable earnings as compared to the prior year. The unfavorable timing of the phase-out/phase-in provisions of the United States export credit versus the manufacturing credit and the expiration of the research and development credit also adversely affected the rate for fiscal 2006.

Total backlog at July 31, 2006 was $516.7 million, up 25.4 percent from the same period in the prior year. Backlog is one of many indicators of business conditions in our market. However, it is not always indicative of future results for a number of reasons, including short lead times in our aftermarket and the timing of receipt of orders in many of our original equipment and industrial markets. In the Engine Products segment, total open order backlog increased 20.3 percent from the prior year. In the Industrial Products segment, total open order backlog increased 36.4 percent from the prior year. Because some of the change in backlog can be attributed to a change in the ordering patterns of our Customers, it may not necessarily correspond to higher future sales.

Liquidity and Capital Resources

Financial Condition At July 31, 2007, the Company s capital structure was comprised of $156.8 million of current debt, $129.0 million of long-term debt and $624.7 million of shareholders equity. The Company had cash and cash equivalents of $55.2 million at July 31, 2007. The ratio of long-term debt to total capital was 17.1 percent and 15.5 percent at July 31, 2007 and 2006, respectively.

Total debt outstanding increased $105.4 million for the year to $285.8 million outstanding at July 31, 2007. The increase is a result of an increase in short-term borrowings outstanding at the end of the year of $49.7 million as compared to the prior year and an increase in long-term debt of $55.6 million (including current maturities) from the prior year.

The increase in long-term debt was comprised of two new note agreements. On May 18, 2007, the Company issued a 1.65 billion yen, or approximately $13.9 million, guaranteed note that matures on May 18, 2014. The debt was issued at face value and bears interest payable semi-annually at a rate of 2.019 percent. On June 1, 2007, the Company issued $100 million of senior unsecured notes. The first $50 million was funded on June 1, 2007, and the remaining two $25 million tranches will be funded on September 28, 2007 and November 30, 2007. The three tranches are due on June 1, 2017, September 28, 2017, and November 30, 2017, respectively. The debt was issued at face value and bears interest payable semi-annually at a rate of 5.48 percent. The proceeds from the notes will be used to refinance existing debt or for general corporate purposes.

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The following table summarizes the Company s fixed cash obligations as of July 31, 2007 for the years indicated (thousands of dollars):

		Payments Due by Period			
Contractual Obligations	**Total**	**Less than 1 year**	**1 - 3 years**	**3 5 years**	**More than 5 years**
Long-term debt obligations	$ 161,094	$ 32,935	$ 11,370	$ 45,119	$ 71,670
Capital lease obligations	1,577	732	534	137	174
Interest on long-term debt obligations	46,513	8,234	11,376	9,183	17,720
Operating lease obligations	18,509	7,914	7,768	2,406	421
Purchase obligations(1)	145,568	141,834	3,734		
Pension and deferred compensation(2)	26,135	2,009	4,764	3,210	16,152
Total	$ 399,396	$ 193,658	$ 39,546	$ 60,055	$ 106,137

(1) Purchase obligations consist primarily of inventory, tooling, contract employment services and capital expenditures. The Company s purchase orders for inventory are based on expected Customer demand, and quantities and dollar volumes are subject to change.

(2) Pension and deferred compensation consists of long-term pension liabilities and salary and bonus deferrals elected by certain executives under the Company s deferred compensation plan. Deferred compensation balances earn interest based on a treasury bond rate as defined by the plan and are payable at the election of the

participants.

As a result of its current over funded status, the Company does not have a minimum required contribution under the Pension Benefit Guarantee Corporation requirements for its U.S. pension plans for fiscal 2008. There is no intention to make a U.S. pension contribution. For its non-U.S. pension plans, the Company estimates that it will contribute approximately $4.0 million in fiscal 2008 based upon the local government prescribed funding requirements. Future estimates of the Company s pension plan contributions may change significantly depending on the actual rate of return on plan assets, discount rates and regulatory rules.

On April 2, 2007, the Company amended and renewed its existing $150 million five-year multi-currency revolving credit facility that was to mature on September 2, 2009. The amendment extends the maturity date of the facility to April 2, 2012 and increases the capacity to $250 million. There were no other material changes in terms and conditions. The agreement provides that loans may be made under a selection of currencies and rate formulas including Base Rate Advances or Off Shore Rate Advances. The interest rate on each advance is based on certain market interest rates and leverage ratios. Facility fees and other fees on the entire loan commitment are payable over the duration of this facility. There was $20.0 million outstanding at July 31, 2007 and no amounts outstanding at July 31, 2006, leaving $230.0 million and $150.0 million available for further borrowing under such facilities at July 31, 2007 and July 31, 2006, respectively. The weighted average interest rate on these short-term borrowings outstanding at July 31, 2007 was 5.59 percent.

The Company also has three agreements under uncommitted credit facilities, which provide unsecured borrowings for general corporate purposes. At July 31, 2007 and 2006, there was $70.0 million available for use. There was $34.1 million and no balance outstanding under these facilities at July 31, 2007 and 2006 respectively. The weighted average interest rate on these short-term borrowings outstanding at July 31, 2007 was 5.58 percent.

The Company also has a 100 million euro program for issuing treasury notes for raising short, medium and long-term financing for its European operations. There was 22.7 million euro, or $31.1 million, outstanding at July 31, 2007 and 35.3 million euro, or $45.0 million, outstanding as of July 31, 2006. The weighted average interest rate on these short-term issuances at July 31, 2007 and 2006 was 4.27 percent and 3.13 percent, respectively. Additionally, the Company s European operations have lines of credit in the amount of 100.1 million euro. As of July 31, 2007, there was 26.0 million euro, or $35.6 million, outstanding. As of July 31, 2006 there was 20.1 million euro, or $25.6 million outstanding. The weighted average interest rate of these short-term borrowings outstanding at July 31, 2007 and 2006 was 5.52 and 3.38 percent, respectively.

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Other international subsidiaries may borrow under various credit facilities. As of July 31, 2007 and 2006, borrowings under these facilities were $2.4 million and $2.6 million, respectively. The weighted average interest rate on these international borrowings outstanding at July 31, 2007 and 2006 was 3.90 percent and 7.92 percent, respectively.

Certain note agreements contain debt covenants related to working capital levels and limitations on indebtedness. As of July 31, 2007, the Company was in compliance with all such covenants.

Also, at July 31, 2007 and 2006, the Company had outstanding standby letters of credit totaling $16.5 million and $18.7 million, respectively, upon which no amounts had been drawn. The letters of credit guarantee payment to third parties in the event the Company is in breach of a specified bond financing agreement and insurance contract terms as detailed in each letter of credit.

Shareholders equity increased $77.9 million in 2007 to $624.7 million. The increase was due to current year earnings of $150.7 million, an increase in accumulated other comprehensive income of $18.8 million primarily resulting from increases due to foreign currency translation of $28.6 million partially offset by $10.2 million of adjustments related to the implementation of the Financial Accounting Standards Board s new pension statement. This statement requires recognition of the overfunded or underfunded status of defined benefit postretirement plans as an asset or liability in the statement of financial position and to recognize change in that funded status in accumulated other comprehensive income in the year in which the adoption occurs and in comprehensive income in the following years. There were also increases of $14.8 million of stock option and other stock activity offset by $76.9 million of treasury stock repurchases and $29.5 million of dividend declarations.

Cash Flows During fiscal 2007, $117.0 million of cash was generated from operating activities, compared with $156.7 million in 2006 and $142.6 million in 2005. Operating cash flows in 2007 decreased by $39.6 million from the prior year, primarily due to payments of $25.3 million to the Company s defined benefit plans and increases in accounts receivable of $31.4 million and inventories of $36.5 million. Accounts receivable increased 14.5 percent, slightly faster than the 13.3 percent increase in sales. Inventories increased due to a number of factors including expanded inventory levels to better serve our Customer needs as global distribution capacity is broadened, additional amounts of inventory in-transit due to higher international sales and the inclusion of inventory related to the Aerospace Filtration Systems acquisition. In addition to cash generated from operating activities, the Company increased its outstanding short-term debt by $44.9 million and net long-term debt by $55.4 million. Cash flow generated by operations and increased debt levels were used primarily to support $76.6 million of net capital expenditures, $76.9 million for stock repurchases, acquisitions and investments of $40.6 million and $28.8 million for dividend payments. Cash and cash equivalents increased $9.8 million during 2007.

Net capital expenditures for property, plant and equipment totaled $76.6 million in 2007, $77.6 million in 2006 and $50.2 million in 2005. Net capital expenditures is comprised of purchases of property, plant, and equipment of $77.4 million, $81.3 million, and $55.0 million in fiscal 2007, 2006 and 2005, respectively, partially offset by proceeds from the sale of property, plant, and equipment of $0.8 million, $3.7 million, and $4.8 million in fiscal 2007, 2006 and 2005, respectively. Fiscal 2007 capital expenditures primarily related to new distribution facilities and productivity enhancing investments at various plants worldwide.

Capital spending in 2008 is planned at $60.0 million to $70.0 million. Significant planned expenditures include the expansion of two current manufacturing facilities. It is anticipated that 2008 capital expenditures will be financed primarily by cash generated from operations and existing lines of credit.

The Company expects that cash generated by operating activities will exceed $150 million in 2008. At July 31, 2007, the Company had $55.2 million cash, $265.9 million available under existing credit facilities in the United States and 151.4 million euro, or $207.3 million, available under existing credit facilities in Europe. The Company believes that the combination of existing cash, available credit under existing credit facilities and the expected cash generated by operating activities will be adequate to meet cash requirements for fiscal 2008, including debt repayment, issuance of anticipated dividends, share repurchase activity and capital expenditures.

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Dividends The Company s dividend policy is to maintain a payout ratio, which allows dividends to increase with the long-term growth of earnings per share. The Company s dividend payout ratio target is 20.0 percent to 30.0 percent of the average earnings per share of the last three years. The current quarterly dividend of 0.10 cents per share equates to 25.8 percent of the average net earnings per share for 2005 through 2007.

Share Repurchase Plan In fiscal 2007, the Company repurchased 2.2 million shares of common stock for $76.9 million under the share repurchase plan authorized in March 2006 at an average price of $35.21 per share. The Company repurchased 3.8 million shares for $118.9 million in 2006. The Company repurchased 3.8 million shares for $116.3 million in 2005. As of July 31, 2007, the Company had remaining authorization to repurchase 4.0 million shares under this plan.

Off-Balance Sheet Arrangements The Company does not have any off-balance sheet arrangements, with the exception of the guarantee of 50 percent of certain debt of its joint venture, Advanced Filtration Systems, Inc. as further discussed in Note K of the Company s Notes to Consolidated Financial Statements. As of July 31, 2007, the joint venture had $3.5 million of outstanding debt. The Company does not believe that this guarantee will have a current or future effect on its financial condition, results of operation, liquidity or capital resources.

Environmental Matters The Company establishes reserves as appropriate for potential environmental liabilities and will continue to accrue reserves in appropriate amounts. While uncertainties exist with respect to the amounts and timing of the Company s ultimate environmental liabilities, management believes that such liabilities, individually and in the aggregate, will not have a material adverse effect on the Company s financial condition or results of operations.

New Accounting Standards In September 2006, the FASB issued SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132 (R)* (SFAS 158). This statement requires recognition of the overfunded or underfunded status of defined benefit postretirement plans as an asset or liability in the statement of financial position and to recognize changes in that funded status in accumulated other comprehensive income in the year in which the adoption occurs and in other comprehensive in the following years. SFAS 158 also requires measurement of the funded status of a plan as of the date of the statement of financial position. SFAS 158 was effective for recognition of the funded status of the benefit plans for the Company s fiscal year 2007 and resulted in a $10.2 million decrease in shareholders equity, net of tax. See further discussion in Note F of the Company s Notes to Consolidated Financial Statements on the impact of this change on the Company s consolidated financial statements. SFAS 158 s provisions regarding the change in the measurement date of postretirement benefits plans will require the Company to change its measurement date from April 30 to July 31 beginning with fiscal year 2009.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN 48). This pronouncement prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006 and will be effective for the Company with its 2008 fiscal year, commencing August 1, 2007. The Company is currently evaluating the effect of FIN 48 on its consolidated financial statements.

Market Risk

The Company s market risk includes the potential loss arising from adverse changes in foreign currency exchange rates and interest rates. The Company manages foreign currency market risk from time to time through the use of a variety of financial and derivative instruments. The Company does not enter into any of these instruments for trading purposes to generate revenue. Rather, the Company s objective in managing these risks is to reduce fluctuations in earnings and cash flows associated with changes in foreign currency exchange rates. The Company uses forward exchange contracts and other hedging activities to hedge the U.S. dollar value resulting from existing recognized foreign currency denominated asset and liability balances and also for anticipated foreign currency transactions. The

Company also naturally hedges foreign currency through its production in the countries in which it sells

its products. The Company s market risk on interest rates is the potential decrease in fair value of long-term debt resulting from a potential increase in interest rates. See further discussion of these market risks below.

Foreign Currency During 2007, the U.S. dollar was generally weaker throughout the year relative to the currencies of the foreign countries in which the Company operates. The overall weakness of the dollar had a positive impact on the Company s international net sales results because the foreign denominated revenues translated into more U.S. dollars.

It is not possible to determine the true impact of foreign currency translation changes; however, the direct effect on reported net sales and net earnings can be estimated. For the year ended July 31, 2007, the impact of foreign currency translation resulted in an overall increase in reported net sales of $47.2 million and an increase in reported net earnings of $5.1 million. Foreign currency translation had a positive impact in several regions around the world. In Europe, the weaker U.S. dollar relative to the euro and British pound sterling resulted in an increase of $42.9 million in reported net sales and an increase of $3.4 million in reported net earnings. In the Asia-Pacific region, the weaker U.S. dollar relative to the Thai bhat had a positive impact on foreign currency translation with a increase in reported net sales of $5.3 million and an increase in reported net earnings of $1.2 million, while the stronger U.S. dollar relative to the Japanese yen and South African rand had a negative impact on foreign currency translation with a decrease in reported net sales of $4.6 million and $4.1 million, respectively, and a decrease in reported net earnings of $0.3 million for both currencies.

The Company maintains significant assets and operations in Europe, Asia-Pacific, South Africa and Mexico, resulting in exposure to foreign currency gains and losses. A portion of the Company s foreign currency exposure is naturally hedged by incurring liabilities, including bank debt, denominated in the local currency in which the Company s foreign subsidiaries are located.

The foreign subsidiaries of the Company purchase products and parts in various currencies. As a result, the Company may be exposed to cost increases relative to local currencies in the markets to which it sells. To mitigate such adverse trends, the Company, from time to time, enters into forward exchange contracts and other hedging activities. Additionally, foreign currency positions are partially offsetting and are netted against one another to reduce exposure.

Some products made in the United States are sold abroad, primarily in Europe and Canada. As a result, sales of such products are affected by the value of the U.S. dollar relative to other currencies. Any long-term strengthening of the U.S. dollar could depress these sales. Also, competitive conditions in the Company s markets may limit its ability to increase product pricing in the face of adverse currency movements.

Interest The Company s exposure to market risks for changes in interest rates relates primarily to its short-term investments, short-term borrowings and interest rate swap agreements as well as the potential increase in fair value of long-term debt resulting from a potential decrease in interest rates. The Company has no earnings or cash flow exposure due to market risks on its long-term debt obligations as a result of the fixed-rate nature of the debt. However, interest rate changes would affect the fair market value of the debt. As of July 31, 2007, the estimated fair value of long-term debt with fixed interest rates was $154.4 million compared to its carrying value of $156.0 million. The fair value is estimated by discounting the projected cash flows using the rate that similar amounts of debt could currently be borrowed. As of July 31, 2007, our financial liabilities with exposure to changes in interest rates consisted mainly of $123.1 million of short-term debt outstanding. Assuming a hypothetical increase of one-half percent in short-term interest rates, with all other variables remaining constant, interest expense would have increased $0.7 million in fiscal 2007.

Critical Accounting Policies

The Company s consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the use of estimates, judgments and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and

expenses during the periods presented. Management bases these estimates on historical experience and various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the recorded values of certain assets and liabilities. The Company believes its use of estimates and underlying accounting assumptions adheres to generally accepted accounting principles and is consistently applied. Valuations based on estimates and underlying accounting assumptions are reviewed for reasonableness on a consistent basis throughout the Company. Management believes the Company s critical accounting policies that require more significant judgments and estimates used in the preparation of its consolidated financial statements and that are the most important to aid in fully understanding its financial results are the following:

Revenue recognition and allowance for doubtful accounts Revenue is recognized when product ownership and the risk of loss has transferred to the Customer and the Company has no remaining obligations. The Company records estimated discounts and rebates as a reduction of sales in the same period revenue is recognized. Allowances for doubtful accounts are estimated by management based on evaluation of potential losses related to Customer receivable balances. The allowance for doubtful accounts is the Company s best estimate of the amount of probable credit losses in its existing accounts receivable. The Company determines the allowance based on historical write-off experience in the industry, regional economic data and evaluation of specific Customer accounts for risk of loss. The Company reviews its allowance for doubtful accounts monthly. Past due balances over 90 days and over a specified amount are reviewed individually for collectibility. All other balances are reviewed on a pooled basis by type of receivable. Account balances are charged off against the allowance when the Company feels it is probable the receivable will not be recovered. The Company does not have any off-balance-sheet credit exposure related to its Customers. The establishment of this reserve requires the use of judgment and assumptions regarding the potential for losses on receivable balances. Though management considers these balances adequate and proper, changes in economic conditions in specific markets in which the Company operates could have an effect on reserve balances required.

Goodwill and other intangible assets Goodwill is tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. The Company performs impairment reviews for its reporting units and uses a discounted cash flow model based on management s judgments and assumptions to determine the estimated fair value. An impairment loss generally would be recognized when the carrying amount of the reporting unit s net assets exceeds the estimated fair value of the reporting unit. The Company performed an impairment test during the third quarter of fiscal 2007 to satisfy its annual impairment requirement. Impairment testing in the third quarter indicated that the estimated fair value of each reporting unit exceeded its corresponding carrying amount, including recorded goodwill and, as such, no impairment existed at that time. Other intangible assets with definite lives continue to be amortized over their estimated useful lives. Definite lived intangible assets are also subject to impairment testing. A considerable amount of management judgment and assumptions are required in performing the impairment tests, principally in determining the fair value of each reporting unit. While the Company believes its judgments and assumptions are reasonable, different assumptions could change the estimated fair values and, therefore, impairment charges could be required.

Inventory The Company s inventories are valued at the lower of cost or market. Domestic inventories are valued using the last-in first-out (LIFO) method, while the international subsidiaries use the first-in, first-out (FIFO) method. Reserves for shrink and obsolescence are estimated using standard quantitative measures based on historical losses, including issues related to specific inventory items. Though management considers these balances adequate and proper, changes in economic conditions in specific markets in which the Company operates could have an effect on reserve balances required.

Product warranty The Company estimates warranty costs using standard quantitative measures based on historical warranty claim experience and, in some cases, evaluating specific Customer warranty issues. The establishment of reserves requires the use of judgment and assumptions regarding the potential for losses relating to warranty issues. Though management considers these balances adequate and proper, changes in the future could impact these determinations.

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Income taxes As part of the process of preparing the Company s Consolidated Financial Statements, management is required to estimate income taxes in each of the jurisdictions in which the Company operates. This process involves estimating actual current tax exposure together with assessing temporary differences resulting from differing treatment of items for tax and book accounting purposes. These differences result in deferred tax assets and liabilities, which are included within the Company s Consolidated Balance Sheet. These assets and liabilities are evaluated by using estimates of future taxable income streams and the impact of tax planning strategies. Management assesses the likelihood that deferred tax assets will be recovered from future taxable income and to the extent management believes that recovery is not likely, a valuation allowance is established. To the extent that a valuation allowance is established or increased, an expense within the tax provision is included in the statement of operations. Reserves are also estimated for uncertain tax positions that are currently unresolved. The Company routinely monitors the potential impact of such situations and believes that it is properly reserved. Valuations related to tax accruals and assets can be impacted by changes to tax codes, changes in statutory tax rates and the Company s future taxable income levels.

Our accounting for income taxes in 2008 will be affected by the adoption of Financial Accounting Standards Board (FASB) Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes,* which we are required to adopt on August 1, 2007. This pronouncement prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. As such, the new standard requires us to reassess all of our uncertain tax return positions in accordance with this new accounting principle.

Employee Benefit Plans The Company incurs expenses relating to employee benefits such as non-contributory defined benefit pension plans and postretirement health care benefits. In accounting for these employment costs, management must make a variety of assumptions and estimates including mortality rates, discount rates, overall Company compensation increases, expected return on plan assets and health care cost trend rates. The Company considers historical data as well as current facts and circumstances and uses a third-party specialist to assist management in determining these estimates.

To develop the assumption regarding the expected long-term rate of return on assets for its U.S. pension plans, the Company considered the historical returns and the future expectations for returns for each asset class, as well as the target asset allocation of the pension portfolio. The Company amended its target asset allocation strategy during fiscal 2007 after its April 30 measurement date. Prior to amending the target asset allocations, the Company s guidelines called for an asset allocation of 55 percent equity securities, 30 percent alternative investments (funds of hedge funds), 10 percent fixed income, and 5 percent private equity. Within equity securities, the Company targeted an allocation of 25 percent small cap, 15 percent large cap, and 15 percent international. For fiscal year 2008, the Company s asset allocation guidelines will target an allocation of 45 percent equity securities, 30 percent alternative investments (fund of hedge funds), 10 percent real assets (investments into funds containing commodities and real estate), 10 percent fixed income and 5 percent private equity. Within equity securities, the Company will target an allocation of 15 percent international, 15 percent equity long / short, 10 percent small cap, and 5 percent large cap. Subsequent to the April 30, 2007 measurement date, the assets of the plans were reallocated to conform to the new asset guidelines established by the Company.

A one percent change in the expected long-term rate of return on plan assets would have changed the 2007 annual pension expense by approximately $2.3 million. The expected long-term rate of return on assets assumption for the plans outside the U.S. follows the same methodology as described above but reflects the investment allocation and expected total portfolio returns specific to each plan and country.

The Company s objective in selecting a discount rate for its pension plans is to select the best estimate of the rate at which the benefit obligations could be effectively settled on the measurement date taking into account the nature and duration of the benefit obligations of the plan. In making this best estimate, the Company looks at rates of return on high-quality fixed-income investments currently available and expected to be available during the period to maturity of the benefits. This process includes looking at the universe of bonds available on the measurement date with a quality rating of Aa or better. Similar appropriate benchmarks are used to determine the discount rate for the non-U.S. plans. As of our measurement date of April 30, 2007, the Company decreased its discount rate on U.S. plans to

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6.00 percent from 6.25 percent as of April 30, 2006. The decrease of 25 basis points was consistent with the changes in published bond indices. The change increased the Company s U.S. projected benefit obligation as of April 30, 2007 by approximately $5.5 million and is expected to increase pension expense in fiscal year 2008 by approximately $0.3 million.

At April 30, 2007, the Company s annual measurement date for its pension plans, the plans were over-funded by $64.9 million since the fair value of plan assets exceeded the projected benefit obligation. As of April 30, 2007, the Company had an unrecognized actuarial loss of $7.3 million which will be amortized as pension expense into the future over the average remaining service period of the employees in the plans in accordance with SFAS 87 and SFAS 158.

Forward-Looking Statements

The Company, through its management, may make forward-looking statements reflecting the Company s current views with respect to future events and financial performance. These forward-looking statements, which may be included in reports filed under the Securities Exchange Act of 1934, as amended (the Exchange Act), in press releases and in other documents and materials as well as in written or oral statements made by or on behalf of the Company, are subject to certain risks and uncertainties, including those discussed in Item 1A of this Form 10-K, which could cause actual results to differ materially from historical results or those anticipated. The words or phrases will likely result, are expected to, will continue, estimate, project, believe, expect, anticipate, forecast and similar expressions to identify forward-looking statements within the meaning of Section 21e of the Exchange Act and Section 27A of the Securities Act of 1933, as amended, as enacted by the Private Securities Litigation Reform Act of 1995 (PSLRA). In particular the Company desires to take advantage of the protections of the PSLRA in connection with the forward-looking statements made in this annual report on Form 10-K.

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date such statements are made. In addition, the Company wishes to advise readers that the factors listed in Item 1A of this Form 10-K, as well as other factors, could affect the Company s performance and could cause the Company s actual results for future periods to differ materially from any opinions or statements expressed. The Company undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk disclosure appears in Management s Discussion and Analysis on page 18 under Market Risk.

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Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Management s Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company. Management conducted an evaluation of the effectiveness of internal control over financial reporting based on the framework in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this evaluation, management concluded that the Company s internal control over financial reporting was effective as of July 31, 2007.

William M. Cook	Thomas R. VerHage
Chief Executive Officer	Chief Financial Officer
September 28, 2007	September 28, 2007

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Report of Independent Registered Public Accounting Firm

To Shareholders and Board of Directors of Donaldson Company, Inc.

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of earnings, of cash flows and of changes in shareholders equity present fairly, in all material respects, the financial position of Donaldson Company, Inc. and its subsidiaries at July 31, 2007 and 2006, and the results of their operations and their cash flows for each of the three years in the period ended July 31, 2007 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of July 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control Over Financial Reporting. Our responsibility is to express opinions on these financial statements, on the financial statement schedule, and on the Company s internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note A to the consolidated financial statements, the Company changed the manner in which it accounts for defined benefit arrangements effective July 31, 2007 and changed its method of accounting for share-based payments as of August 1, 2005.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP
Minneapolis, Minnesota

September 28, 2007

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Consolidated Statements of Earnings
Donaldson Company, Inc. and Subsidiaries

	Year ended July 31,		
	2007	**2006**	**2005**
	(thousands of dollars, except share and per share amounts)		
Net sales	$ 1,918,828	$ 1,694,327	$ 1,595,733
Cost of sales	1,313,964	1,137,747	1,090,158
Gross margin	604,864	556,580	505,575
Selling, general and administrative	357,306	329,905	316,851
Research and development	36,458	33,887	32,234
Operating income	211,100	192,788	156,490
Interest expense	14,559	9,875	9,414
Other income, net	(8,320)	(6,254)	(7,657)
Earnings before income taxes	204,861	189,167	154,733
Income taxes	54,144	56,860	44,179
Net earnings	$ 150,717	$ 132,307	$ 110,554
Weighted average shares basic	80,454,861	82,992,475	84,990,739
Weighted average shares diluted	82,435,756	85,139,250	86,883,408
Net earnings per share basic	$ 1.87	$ 1.59	$ 1.30
Net earnings per share diluted	$ 1.83	$ 1.55	$ 1.27

The accompanying notes are an integral part of these Consolidated Financial Statements.

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Consolidated Balance Sheets
Donaldson Company, Inc. and Subsidiaries

	At July 31, 2007	At July 31, 2006
	(thousands of dollars, except share amounts)	
Assets		
Current assets		
Cash and cash equivalents	$ 55,237	$ 45,467
Accounts receivable, less allowance of $6,768 and $8,398	357,341	312,214
Inventories	201,221	153,165
Deferred income taxes	22,591	17,407
Prepaids and other current assets	37,254	33,152
Total current assets	673,644	561,405
Property, plant and equipment, net	364,433	317,364
Goodwill	124,607	110,609
Intangible assets	46,301	22,129
Other assets	110,032	112,560
Total assets	$ 1,319,017	$ 1,124,067
Liabilities and shareholders equity		
Current liabilities		
Short-term borrowings	$ 123,114	$ 73,368
Current maturities of long-term debt	33,667	6,541
Trade accounts payable	173,862	163,783
Accrued employee compensation and related taxes	55,578	49,129
Accrued liabilities	44,692	42,969
Other current liabilities	28,031	24,079
Total current liabilities	458,944	359,869
Long-term debt	129,004	100,495
Deferred income taxes	37,624	40,890
Other long-term liabilities	68,747	76,011
Total liabilities	694,319	577,265
Commitments and contingencies (Note K)		
Shareholders equity		
Preferred stock, $1.00 par value, 1,000,000 shares authorized, none issued		
Common stock, $5.00 par value, 120,000,000 shares authorized, 88,643,194 shares issued in 2007 and 2006	443,216	443,216
Retained earnings	387,257	275,598
Stock compensation plans	20,821	20,535
Accumulated other comprehensive income	70,008	51,194
Treasury stock 9,500,372 and 8,102,921 shares in 2007 and 2006, at cost	(296,604)	(243,741)
Total shareholders equity	624,698	546,802

	At July 31,	
Total liabilities and shareholders equity	$ 1,319,017	$ 1,124,067

The accompanying notes are an integral part of these Consolidated Financial Statements.

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Consolidated Statements of Cash Flows
Donaldson Company, Inc. and Subsidiaries

	Year ended July 31,		
	2007	2006	2005
	(thousands of dollars)		
Operating Activities			
Net earnings	$ 150,717	$ 132,307	$ 110,554
Adjustments to reconcile net earnings to net cash provided by operating activities			
Depreciation and amortization	49,566	44,700	44,284
Equity in (earnings) loss of affiliates	(691)	(664)	323
Deferred income taxes	(4,628)	6,868	2,957
Tax benefit of equity plans	(5,898)	(10,943)	
Stock option expense	3,422	2,832	
Other, net	(13,241)	(13,551)	2,520
Changes in operating assets and liabilities, net of acquired businesses			
Accounts receivable	(31,418)	(12,147)	(17,349)
Inventories	(36,469)	587	(6,745)
Prepaids and other current assets	841	(5,794)	2,087
Trade accounts payable and other accrued expenses	4,844	26,649	3,957
Payment of litigation judgment		(14,170)	
Net cash provided by operating activities	117,045	156,674	142,588
Investing Activities			
Purchases of property, plant and equipment	(77,440)	(81,272)	(54,979)
Proceeds from sale of property, plant, and equipment	857	3,688	4,781
Acquisitions, investments, and divestitures of affiliates	(40,615)	(4,560)	(13,362)
Net cash used in investing activities	(117,198)	(82,144)	(63,560)
Financing Activities			
Proceeds from long-term debt	64,903	4,400	30,000
Repayments of long-term debt	(9,507)	(7,613)	(23,944)
Change in short-term borrowings	44,904	(31,650)	81,917

	Year ended July 31,		
Purchase of treasury stock	(76,898)	(118,909)	(116,268)
Dividends paid	(28,806)	(26,443)	(19,757)
Tax benefit of equity plans	5,898	10,943	
Exercise of stock options	7,346	4,774	2,703
Net cash used in financing activities	7,840	(164,498)	(45,349)
Effect of exchange rate changes on cash	2,083	1,369	883
Increase (decrease) in cash and cash equivalents	9,770	(88,599)	34,562
Cash and cash equivalents, beginning of year	45,467	134,066	99,504
Cash and cash equivalents, end of year	$ 55,237	$ 45,467	$ 134,066
Supplemental Cash Flow Information			
Cash paid during the year for:			
Income taxes	$ 59,179	$ 36,145	$ 33,087
Interest	12,630	9,287	8,453

The accompanying notes are an integral part of these Consolidated Financial Statements.

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Consolidated Statements of Changes in Shareholders Equity
Donaldson Company, Inc. and Subsidiaries

	Common Stock	**Additional Paid-in Capital**	**Retained Earnings**	**Stock Compensation Plans**	**Accumulated Other Comprehensive Income (Loss)**	**Treasury Stock**	**Total**
	(thousands of dollars, except per share amounts)						
Balance July 31, 2004	$ 443,216	$	$ 113,271	$ 20,589	$ 31,558	$ (59,341)	$ 549,293
Comprehensive income							
Net earnings			110,554				110,554
Foreign currency translation					1,877		1,877
Additional minimum pension liability, net of tax					(5,499)		(5,499)
Net loss on cash flow hedging derivatives					(316)		(316)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Stock Compensation Plans	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
Comprehensive income							106,616
Treasury stock acquired						(116,268)	(116,268)
Stock options exercised		(7,273)	(30,080)	9,310		14,992	(13,051)
Deferred stock and other activity			(1,207)	10,675		428	9,896
Performance awards			(6)			620	614
Tax reduction employee plans		7,273					7,273
Dividends ($.235 per share)			(19,757)				(19,757)
Balance July 31, 2005	443,216		172,775	40,574	27,620	(159,569)	524,616
Comprehensive income							
Net earnings			132,307				132,307
Foreign currency translation					15,287		15,287
Additional minimum pension liability, net of tax					8,438		8,438
Net loss on cash flow hedging derivatives					(151)		(151)
Comprehensive income							155,881
Treasury stock acquired						(118,909)	(118,909)
Stock options exercised		(22,381)	12,358			11,934	1,911
Deferred stock and other activity			(11,310)	(17,291)		20,893	(7,708)
Performance awards			320	(2,748)		1,910	(518)
Stock option expense			2,832				2,832
Tax reduction employee plans		22,381					22,381
Dividends ($.410 per share)			(33,684)				(33,684)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Stock Compensation Plans	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
Balance July 31, 2006	443,216		275,598	20,535	51,194	(243,741)	546,802
Comprehensive income							
Net earnings			150,717				150,717
Foreign currency translation					28,615		28,615
Additional minimum pension liability, net of tax					312		312
Net gain on cash flow hedging derivatives					118		118
Comprehensive income							179,762
Treasury stock acquired						(76,898)	(76,898)
Stock options exercised		(7,700)	(9,499)	1,513		19,133	3,447
Deferred stock and other activity			(2,273)	541		3,276	1,544
Performance awards			(1,163)	(1,768)		1,626	(1,305)
Stock option expense			3,422				3,422
Tax reduction employee plans		7,700					7,700
Adjustment to adopt SFAS 158, net of tax					(10,231)		(10,231)
Dividends ($.370 per share)			(29,545)				(29,545)
Balance July 31, 2007	$ 443,216	$	$ 387,257	$ 20,821	$ 70,008	$ (296,604)	$ 624,698

The accompanying notes are an integral part of these Consolidated Financial Statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Donaldson Company, Inc. and Subsidiaries

NOTE A
Summary of Significant Accounting Policies

Description of Business Donaldson Company, Inc. (Donaldson or the Company), is a leading worldwide provider of filtration systems and replacement parts. The Company s product mix includes air and liquid filters and exhaust and emission control products for mobile equipment; in-plant air cleaning systems; compressed air purification systems; air intake systems for industrial gas turbines and specialized filters and membranes for such diverse applications as computer disk drives, industrial bags and semi-conductor processing. Products are manufactured at more than 35 plants around the world and through three joint ventures. Products are sold to original equipment manufacturers (OEM), distributors and dealers, and directly to end users.

Principles of Consolidation The Consolidated Financial Statements include the accounts of Donaldson Company, Inc. and all majority-owned subsidiaries. All intercompany accounts and transactions have been eliminated. The Company s three joint ventures that are not majority-owned are accounted for under the equity method. The Company does not have any variable interests in variable interest entities as of July 31, 2007. The company uses a fiscal period which ends on a calendar basis for international affiliates and on the Friday nearest to July 31 for domestic purposes. Fiscal year 2007 results included 53 weeks of domestic sales and earnings.

Use of Estimates The preparation of Financial Statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Foreign Currency Translation For most foreign operations, local currencies are considered the functional currency. Assets and liabilities are translated to U.S. dollars at year-end exchange rates, and the resulting gains and losses arising from the translation of net assets located outside the United States are recorded as a cumulative translation adjustment, a component of accumulated other comprehensive income in the Consolidated Balance Sheets. Elements of the Consolidated Statements of Earnings are translated at average exchange rates in effect during the year. Realized and unrealized foreign currency transaction gains and losses are included in income, net in the Consolidated Statements of Earnings. Foreign currency transaction gains of $0.2 million, $0.3 million, and $1.0 million are included in other income, net in the Consolidated Statements of Earnings in 2007, 2006 and 2005, respectively.

Cash Equivalents The Company considers all highly liquid temporary investments with a maturity of three months or less when purchased to be cash equivalents. Cash equivalents are carried at cost that approximates market value.

Accounts Receivable and Allowance for Doubtful Accounts Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is the Company s best estimate of the amount of probable credit losses in its existing accounts receivable. The Company determines the allowance based on historical write-off experience in the industry, regional economic data and evaluation of specific Customer accounts for risk of loss. The Company reviews its allowance for doubtful accounts monthly. Past due balances over 90 days and over a specified amount are reviewed individually for collectibility. All other balances are reviewed on a pooled basis by type of receivable. Account balances are charged off against the allowance when the Company feels it is probable the receivable will not be recovered. The Company does not have any off-balance-sheet credit exposure related to its Customers.

Inventories Inventories are stated at the lower of cost or market. Domestic inventories are valued using the last-in, first-out (LIFO) method, while the international subsidiaries use the first-in, first-out (FIFO) method. Inventories valued at LIFO were approximately 30 and 34 percent of total inventories at July 31, 2007 and 2006, respectively. For inventories valued under the LIFO method, the FIFO cost exceeded the LIFO carrying values by $32.7 million and $31.7 million at July 31, 2007 and 2006,

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respectively. Results of operations for all periods presented were not materially affected by any liquidation of LIFO inventory. The components of inventory are as follows (thousands of dollars):

	July 31, 2007	July 31, 2006
Materials	$ 87,490	$ 56,194
Work in process	19,793	20,304
Finished products	93,938	76,667
Total inventories	$ 201,221	$ 153,165

Property, Plant and Equipment Property, plant and equipment are stated at cost. Additions, improvements or major renewals are capitalized, while expenditures that do not enhance or extend the asset s useful life are charged to operating expense as incurred. Depreciation is computed under the straight-line method. Depreciation expense was $46.6 million in 2007, $42.6 million in 2006, and $42.6 million in 2005. The estimated useful lives of property, plant and equipment are 10 to 40 years for buildings and 3 to 10 years for machinery and equipment. The components of property, plant and equipment are as follows (thousands of dollars):

	July 31, 2007	July 31, 2006
Land	$ 19,946	$ 18,336
Buildings	215,407	182,969
Machinery and equipment	525,958	473,483
Construction in progress	35,053	33,246
Less accumulated depreciation	(431,931)	(390,670)
Total property, plant and equipment	$ 364,433	$ 317,364

Internal-Use Software The Company capitalizes direct costs of materials and services used in the development and purchase of inter